US Policy Response to COVID-19

NBER COVID-19 Policy Panel

Nellie Liang
Senior Fellow, Brookings Institution

July 8, 2020
US COVID-19 response

• Health care response is paramount

• Fiscal – CARES Act $2.2 T on Mar 27
  • Health, Unemployment, Direct payments
  • $349 for PPP (subsequently increased) and $500 B for business loans

• Financial stabilization policies
  • Monetary policy – Rate cuts start Mar 3
  • Emergency liquidity measures
    • To “break the panic” when can’t price risk because of high uncertainty
    • Prevent liquidity stress from becoming insolvency
    • Provide a bridge to a government transfer or more permanent solution
  • Macropurposential policies – ease pre-existing buffers and forbearance
Financial stabilization in 2020

• Approach is different from 2008
  • More aggressive, crisis did not originate in the financial sector
• But goals are similar
  • Limit immediate damage and position the economy to recover quickly
• Financial instability = Extreme shock * Moderate financial vulnerabilities
  • Financial vulnerabilities amplified the extreme corona virus shock
  • Most surprising – Market dysfunction for Treasury and investment-grade bonds; fire sales by hedge fund and m_REITs
  • Less surprising but destabilizing – investor runs on prime MMFs; large redemptions from bond MFs
  • Bright spot - Banking sector resilience
Fed emergency liquidity responses

• Authorities – Direct or 13(3)
  • Fed can purchase US government securities
  • Lend freely against collateral to financial firms facing liquidity strains
  • Lending under 13(3) - determine unusual and exigent circumstances and extend credit “secured to its satisfaction”

• Market-maker of last resort and Lender of last resort
  • ~ $3.0 T (as of 6/24)
  • Purchases and repo of Treasuries and agency securities
  • Dollar swap lines and dollar repo
  • Discount window, primary dealer credit facility, money market, PPP facility
Fed 13(3) Credit facilities

• New facilities to support businesses and municipalities
  • Mainly backstops or last-resort financing
  • Business borrowers have limits on exec comp, dividends, share repurchases
  • Amount disbursed ~$14 B (as of 6/24)

• Corporate credit
  • $8.7 B (up to $750 B with Treasury capital $75 B)
  • PMCCF – purchase new issues from inv-grade and fallen angel borrowers
    • Backstop like CPFF, at terms more expensive than in normal market conditions
  • SMCCF - purchase bonds and bond ETFs in the secondary market to support market functioning and new issuance

• Municipal
  • $1.2 B (up to $500 B with Treasury capital $35 B)
  • Purchase new issue notes – tax anticipation, revenue anticipation, etc – of up to 3 years
  • Terms more expensive than in normal market conditions
13(3) Credit facilities (cont)

• Main Street ($0, up to $600 B, Treasury capital $75 B)
  • Banks underwrite loans to small- to mid-sized businesses, and subject to Fed/UST underwriting
  • Retain 5% and sell 95% to Fed/UST (English and Liang, 2020)
  • Need to lend to be effective
  • But loans cannot be forgiven, so may not help many firms
  • Congress should consider other options- state contingent insurance, preferred stock - if more businesses need help
Financial conditions and policy actions

Source: US CISS from ECB Statistical Data Warehouse. Lewis, Mertens, and Stock, Weekly Economic Index.
https://www.newyorkfed.org/research/policy/weekly-economic-
Banks and feedback to the macroeconomy

- US banks resilient so far, with Basel III reforms and stress tests
  - Macroprudential goals - banks in stress can absorb losses and not cut back lending

- Bank stress tests 2020
  - Macro stress scenarios provided to banks in Feb 2020, before pandemic
  - Could have revised scenarios and asked banks for new capital plans in Mar / April
  - Instead analyzed bank capital in three alternative scenarios: V-, U-, and W-shaped recoveries, with bigger balance sheets and targeted weak industries
    - Not release firm-level results, but show a wide range of outcomes
    - For W- recovery, 25th percentile is near 4.5 percent (min req) and 75th is near 10 percent

- Capital requirements determined for each firm, as per rule, by a full stress test based on Feb scenarios
Will banks remain resilient?

• Actions taken
  • Suspended share repurchases and capped dividends for 2020 Q3 for all banks
    • Repurchases ~ 70 percent of distributions in 2019 (Kohn and Liang, 2019)
  • Limit dividends to amount based on recent earnings
  • Require banks to resubmit new capital plans later this year
  • Board will conduct additional analysis each quarter

• Should they have shut off dividends for all banks?
  • Some firms will need more capital under alternatives, and don’t want to reveal the weak (Blank, Hansen, Stein, Sunderam, 2020)
  • Process to limit dividends along with disclosures is enough, absent more clarity about the economy
Longer-run challenges

• Moral hazard, though current reason for intervention differs from 2008
  • Reduced downside tail risk
  • Fed ventured further into credit (corporate and muni bonds, Main Street) this time

• Need to reduce financial vulnerabilities before next time
  • Markets and market-based finance
    • Treasury market structure resilience
    • Prime MMFs gates
    • Open-end bond funds with daily redemptions
    • Limited data on fund leverage

• Banks
  • Leverage ratio
  • Stress tests, usability of buffers, and TBTF
Appendix
Composite indicator of systemic stress

• Index of five components
  • Money market
  • Equity markets (nonfinancial corps)
  • Bond markets (government and nonfinancial corps)
  • Foreign exchange markets
  • Financial intermediaries

• Higher when more components high at the same time

Source: ECB Statistical Data Warehouse.
Government Commitments for Systemic Policies and GDP and Employment Growth

Notes: see second page.

Copyright © 2020 Hutchins Center at the Brookings Institution and Yale Program on Financial Stability, www.som.yale.edu/financialcrisischarts

First Responders, eds Bernanke, Geithner, Paulson, with Liang, 2020