Institute and Faculty of Actuaries

27 May 2020

Economic Impact of Coronavirus

The Institute and Faculty of Actuaries (IFoA) is a royal chartered, not-for-profit, professional body. We represent and regulate over 32,000 actuaries worldwide, and oversee their education at all stages of qualification and development throughout their careers.

Key points

The actuarial profession has a duty under its Royal Charter to put the public interest first, and this includes a commitment to sustainable financial provision for individuals. Stable, long-term financial provision requires that wealth creation processes are working as effectively as possible. We have therefore focused our response to this inquiry on the issues explored in the section 'Economy, public finances and monetary policy'.

Our starting point is that this inquiry should be the beginning of efforts to tackle the UK's long term economic problems from a cross-society / cross-party perspective.

Once the principle of setting up a collaborative effort across society is accepted, the next key task is to identify the highest priority questions to address. We discuss this in our final response below, and propose that one such priority should be examining the case for very significant investment in energy, housing and transport infrastructure to decarbonise the economy.

Should you want to discuss any of the points raised please contact Matthew Levine, Policy Manager (matthew.levine@actuaries.org.uk) in the first instance.

Beijing	14F China World Office 1 · 1 Jianwai Avenue · Beijing · China 100004 · **Tel**: +86 (10) 6535 0248
Edinburgh	Level 2 · Exchange Crescent · 7 Conference Square · Edinburgh · EH3 8RA · **Tel**: +44 (0) 131 240 1300
Hong Kong	1803 Tower One · Lippo Centre · 89 Queensway · Hong Kong · **Tel:** +852 2147 9418
London (registered office)	7th Floor · Holborn Gate · 326-330 High Holborn · London · WC1V 7PP · **Tel**: +44 (0) 20 7632 2100
Oxford	1st Floor · Park Central · 40/41 Park End Street · Oxford · OX1 1JD · **Tel**: +44 (0) 1865 268 200
Singapore	163 Tras Street · #07-05 Lian Huat Building · Singapore 079024 · **Tel**: +65 6906 0889

Introduction

1. In our response to these questions, we will focus on the need for long-term thinking on the economy and how society is structured, as well as dealing with the immediate problems the current crisis continues to inflict on the country. Whilst the full set of questions are useful to set context, the question that most directly addresses the need for fresh long-term thinking is the final question under the "Economy, public finances and monetary policy" section, about lessons that society can learn for the future. We are encouraged that since the financial crisis of 2007-9 some momentum has developed in new economic thinking, especially thinking that starts with fundamental questions such as ecology, the environment, and recognising the importance of facing up to radical uncertainty. This existing healthy momentum represents an opportunity to be grasped today.

2. In the face of many unknown and unknowable questions, including some of those set out in the consultation terms of reference, we welcome Parliament embarking on a process of thinking about the future shape of the country and the economy. This process should continue independent of political or electoral cycles, as an urgent priority, involving all segments of society, and we set out some suggestions at the end of this response.

3. Our response reflects the alignment between the focus of the Committee's inquiry and that of the IFoA's Member Interest Group on Economics.

4. The Committee will be familiar with our work from other inquiries. For example, in 2017, following our written submission the Committee invited the IFoA to give evidence in person to its inquiry into the future of the UK's insurance regulation. Our IFoA COVID-19 Action Taskforce and specialist Boards covering pensions and life and general insurance matters are actively considering the extent to which these systemically important financial institutions are ready to face the challenges that the recovering economy will present. The Committee has previously recognised the value of actuaries' unique perspective, and we would welcome any opportunity to share the insights from this work in the weeks ahead.

The actuarial context

5. A core focus of the actuarial profession is long-term financial provision for individuals. For example, the insurance sector plays a key role in the UK economy both as an employer but also in the provision of a critical service to the economy. The sector has a vital role to play over the coming years in helping the UK economy manage its way through the Covid-19 period and beyond. As actuaries, we help to steer not only insurers but also other financial entities such as pension funds and friendly societies, with a view to meeting the expectations and needs of those that rely on them for financial security.

