Webinar: Evaluating U.S. financial stabilization measures for COVID-19

FEATURING
MARKUS BRUNNERMEIER, PRINCETON BCF
NELLIE LIANG, HUTCHINS CENTER AT BROOKINGS

Thursday, March 26, 2020
12:30 PM ET
Limited Space Available
Registration Required

Twitter: @MarkusEconomist
Intro

- What’s happening to
  - People
    - Health
    - Gaining time
  - Real economy
    - Supply chains
    - Hoarding
  - Financial markets
    - Financial runs

- Ramanan Laxminarayan
  Ctr. for Decease Dynamics
  next Monday, 12:30 p.m.

- Olivier Blanchard
  Monday, April 6th

- Nellie Liang –
  today
Shocks and Amplification

- Initial economic shock
- Amplification/feedback effects/spirals/non-linearities
  - Risk-on to risk-off
  - Flight-to-safety (safe asset = good friend indeed)
- Multiple equilibria
Small shocks: **Self-stabilizing**

- Financial markets are stabilizing for small/normal shocks
Large shocks: De-stabilizing

- Financial markets freeze – situation worsens also in long-run due to morphing
Large shocks: De-stabilizing

- Aim policy intervention

Policy aim

Non-linearities
Brunnermeier & Sannikov 2014,16
Liquidity

- **Funding Liquidity**
  - Primary market/issuance/origination of loans
    - For firms, SMEs, ...
    - For market makers

- **Market Liquidity**
  - Secondary market – bid-ask spread, volume
Liquidity Spirals

- **Funding Liquidity**
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Brunnermeier & Pedersen 2009
Financial Markets

- Stock market

- Credit/Funding Markets – Who funds gov./businesses/HH?
  - Via capital markets & shadow banks
    - Gov. / Corporate bonds (long-run)
    - Repo market = collateralized lending
    - Money market funds
    - Market making (step between buyer and seller of assets)
  - Via banks
    - Loans
    - Interbank market
SME lending

- “FED’s capital market approach doesn’t reach SMEs”

- “Evergreening proposal (not “forevergreening”)”

- Inverse policy prescriptions: dos-and-don'ts are reversed
  - Normal times:
    Avoid evergreening, since zombies crowded out new firms/investment
  - Now:
    Promote evergreening to maintain (social) capital ...
US Financial Stabilization Policies for COVID-19

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Brookings Institution
March 26, 2020
US COVID-19 response

• Health
• Fiscal - $2 T CARE package
  • $367 B for small businesses; $500 B for businesses
  • $700 billion for TARP in 2008
• Monetary policy – Cut target rate to range of 0 - .25%
• Financial stabilization
  • Financial markets need to be able to price risk, but difficult with high uncertainty
  • Emergency liquidity provision
  • Macroprudential policies
Financial stabilization in 2020

• Approach is different from 2008, when the crisis originated in the financial sector
  • More aggressive from the start to support credit

• But similar goals
  • To limit the damage to the economy, and
  • To position the economy to recover more quickly when the pandemic recedes

• Liquidity
  • Can help to prevent liquidity stress from becoming insolvency
  • Can be a bridge to government transfers or other solutions to sharing the costs of the pandemic
Authorities for providing liquidity

- The Fed can purchase US government securities
- Under 13-3, Fed can determine unusual and exigent circumstances, and credit can be extended “secured to its satisfaction”
  - Collateral pledged needs to be sufficient to protect the taxpayer
  - Security can also be provided by government capital, fees and other features of the program
- Dodd-Frank – Lending needs to be broad-based
- Requires approval of the Secretary of the Treasury
Overview of Intervention types

- **Purchase** assets --> FED carries risk
- **Repo** – lend against collateral --> FED carries little risk unless collateral values fall too much
- **Lend** – SPV funded by capital from US fiscal authorities and Fed loans
  - US Treasury in first-loss position
- **Macroprudential**
Overview of asset classes

