Small business in path of COVID-19 tsunami

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Each financial crisis has its own set of circumstances, requiring central banks and federal governments to be nimble, open-minded, and creative in their responses. In this crisis, small- and medium-sized businesses are the most vulnerable sectors of the economy. They need strong support. Policymakers must follow a different playbook from earlier financial crises. The measures taken in 2008, for example, will not work or will be vastly insufficient.

Earlier crises offer meagre guidance

Central banks — in the past, a major source of liquidity to the capital markets — face very real limitations in how much they can do given today’s extremely low interest rates. Instead, we must look for much-needed help from other sources, such as government support for bridging loans, to address the serious challenges markets and economies are dealing with today. Unfortunately, earlier financial crises offer scant guidance on how to cope with the current crisis because few similarities exist between then and now.

The GFC that began in 2007, and worsened in 2008, resulted from a series of financial events exacerbated by overleveraged, high-risk banks. The target of mitigation, therefore, was to bail out the banks.

Since the GFC, banks’ balance sheets have improved substantially, and regulators have imposed stress testing to ensure they stay that way. The banks were the most vulnerable part of the economy in 2008, but the most vulnerable element today is small- and medium-sized businesses that are integral to global supply chains.

This crisis is also very different from the GFC when the US Federal Reserve’s target interest rate was 5.25% before the first rate cut in September 2007. Contrast that to a target rate of 1.5% earlier this month. That’s a big gap in how much ammunition the Fed had to work with.

Similarly, the Reserve Bank of Australia has little room to slash rates as it has already reached the lowest cash rate in the nation’s history.

We can also look to 9/11, an event that sparked a crisis of confidence and much uncertainty. Likely the closest comparable to the current crisis, it nevertheless provides little guidance for the path forward today because the market was in a drawdown when crisis struck. The current crisis began when the market was at an all-time high.

The trigger of our current crisis is biological rather than financial. Comparable historical health-related crises are the 1918 Spanish flu pandemic and the 2003 SARS epidemic. The first comparison is problematic. Indeed, although many more people died from the flu than died from combat in World War I, the equity markets actually did quite well because the war was over and people believed the economy would be strong. The markets benefited from the peace dividend.

The 2003 SARS crisis resembles in many ways the unknowns surrounding the COVID-19 crisis. Yet, in 2003 the equity markets rose, much like in 1918–19. How is that possible? The answer is that the starting points of the market differed. In 2003, the S&P 500 Index was in drawdown, having lost over 40% of its value after the tech bubble burst at the beginning of the decade. The market was already cheap.

In 2020, however, the equity market was quite expensive, at an all-time high with historically high valuations, when the downturn began. That is why we are seeing an unusually steep decline (https://www.researchaffiliates.com/en_us/publications/video/794-the-economic-impact-of-covid-19-part-iii.html) and high volatility as the market revalues itself.

A different playbook

Policymakers must ensure (not just hope) that banks do not choke off the flow of credit to households and businesses, especially small businesses. We don’t want to repeat the mistake of the GFC when large corporations got first priority and small- and medium-sized businesses were relegated to the back of the queue.
This crisis impacts everybody, unlike the GFC. Therefore, we need to focus on making sure the supply chains are maintained and supported. As consumers, we know the final seller or major producer of a good, but are much less familiar with the critical smaller businesses that supply the parts of that good.

Small- and medium-sized businesses are a very important part of our economy. They are responsible for 49% of employment in the United States and 44% in Australia. More importantly, 64% of US employment growth comes from small- or medium-sized businesses. In Australia, this figure is 57%. Not adequately meeting the cash-flow needs of small businesses will make the almost inevitable recession more painful and delay the recovery.

Many companies were very successful when this exogenous event, the COVID-19 pandemic, struck swiftly like a natural disaster and put them at risk. Extraordinary steps are necessary. To let high-quality businesses fail would be a serious mistake. If these firms, many of which are integral to the supply chain, go under, there will be a painful spike in unemployment.

Of course, banks will be stressed, perhaps beyond the stress tests they have all passed, but the focus should not be on the banks. The focus should be making sure that the banks make at least an equal amount of lending available for both small and large businesses. Policymakers should insist on this.

Guarantees to keep the Commercial Paper (CP) market open offers no direct benefits for small businesses because they don’t issue it. There is an indirect benefit, however, in that to the extent large businesses can find funding through the CP market, banks have more to lend to smaller businesses.

Looking ahead

The turning point in this particular crisis will be when the number of new COVID-19 cases starts to decrease. This will be very clear and hopefully happens fairly quickly. This contrasts with the GFC, which was a very long recession. In real-time during the GFC, we were not sure how serious the situation was, maybe a problem with a few banks or maybe more. Then it became a slow-moving train wreck. It just got worse and worse and worse.

The current crisis appears to have a timeline. We can observe other countries’ experiences, so we can actually see our future. A good comparison is South Korea, which indicates maximum pain may be short-lived. The real question is, can we mitigate the damage to the economy so that we can snap back with a V-shaped recovery rather than a U-shaped or, even worse, an L-shaped growth path? It is incumbent upon our policymakers to make sure we are in the best possible shape in terms of our economic recovery.

And, of course, all of this is secondary to the issue of health.

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