6. The IFoA has done extensive thinking on intergenerational fairness issues, both in our own right and as a convener of external views[1]. This is an important issue in relation to the economic impact of coronavirus. For example, as we note below (p9), high real asset prices are a significant driver of inter-generational inequalities.

7. As the trend grows towards individuals having to provide increasingly for themselves (illustrated by the Institute & Faculty of Actuaries' "The Great Risk Transfer"[2] theme), we are also concerned with the challenges to individuals to navigate the uncertain economic future for themselves. It is a matter

[1] https://www.actuaries.org.uk/news-and-insights/public-affairs-and-policy/intergenerational-fairness
[2] https://www.actuaries.org.uk/news-and-insights/public-affairs-and-policy/great-risk-transfer

of public interest that the stability and durability of the financial system is maintained. This needs an approach that recognises the inter-dependencies that exist within complex systems, as well as sometimes the unintended consequences, for behaviour, of regulation and state intervention (e.g. moral hazard).

8. Long-term financial provision and stability requires that the economy is working well; in particular that the wealth creation processes are working as effectively as possible. We are supportive of an approach to business that considers not only the necessary expected returns to meet the needs of investors but also the impact on society, especially employees, where personal development, fulfilment and ultimately employability are an important outcome. The Government's "levelling up" agenda, and questions of how to address inequality, both of which feature in the consultation terms of reference, suggest a long-term approach to economic development that considers the UK's industrial competencies and skill levels across all industries. We do not believe that it is wise to rely too heavily on the financial sector; having an economy that is more diverse should make the economy more resilient and productive as well as being better for the life chances of the population as a whole.

<u>The consultation questions on the economy, public finances and monetary policy</u>

9. We do not attempt to answer all the questions, and some of our responses raise issues that come to light when considering the questions, rather than answering all the questions directly. As well as the long-term focus that informs our thinking, as explained above, there are some immediate consequences of the coronavirus that are not spelled out in the questions quite as starkly as they could be. Questions are labelled A through G to facilitate cross-referencing.

A. What economic challenges may arise as the public health and social distancing policies are lifted and the economy begins to recover? What preparations can be made to manage these challenges? For example, could there be difficulty in restarting sectors of the economy quickly, a risk of a spike in inflation, or pressure on the UK balance of payments?

10. Well before the economy begins to recover, a vital question for many companies is "Who is going to end up owning what?" This matters not only to those responsible for other people's savings, including all types of pension fund, but those who are responsible for their own savings and investments, and should be of wider national interest. Companies adversely affected by the public health and social distancing policies that are funded with debt as well as equity are more likely to run out of shareholders' funds, and effectively to become owned by the creditors, who are likely to look for a quick sale. This has long-running implications for the types of businesses that emerge post-crisis and ultimately the direction of the UK economy.

11. Following on from this, are there certain companies and industries which are important to the UK's future competitiveness, jobs, exports, and 2050 net zero carbon target, which are at risk of being lost in the UK? (This is a vital consideration in the thinking we recommend at the end of this response).

12. Inflation was mentioned in the question. The finances of an older generation on fixed incomes were very badly affected by the inflation of the post war years, including the 1970s, and there will be a concern that policies adopted at the current time could have long-term inflationary consequences. Supporting the UK's productive businesses through the initial shock which preserves their ability to respond on the supply side when the economy eventually re-opens may prove a useful counter to inflationary pressures.

13. Against this, the immediate outlook for prices would appear to be in the opposite direction, with a risk of deflation. On the demand side, stakeholders have adapted in this period of rapid change and lived without goods and services previously considered necessary. It remains to be seen, which of these

adaptations will continue post-crisis. For example, businesses may choose to curtail the use of prime London office space or international business travel. This is a difficult balancing act and is likely to remain so for some years. The impact of such shifts on inequality and intergenerational equity should be key considerations in the policy response.