• Purchase
  • US Treasury securities, agency debt and agency-RMBS
  • Agency-CMBS NEW in 2020

• Repo with primary dealers
  • Wide range of securities, including corporate bonds, ABS, and private RMBS (large in 2008)

• Lend through SPV (new issue)
  • Commercial paper, unsecured and ABCP (large in 2008)
  • Asset-backed securities
  • Corporate bonds (long-term) NEW
  • Municipal short-term credit NEW

• SME loans? - New in 2020
Asset purchases and repo

• To support market liquidity and ensure transmission of monetary policy

• Purchase and repo US government securities, Treasury and agency securities
  • Announced purchases ($700 B) and repo ($1.5 T)
  • Escalate purchases - $375 B in Treasury and $250 B in agency securities, in a week period, and expanded to agency CMBS
  • And stated will purchase more if needed

• Fed balance sheet
  • Sep 2, 2019 - $3.8 T
  • Mar 16, 2020 $4.7 T
Traditional and novel lender of last resort

• Discount window – lowered rate, extended maturity, and encouraged use of the window
  • Financial strength of banks should reduce any stigma
  • Stigma was pervasive in 2008
• Primary dealer credit facility (PDCF)
  • In 2008, expanded the discount window to primary dealers
  • Implemented initially with collateral limited to US government securities
  • Later was expanded to a broad array of collateral
• In 2020, the Fed announced PDCF would accept broad collateral
Short-term credit markets

• Provide short-term funding to corporations, and extend to municipalities in 2020

• Commercial paper funding facility – CPFF
  • Offer 3-month paper to A1-P1 issuers, based on pre-announcement amounts
  • Participation fees and based on issuance, $10 billion from Treasury

• Money market mutual fund liquidity facility – MMLF
  • Lend to banks based on collateral they purchase from MMFs, such as commercial paper and short-term municipal securities
  • $10 billion in Treasury capital
Medium-term corporate credit NEW

• Provide liquidity and support market functioning
  • Rates and terms more expensive than could obtain in normal market conditions
  • Firms will return to markets when conditions stabilize
  • Each has capital from Treasury ($10 B) and lending from the Fed

• Primary Market Corporate Credit Facility (PMCCF)
  • Companies with investment-grade ratings can issue bonds or loans with maturity of up to 4 years
  • Amount is limited based on outstandings
  • Firms that borrow and defer payments cannot pay dividends or buyback shares

• Secondary Market Corporate Credit Facility (SMCCF)
  • Purchase existing investment grade bonds and bond ETFs in the secondary market
  • No more than 10% of outstanding or 20% of ETF
Macroprudential policies

• Fed encouraged banks to use their capital and liquidity buffers - NEW in 2020
  • CCyB is set at 0 percent in the US, so it cannot be lowered
  • But banks have “management buffers” above current capital required by regulations and stress tests
  • Banks announced they would reduce share repurchases through the second quarter, which increases buffers to absorb losses
  • Less clear how to use liquidity buffers since not pre-specified

• Regulators issued guidance to banks to work with borrowers affected by COVID-19
  • Deferred payments or maturity extensions would not be classified as a troubled debt restructuring and would not incur a capital charge
  • These modifications are viewed as beneficial to the borrower, lender, and broader economy
Main Street Business Lending NEW

- Expects to announce soon, no details yet
- To support lending to eligible small-and-medium sized businesses, complementing efforts by the SBA as expanded in CARE
- Fed programs – “capital/credit market approach” do not reach SMEs
  - 50% Bank funded
  - 35% Trade credit
  - 10% FinTech
- SBA - $367 billion in CARE to lend to small businesses (< 500 employees) hit by virus, with loan forgiveness if retain employees
- Fed – program for firms with between 500 to 10,000 employees
- Open design questions: How to encourage lending by banks? How to incentivize banks to EVERGREEN to rollover existing loans?
Government Commitments for Systemic Policies and GDP and Employment Growth

Notes: see second page.


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