An Imperative for Support Measures - Abundant Liquidity to Accompany Payment Discipline

By Kori Udovički, orig. 29/03/2020, rev. 01/04/2020

The pandemic struck us just at the very moment when the payment discipline in Serbia begun significantly to improve. The measures to strengthen financial discipline in the private sector adopted in 2016 and the reduction in government arrears in the context of the fiscal consolidation, significantly reduced the chains of illiquidity in the system. Of course, no one could expect the pandemic, and it will inevitably cost us. But if the payment discipline is now loosened, the pandemic will cost us much more. Clearly, those who cannot access liquidity will simply not be able to pay. It is the Government's responsibility to make sure there are as few of those as possible. In this, it must start from itself.

If the Government wants to mitigate the economic downturn during a pandemic and ensure its rapid recovery once the pandemic is over - a key task is to accompany intervention measures with safeguarding payment discipline. I start by assuming that it is clear to the reader how important this discipline is to economic growth. In short: non-payment creates a chain of illiquidity, which then creates problems for everybody. The first debtor affects his partners, suppliers, and employees, who in turn pull those, now many, into the third line of iterations, and so on. In this way, illiquidity snowballs through the system, further affecting everyone - even those whose business otherwise would not have been affected by pandemic at all. Its worse aspect is that it tends to spread distrust, discouraging new business ventures, and this carries over into the post-crisis period. Simply, economic activity is stifled over the longer term.

Payment discipline is actually one of the pillars of financial discipline. We understand financial discipline as "you incur only those costs that you can afford to pay". We mostly interpret this as having to plan one's budget carefully – which is, certainly, its first pillar. However, the discipline of realistic planning does not make sense unless it is accompanied by payment discipline. Once a cost has been incurred –it *must* be paid for. Even if it requires borrowing to pay. Not even the best plans can predict everything. Liquidity needs to be available/accessible if prompt payment is to always be possible. So, access to liquidity can be considered the third pillar of financial discipline. These three pillars reinforce one another. We will really take care to plan realistically only if we know with certainty that we will have to pay. Only if we plan realistically, will we be creditworthy when we need to access liquidity when unexpected problems do happen. And, finally, only if we have access to liquidity, will we be able to act upon that creditworthiness, that is--to borrow and to pay.

Financial discipline is a matter of political will and upgrading of the financial management system. In the distant past, we planned unrealistically and borrowed without much consideration. In the end, we paid for it through inflation. In the 1990s we had both hyperinflation and non-payment. Since the 2000s, we have started to plan somewhat more realistically, but not sufficiently. Therefore, we continued to fall back on non-payment, the so-called arrears. The unpaid expenditures from this year burden next year's budget and hence leave less space for next year's spending. However, this means that instead of the financial market, the difference is financed by businesses and citizens. The key at this point is to understand how harmful is the non-payment culture, and to tackle it. The Government needs to dare to look for liquidity in the market to cover the difference between expenditures and revenues, even unexpected ones. For financial discipline to be maintained despite more flexible borrowing in the market, Serbia needs to use more decisively and honestly its financial management instruments: primarily budget planning and oversight, which have been built over the past two decades.

Controlling the level of spending by limiting payments, in a time when the state needs to stimulate economic activity by increasing the deficit, is like stepping on the gas of a car while pulling the parking brake. It is this odd combination of actions that explains why in 2010-13 large fiscal deficits did not contribute more to growth. By the same token, a combination only in opposite directions explains how the recent sharp fiscal consolidation of 2015-2017 was not accompanied by such a larger contraction in economic growth: the tightening of the fiscal belt was accompanied by a reduction in public sector arrears giving the economy a substantial liquidity relief. It would be inexcusable if we fall into using the same wrong combination of instruments again. We need a *true* fiscal stimulus: a fiscal deficit, ie. overall public spending, paid for by adequate liquidity.