14. Even before the pandemic there were a whole host of issues where a long-term view is essential to meet today's needs, without putting younger, or future generations at a disadvantage. We note the series of reports produced by the IFoA in 2017 on this issue, especially the third report which focuses on Health and Care, and includes a range of health issues, including the sustainability of the health system and social care funding (see reference 1 on p2). The current crisis only serves to emphasise the challenges in healthcare and long term care, and the need for fresh thinking.

B. What will be the economic impacts of the coronavirus outbreak and the social distancing measures in terms of sectors and regions and how temporary/permanent will they be?

15. There will be some businesses which were only barely viable before the lock-down, and which nobody will want to take on post-bankruptcy. This may accelerate the impact of online communication on the high street with continued closures of local shops, pubs and post offices in rural areas. The market clearing prices for industrial and retail space may move significantly. Where the remote working deployed by the financial services sector continues, there could be increased availability of employment outside of London, if some roles continue to be performed remotely. And regional development policies that involve local communities may be needed, in order to promote activity and help tackle unemployment, in industries or geographies where it is most pervasive and likely to persist. This is likely to involve large State pump-priming and a rebalancing of taxation to better align to our increasingly digital economy.

C. What will be the impact on inequalities within society and how should the Government address inequalities that may have been exacerbated by the crisis?

16. There are many aspects to inequality, and we answer this question in three parts: Part one: long-term thinking about inequality arising from trends in the world of work, leading to thinking about jobs, capabilities, and competitiveness.

    This crisis has set in stark relief the division, which has been growing due to developments in both technology and globalisation, between higher skilled and lower skilled jobs. Whilst Government policy has provided safety nets as an essential and immediate concern, this crisis should prompt some deep and careful long-term thinking about productivity, capabilities, international competitiveness, well-being through employment, and retraining across different career stages and sectors.

    Such careful thinking needs to recognise that we cannot accurately predict the future, many things are unknowable, and we need to build and embed resilience and flexibility in the economy. Now is the time to face up to long-term challenges, including the existential challenge of climate change.

    As regards the "levelling up" agenda mentioned below, if this is to be anything more than short-term palliatives, the long-term thinking referred to above is essential.

17. Part two: different levels of personal resilience arising from a combination of employability and levels of debt in relation to income, and policies to address these.
    1) Low levels of individual resilience are likely to lead to large numbers of individual bankruptcies and defaults on loans and mortgages. In the absence of preventative measures, this is likely, when coupled with sharp falls in housing prices and insolvencies and defaults on business loans, to lead

to a banking crisis owing to the lack of resilience in our financial system. There are therefore two stages of actions required:

2) Supporting businesses currently benefitting from the furlough and loan guarantee schemes. Many of these will not be able to recover to their income levels pre-pandemic for some time, may have high fixed expenses and will be highly geared.
3) Supporting people who find they are unemployed post-furlough, with any private pensions hit by falling asset values and in houses whose asset values have also fallen sharply and cannot be borrowed against.

18. This will require very high levels of funding in the short to medium term. However, once the economy does start to recover, the measures that will have been required will motivate the need to build financial resilience to protect against future shocks. This will mean consideration of many economic areas, including the following:
    1) A more generous level of universal benefits at all ages, including pensions
    2) A review of the tax system
    3) A review of the many services, from transport to heating to higher education, which are currently funded via private rather than public debt, to reduce the pressure on individuals to take on debt in the first place
    4) Requirements on companies (especially those to whom support has been provided) to avoid policies which reduce their and their employees' future financial resilience

19. <u>Part three</u>: Differences in health outcomes between different groups, whether in terms of income or any other differentiating factors. This is an aspect on which there is currently considerable actuarial research.

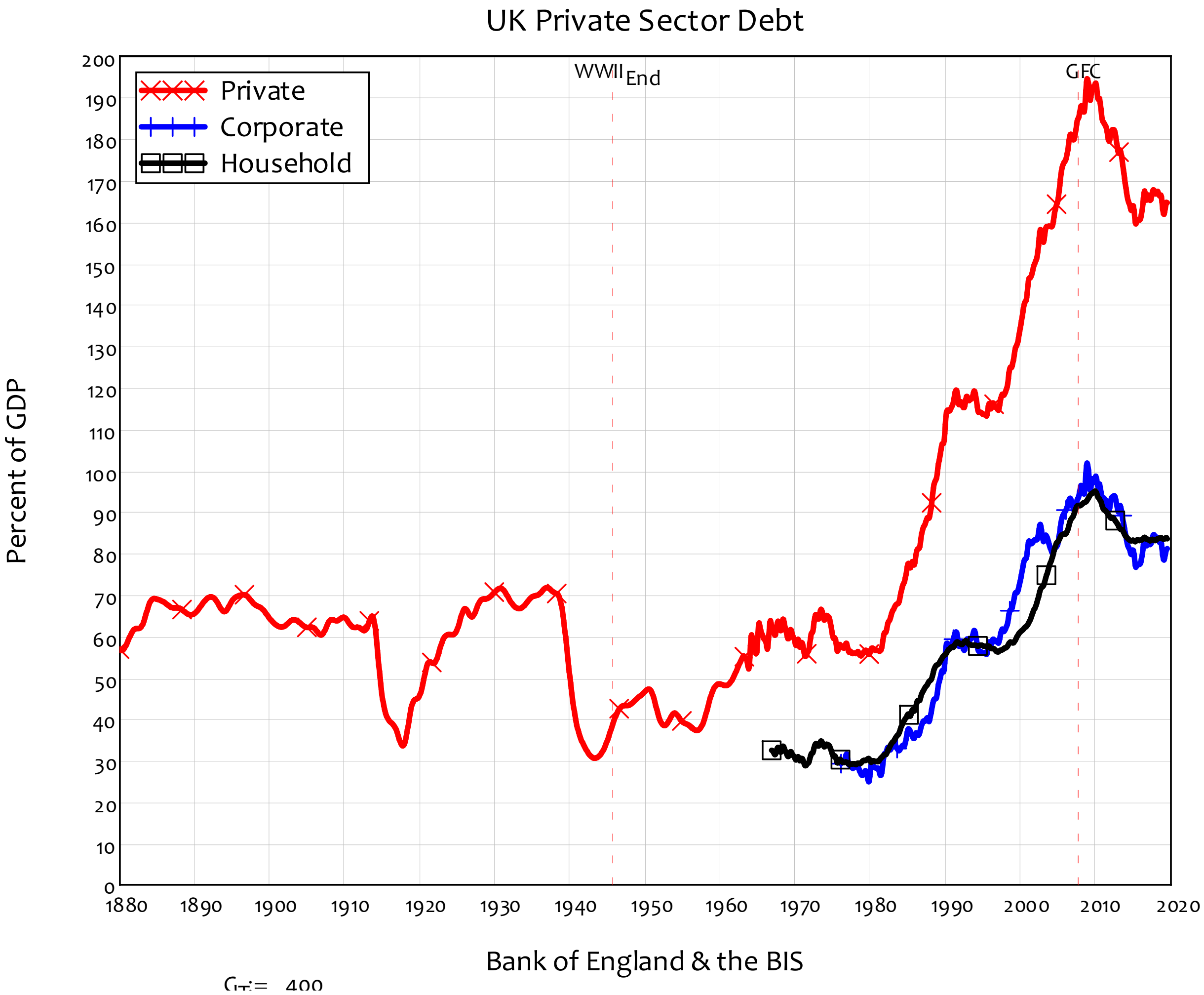
D. What will be the impact on the public finances?

- ***What are the potential future implications for tax and spending?***
- ***What are the implications for the Government's "levelling up" agenda announced in the Budget/infrastructure strategy?***

20. <u>Part one:</u> Level of private debt and the effect on the economy.

21. The state of public finances is a vital question, of course, and must be a consideration in any plans for the future, but it may be essential for the Government sector to run a significant deficit in order for the private sector to survive.