The price of the fiscal package, as well as its allocation, will be less important than the need that it be accompanied by a clear intention to maintain a sound financial discipline and the measures to do so. This should by no means be taken as a call to abandon reasonable budget planning. The state must weigh a very significant, but feasible package of support to the economy and citizens. In this greatly uncertain context, it is likely to err, but it should err on the side of looseness rather than tightness. We are witnessing "the mother" of unimaginable, unexpected events. Responsible planning, the first pillar of financial discipline will be observed if the plans are as realistic as possible, and then are revised as frequently as needed. The government, businesses, and citizens should certainly expect to produce much less this year, and therefore to be able to consume much less.

If paid in liquidity, excessive spending will be punished by inflation, which then needs to be quickly corrected. However, in its early stages of acceleration inflation would get as much production rescued as possible. Some increase in inflation should be expected and allowed, (this is a supply contraction crisis). However, if inflation starts accelerating, beyond 5-7%, then it could and should be arrested with corrective measures—tightening of *spending*, not by running arrears. Loosening of financial discipline overall, would, of course, mean repeating the biggest mistake of the past. If accompanied by excessive liquidity, it would lead to hyper-inflation. If, as is more likely, accompanied by insufficient liquidity and non-payment it would drag us into a "swamp" of unfulfilled obligations, general illiquidity and insolvency as well as distrust, putting a break on the eventual recovery for the fourth time in three decades. This, clearly, would depress economic activity for a long time to come.

Focus on Payment Discipline

In order to support payment discipline throughout the system, the government must show commitment, set an example, and pay off all its outstanding obligations. These are still substantial. Until recently, the state was the key ingredient in the lack of payment discipline in Serbia. On the one hand, as by far the largest single buyer in the market (procurement of goods and services by the public sector amounts to about 20% of GDP), its non-payments were, and may still be, the first and the biggest link in chains of non-payment. On the other hand, it is the Government that, through its example and actions, sets the culture of (non) payment. It sets the culture by taking on (un)realistic obligations and then (not)paying them, as well as systematically enforcing discipline in the private sector. This applies to both obligations that the Government assumes itself, and to those it obliges others to enter. Say, for example, that the Government requires the corporate sector not to lay off employees. As we all know that many companies will not be able to pay them, if the Government would not provide the means for them to do it, then we would all know from the outset that the Government is counting with arrears. The culture of non-payment would start to spread.

Maintaining a steady flow of money into the economic system will require the state to cover the difference between planned and realized resources through borrowing on the financial markets (in these circumstances, ultimately, with the central bank "printing money"), and not as was the case so far, by running arrears. Only thus will it extinguish the fire of illiquidity instead of stoking it with non-payment. On the one hand, the deficit needs to be maintained at the desired level by strengthening budget discipline, i.e. through more realistic budget planning (and by revising plans when developments go in an unexpected direction). On the other hand, payments and / or injection of liquidity into the system must go smoothly. The "music has to keep going" while the government has to keep paying promptly for it.

Realistic budgeting requires a systematic, not just political, disciplining of the public sector. Politicians at the helm of the state, like all of their appointees as well as civil servants, should *believe* that they are to budget realistically and that their expenditures will be paid promptly. This requires the introduction of genuine professional *ex-ante* control of public budgets that will check the reality of planning. At first, politicians might think that they are at a loss because their discretionary influence on spending would be curtailed. However, they would soon discover that they can still steer spending through policies, while earning many points for successfully managing the crisis.

As far as the private sector is concerned, the discipline of payment suffices to enforce financial discipline. Until the culture is changed, payment discipline must be imposed, but it also has to be feasible. On the one hand, the prospect of enforced collection or bankruptcy, if credible, will force everyone to plan costs realistically and to pay for them. On the other hand, in situations just like the current one, the private sector needs to have access to enough liquidity to pay even when their plans will obviously have been missed.

Availability of Liquidity

Securing enough liquidity, the third pillar of financial discipline, in general is the responsibility of the central bank. In these circumstances, it will also require that NBS's measures be strongly supported by the Government.