22. There is no mention in the questions of the level of private debt and the effect on the economy. The financial crisis of 2007-9 and the aftermath made it clear that the level of private debt is a more important influence on the macroeconomy than the level of public debt. More than 10 years after the crisis the UK still has historically high levels of private debt, which tends to increase inequality and reduce resilience. In the 100 years from 1880 the level of private debt to GDP never exceeded 75%, whereas it is now over 160%.



[3]

23. It is very important that the notion of crowding out of the private sector investment by public sector spending is not a determining factor in the policy response to the crisis. Private investment can in fact be discouraged through a lack of public investment with evidence pointing towards public investment "crowding in" private investment[4] especially in times of insufficient demand and low growth. A combination of public and private investment will be required to drive a resilient investment led recovery rather than one that is led by private debt fuelled consumption, which could be more vulnerable to economic shocks. It is extremely unlikely that crowding out would occur in the conditions of the pandemic or the aftermath.

24. Consideration should be given as to how the government might adopt conditions to its support of businesses in order to drive patient capital investment by the private sector and appropriate corporate governance. This could potentially influence longer-term challenges such as resilience to climate change.

[3] Chart provided by Professor Steve Keen, Hon Professor, UCL & ISRS Distinguished Research Fellow, based on Bank of England and BIS data

[4] See Chapter 7. Investment led Growth: A Solution to the European Crisis. Stephany Griffith-Jones & Giovanni Cozzi in "Rethinking Capitalism; Economics and Policy for Sustainable Inclusive Growth".

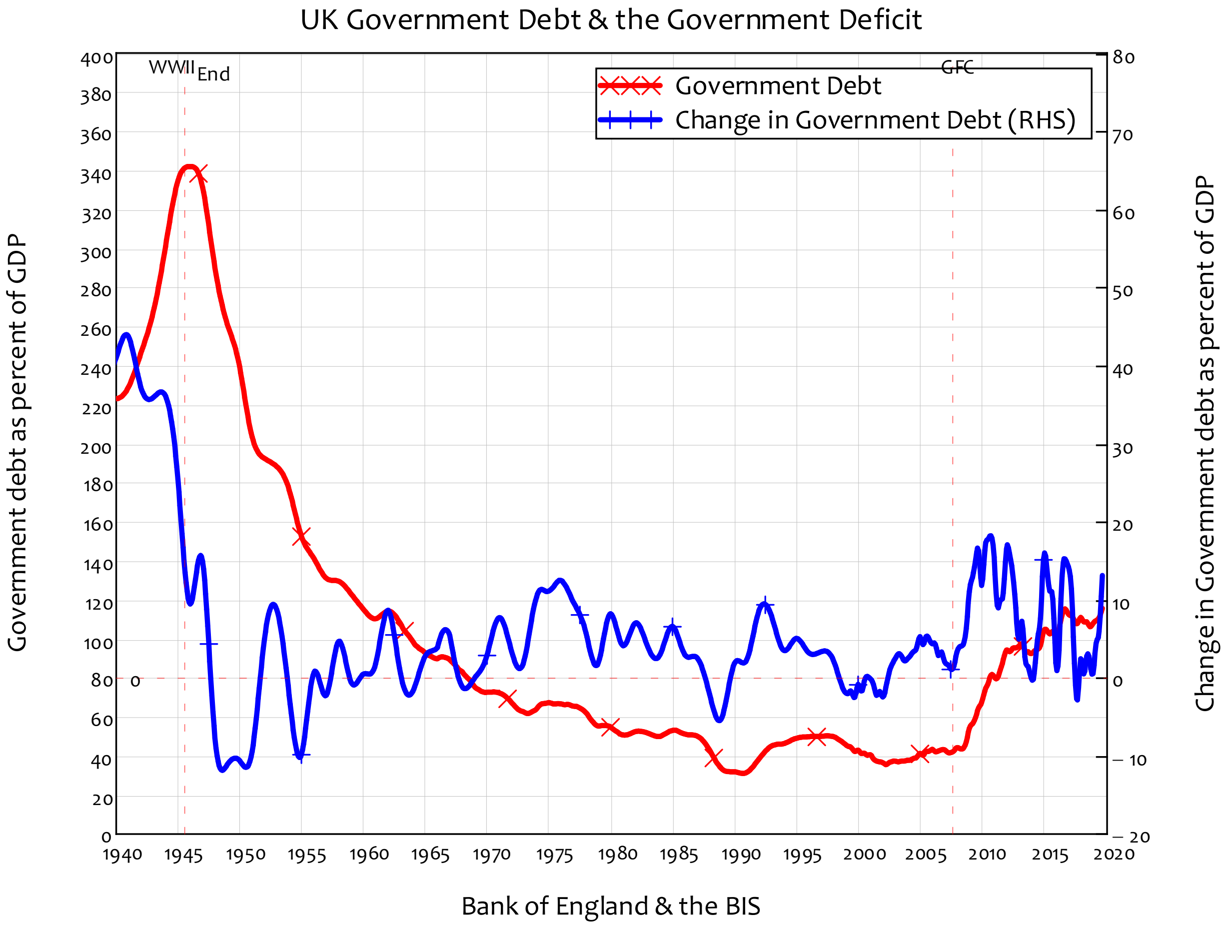
25. Part two: Reducing the public debt to GDP ratio

We propose that unconventional approaches are best placed to reduce the public debt to GDP ratio. The disadvantages of relying solely upon the conventional approach to seek to increase GDP through growth are set out in our response to question F below.

26. It is important that lessons are learned from the policy response to the 2007-9 crisis as these illustrate the disadvantages of the conventional approach to seek to reduce public debt by running a budget surplus. Even once the economy is well on the way to recovery, attempting to run a budget surplus is not an effective way to reduce the public debt to GDP ratio and would impede recovery. History has shown this empirically in the aftermath of the 2007-9 and other crises. This may seem counter-intuitive, but:

- Firstly government surplus reduces GDP by precisely as much as it reduces government debt and
- Secondly it reduces GDP indirectly by reducing the amount of money in the economy, and thus reducing the turnover/circulation of money in the economy.

27. A direct reduction in government debt by running a surplus can then actually increase the ratio of government debt to GDP. This counter-intuitive effect explains why the government debt to GDP ratio plunged so dramatically after WWII, even though, most of the time, the change in government debt was positive.



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[5] Chart provided by Professor Steve Keen, Hon Professor, UCL & ISRS Distinguished Research Fellow, based on Bank of England and BIS data

28. Direct monetary financing of government spending is already considered as an option by the Bank of England[6], which seems perfectly sensible. However, care should be taken to maintain transparency and accountability. It is interesting to note that direct monetary financing was carried out as far back as the outbreak of World War 1[7]. It is also worth noting that not an insignificant portion (nearly 25% in Q4 2019[8]) of the government's outstanding debt is owned by the Bank of England through its QE programme.

29. Any economic models or discussion of these issues must start from a correct understanding of money creation and the monetary system. The "loanable funds" model of banking leads to the conclusion that private debt is unimportant to the aggregate level of demand in the economy, because for every debtor there is a creditor and the net effect on total demand is zero. The loanable funds model is incorrect; the reality is that when a private bank issues a loan, deposits (and hence purchasing power) are created[9]. Similarly, when a loan is repaid deposits are destroyed. When more deposits are being created than being repaid the money supply expands. When this purchasing power is spent the aggregate level of demand in the economy increases. Equally if more loans are repaid than taken out, for example due to a lack of confidence in future economic prospects by business and households or stricter lending criteria by banks, the money supply and hence aggregate demand contracts with impacts on the real economy. Both the level of private debt and the rate of credit creation are important factors affecting the macroeconomy, so the extremely high level of private debt should be considered in any discussion of policy.

30. Above all, imagination should be used in the policy response, learning lessons from the past but also recognising that these are unprecedented times. As such, we should not rule out potential solutions because they do not fit within the standard economic models, which are built on an assumption of marginal choices. We are currently living through a time when events are distinctly non-marginal (which makes it obvious that cost-benefit analysis is unlikely to be the right tool to assess policy in this environment). Also, in these unusual times prior beliefs about the economy should not be the sole basis for deriving solutions as these beliefs can be overly doctrinal, and not a strong foundation for innovation or imagination.