The NBS has already taken adequate earliest measures to ease the immediate pressure of debt servicing on the economy and citizens. As a first measure, a moratorium on debt payments was introduced. This has put pressure on banks' liquidity that the NBS has eased using favorable monetary and foreign exchange operations. Subsequent measures should contribute to the activation of the financial sector in support of the economy, especially the most affected ones. The problems are twofold in a crisis situation like the current. First, banks will need stronger incentives, as well as guarantees, to dare to issue new loans to most of their clients. It should be expected that tomorrow's package of measures lends support to short-term lending, with low, zero or even negative interest rates. Negative interest is a subsidy to a bank and / or even a business entity. In this case, it is not only about providing liquidity but also about financial assistance to the borrower. The package is likely to also include significant government guarantees for loans issued by banks during the crisis, especially to the hardest hit sectors.

However, the second problem is that **the above classic package of measures, aimed at enhancing liquidity through the financial system will not be enough for Serbia because its financial sector does not reach far or deep enough**. The financial markets are so-called "shallow"-reflected in the low ratio of total domestic credit to GDP. While in countries with developed financial markets it is common for it to be 90-140% of GDP, in Serbia it is around 50%. In the more advanced transition countries. it is generally above 70-75%. This means, on the one hand, that our businesses rely heavily on own-resources and would not be hit as quickly by the bank credit crunch as those in more financialized countries. However, for the same reasons, our economy's ability to recover from the crisis will depend on these funds not being exhausted. A particular issue is that most businesses are farmers and SMEs. SMEs generate about 27% and farmers about 6% of GDP. About half of SMEs do not borrow from banks, and the majority of those who borrow do so rarely. Under these conditions, banks will not know them well enough to take the risk or lending now. To make the problem worse, banks require guarantees in personal property from small businesses. How many will be willing to risk their property? And how fair is it to require it under these circumstances?

Matters are made worse by the fact that Serbia does not have an extensive network of special institutions dedicated to supporting and financing SMEs, like other countries do. For example, Germany’s package of measures envisages that significant amounts of liquidity assistance (€ 750 billion) are pumped through separate networks—the regular financial system and the network of support institutions for SMEs.

The state should help the NBS with its own actions as well. **It would be a good idea to expedite the payment of all the Government’s liabilities dragging through the courts, or waiting in line to be paid by the Treasury**. We know less about the Government's first actions, but I hope that at least it will continue to spend regularly and pay its obligations promptly so that its powerful demand and liquidity help mitigate the contraction of the economy - until targeted measures in the announced package become operational. Also, in the very short term, I expect the state to assist the system's liquidity through segmented deferral of tax liabilities - at different rates for differently affected sectors and even for different sizes of businesses. A low interest rate would encourage those who still do not need the liquidity to pay them anyway. The Government’s support measures for businesses and citizens will also supply liquidity. Subsidies were already provided to pensioners, and the payment of subsidies per employee for SMEs, should also be considered, especially for those in the most affected sectors. This would reach a significant number of households.

Many countries in the world (and Slovenia among them) have announced the purchase of corporate bonds that are likely to target vulnerable sectors. There are no corporate bonds in Serbia, but the possibility to help corporations issue them and hence start the development of the market should be considered. In particular, the economic viability and operational feasibility of securitizing claims on certain segments of the corporate sector, especially SMEs, should be considered. For example, the administrative securitization of 30% of the economy's claims on SMEs with certain characteristics (size, sector, previous business performance) should also be considered. These securities could be packaged and the banks could buy them using facilitated credit terms and guarantees from the state. After the crisis, banks could unpack the packages, collect claims, and trade those securities. Most likely, business would emerge to interested in dealing with the assessment of the value of these securities and willing to trade and collect on them. Unlike many other scenarios, the risk of such a liquidity injection would be split between banks and the state and its cost could be calculated in advance.

The Serbian economy will not emerge stronger from this crisis, as will not the economies of the rest of the world. However, if there is political will, and with the proverbial ability of Serbia’s society to rally action and improvise in response to adversity, Serbia can come out of this crisis with a significantly strengthened system of macroeconomic management. This would allow it to be among the faster, instead of the slowest recovering countries.