31. One example of an unconventional policy measure may be debt cancellation (debt jubilee). This would involve the replacement of a portion of private debt by government created money (potentially using the Central Bank's balance sheet, of which there is a long history of responding to crises[10]) that is distributed to all citizens, and would not be debt-backed. This would simultaneously reduce the burden of interest paying debt, protect banks from loans that cannot be paid back, while maintaining the volume of money in circulation unchanged. Measures could be put in place to avoid the risk of inflation that some would point to and any resultant moral hazard, e.g. a requirement that such money be used to pay down debt first thus reducing the private debt burden. For those who remain heavily indebted there could be simple restrictions placed on further loans, so that debt is being paid down rather than rolled over and expanded.

E. What will be the impact of high levels of Government debt on market interest rates, private investment, capital formation and future productivity?

[6] HM Treasury and Bank of England announce temporary extension to Ways and Means facility 9 April 2020

[7] https://bankunderground.co.uk/2017/08/08/your-country-needs-funds-the-extraordinary-story-of-britains-early-efforts-to-finance-the-first-world-war/

[8] https://progressiveeconomyforum.com/publications/can-the-bank-of-england-do-it-the-scope-and-operations-of-the-bank-of-englands-monetary-policy/

[9] https://www.bankofengland.co.uk/quarterly-bulletin/2014/q1/money-creation-in-the-modern-economy

[10] https://bankunderground.co.uk/2017/07/03/central-bank-balance-sheets-past-present-and-future/

32. These matters are important but very difficult to know. The economy is a complex system composed of inter-dependencies, the behaviour of which is difficult to predict, but which nevertheless are worth focusing attention on over time. As we will suggest below, this requires a new approach to economic thought, where Parliament could play a key role.

33. We would also note that high real asset prices, driven by low real interest rates and high levels of leverage, are a big problem and a significant driver of current inequalities and significant inter-generational imbalances. The IFoA have previously raised the area of inter-generational fairness as something which requires addressing[11].

F. What has and will be the impact on global growth and what shape is the international recovery likely to take?

- ***Are there international examples of economic policymaking that we can use?***
- ***How is the UK Government co-ordinating with other governments to boost global growth?***
- ***How are countries coordinating their efforts to assist the global recovery?***

34. With climate change an immediate emergency of ultimately much greater magnitude than the coronavirus crisis, it is important that any thinking about "growth" recognises the natural limits arising from the ecology of the earth, and the impact of human activity on that ecology. Growth should not be seen as a "magic bullet" through which the populations of the future pay for the problems of today. Additionally, social issues such as inequality should also be considered. Who are the beneficiaries of this growth and who is left behind? Is it balanced? Is it inclusive? What are the consequences of today's growth on future generations? How does growth improve the wellbeing of people and planet? A key consideration for government is how to make the economic recovery an inclusive and sustainable one. A good starting point may be to revisit the sustainable development goals and progress required in these areas.

G. What are the lessons that society can learn for the future e.g. reducing carbon emissions, increased home working, business resilience?

35. We suggest that this last question is the most fruitful of all of the questions posed. Some lessons are plain, such as a realisation that increased home working can be both practical and beneficial, and the importance of business resilience. Also evident is the importance of resilience in supply chains and the value of diversification over extreme specialisation. However, **now** is the time for a collaborative effort across society to set up mechanisms for long-term thinking, mechanisms that are themselves resilient (i.e. resistant) to the priorities of the moment. Many questions that are important have in the past received little attention, for reasons such as the following:-
    1) They were just "too difficult" to tackle because they required difficult types of thinking, such as systems thinking, that were completely different from traditional approaches in economics.
    2) All attention was taken by immediate priorities e.g. the next 12-month's budgeting period.
    3) The dominant influences behind policymaking suffered from a problem that can beset all professions, namely a comfort with the status quo. Fresh thinking and new ideas can often be seen as a challenge to the status of existing teachings and orthodoxy. Those few economists who warned about the danger of increasing private debt, and who saw the problems of 2007/8 coming, were not listened to. The actuarial profession is now engaged in encouraging pluralism in economic thought. We believe that the tide has been turning, evidenced for example by the following organisations:

[11] https://www.actuaries.org.uk/news-and-insights/public-affairs-and-policy/intergenerational-fairness/issue-2-retirement

- The Rebuilding Macroeconomics Network Plus[12], funded by the Economic and Social Research Council
- The Centre for the Understanding of Sustainable Prosperity (CUSP)[13], also funded by the ESRC
- The OECD's New Approaches to Economic Challenges group, for example a report in 2019 entitled "Beyond growth: towards a new economic approach"[14].
- The UCL Institute for Innovation and Public Purpose[15]
- Organisations such as the Institute for New Economic Thinking (INET), Exploring Economics, Positive Money, Promoting Economic Pluralism, London Mathematical Laboratory, Rethinking Economics, and many others

All of these are further encouraging evidence of a new energy for innovation and fresh thinking[16].

36. Identifying the big questions is the essential initial step, once the principle of setting up a collaborative effort across society has been accepted. These questions will need occasional refining, additions, and refocusing, but some ideas to start with are set out here:-
    1) What diverse businesses, activities and skills are necessary for a society to give the greatest opportunities for productive employment and personal development and fulfilment to all its people, and does not leave a forgotten underclass behind. (Referring to a point made earlier, there is a risk that the current crisis could lead to important businesses and capabilities being lost to the UK)
    2) How can such an economy be internationally competitive, resilient and, having regard to the urgent problem of climate change, carbon net-zero or negative?
    3) What does the new social contract between the government and private sector look like? This has two aspects:
        a. What relationship is needed between public and private sectors to ensure that if the state (and taxpayer) is absorbing the downside risk of private enterprise, it then shares in the upside benefit of recovery?
        b. What combination of Government direct spending and involvement on the one hand, and of market shaping policies to steer the thinking of businesses towards a long-term mentality, and away from short-term capital gains on the other, is needed? (Noting that trying to control behaviour by regulation always fails if the influences that really drive behaviour work in a different direction).
    4) Starting every long and uncertain journey with a single step, what steps and policies are sensible to introduce immediately given the broad goals that emerge from discussing the questions above?

These are not lessons or questions for the future but for now.

37. The case for decarbonising the economy through massive investment in energy, housing and transport infrastructure is clear. With clear evidence from the enormous scientific consensus the Intergovernmental Panel on Climate Change, to campaigners such as Extinction Rebellion, and the very public proclamations by the former Governor of the Bank of England, to the politics of policy variations on a Green New Deal in a number of countries.

38. Actuaries advise clients on the impact of likely future regulatory change as part of their work and are already building in responses to climate change within their advice. The pandemic has indicated that big behavioural changes can be effected very quickly if the need is established and we would therefore

[12] https://www.rebuildingmacroeconomics.ac.uk/
[13] https://www.cusp.ac.uk/
[14] http://www.oecd.org/naec/averting-systemic-collapse/
[15] https://www.ucl.ac.uk/bartlett/public-purpose/
[16] We can also point to many recent publications such as the book "Radical uncertainty" by John Kay and Mervyn King.

expect most of the trends we have already seen in decarbonisation amongst business clients will as a result now accelerate.

39. Significant government spending is required to create the necessary infrastructure, in energy, transport and housing in particular, and to create opportunities for the substantial amounts of private capital currently searching for sustainable future-proof investments.

40. Home working levels will clearly increase. People may commute further but less often. Inner city property may see a permanent fall in demand. All firms which are highly connected with the operations of financial centres will be impacted by these changes. This is also likely to impact the proportion of different types of employment contracts going forward. The regulation around this will need to protect the resilience of the individual as well as that of the businesses created through their efforts.