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Part 1: Hitting the Hard 0% Interest Rate Floor

While I'm going to pass along to you my thoughts I want to emphasize that I wasn't, and still am not, able to anticipate the most important things happening in the markets because of the rare nature of the circumstances. While what I don't know is much greater than what I know, I will tell you what I think for you to take or leave as you like.

As you know, for some time now I have been concerned that when the economic downturn would come it would lead to hitting the 0% interest rate in an economic downturn with a lot of debt outstanding and big wealth and political gaps the way that configuration of events happened the 1930s. The coronavirus was the thing to cause the downturn, which surprised me. While it is an extremely serious infectious disease and that will produce many harmful economic impacts, these things alone don't scare me; however, when combined with long-term interest rates hitting the hard 0% floor, that really worries me.

Long-term interest rates hitting the hard 0% floor means that virtually all asset classes go down because the positive effects of interest rates falling won't exist (at least not much). Hitting this 0% floor also means that virtually all the reserve country central banks' interest rate stimulation tools (including cutting them and yield curve guidance) won't work and QE (i.e., printing money and buying debt assets) won't work much (because bonds can't be pushed much higher and they are also less likely to be sold to buy other assets). Further, with this hard 0% interest rate floor, real interest rates will likely rise because there will be disinflation or deflation resulting from lower oil and other commodity prices, economic weakness, and more credit problems. If that plays out in the typical way, rising credit spreads will raise debt service payments to weaker credits at the same time as credit lending shrinks, which would intensify the credit tightening, deflationary pressures, and negative growth forces. God help those countries that have these things and a rising currency, too.

We are trying to imagine how this will play out. To do that we are taking existing market prices and visualizing what will happen if things stay exactly where they are. For example, we think about pension funds and insurance companies and others that have long-term liabilities that are funded with these equity and equity-like assets. Do the mark-to-market accounting of what that will be like by taking the present value of liabilities and looking at the expected returns of the assets that they have to fund them. They will come up short. We imagine what they will have to do—i.e., sell assets to make payments. We think about oil producers (countries or companies) and imagine what they will have to do—i.e., slash spending and sell assets. We imagine what that will mean for economic activity and market prices, and that's seriously worrisome. These are only a couple of things that I'm thinking about and I'm sure what I'm thinking about is only a small percentage of the financial disruptions that will happen. Remember that most investors and businesses are long on a leveraged basis so that the declines in asset prices will have bigger effects than the unlevered declines that are shown in market prices.

Contrary to popular thinking, the markets will have a bigger effect on the economy than the economy will have on the markets. For that reason, calculating who is in what positions and figuring out what they will need to do because they are in those positions (e.g., cut expenses, sell assets, etc.) is most important. That's what we are struggling hard to do and are doing inadequately.

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The one thing that seems most clear is that with monetary policy so impotent, there needs to be strong fiscal support, most importantly targeted at those who will be most economically devastated and who it's appropriate to protect, with central banks playing their role of holding rates down by doing whatever it takes. That brings me to the second part of the *Observation*s for today.

Part 2: Because the Forces at Hand Are So Deflationary and Because Monetary Stimulation Is So Impotent, a Larger Dose of Fiscal Stimulation with Monetary Cooperation Is Needed, Low-Risk, and Politically Desirable

Ramsen Betfarhad

While fiscal stimulation measures are being put into place, they're generally not large or targeted enough to neutralize the economic and market effects of the virus.

In the US:

What will happen is still being worked out. There will soon be a small deal announced and then there will be further negotiations. Thus far, there has been only a very small fiscal response consisting of:

- $3 billion for research and development of vaccines, test kits, and other treatments
- $2.2 billion for the Centers for Disease Control and Prevention to contain the outbreak
- $1.2 billion for the State Department to assist in battling the spread of the virus overseas
- $1 billion for medical supplies, healthcare preparedness, and community centers
- $1 billion authorized for the SBA to make subsidized SME loans
- $500 million for Medicare providers to provide telemedical services
- $300 million to ensure vaccines are delivered to individuals at little or no cost

There is talk of a payroll tax cut; in 2011-12, the cut was about 0.6% of GDP (a similar cut today is estimated at 0.75% of GDP). We hear President Trump supports a complete payroll holiday until after the November election (it's not detailed, but supposedly it encompasses both employer and employee contributions, estimated at ~$500 billion). While that's big and unfocused and would probably do him some good in the election, it probably won't happen. Congressional Democrats and some Republicans don't support it because payroll tax cuts are regressive and undermine Social Security funding, and the business part of the cut is considered too business-friendly. It is, however, indicative that he might be in favor of a big stimulation, though there are no signs that it will be targeted. In time and with further deterioration in conditions, maybe he will support more related tax credits. These have been the go-to stimulus moves in the past (tax credits in 2008 and 2009; payroll tax cut in 2011-12).

For now, there hasn't been much focus on relatively targeted measures, which I believe is a problem because specific areas need the most help for this debt/economic problem not to spread. I'm not saying that nothing was created, because there have been some increased subsidized SBA loans to SMEs, paid sick leave for those affected, coverage of most of the cost of virus treatment for the uninsured (potentially tapping FEMA), and increased funds for state and local healthcare services (by tapping emergency and disaster-related funds via FEMA and its Disaster Relief Fund), extension of unemployment benefits, and increased funding of other direct transfers, e.g., food stamps for those in hard-hit areas. The House will vote this week on a set of targeted measures (including free testing for the virus, expanded unemployment insurance and paid sick leave for those affected, and subsidized meals for students eligible for free school lunches). But these measures will be relatively small and offer modest support to those with economic problems.

Thus far, there has not been debt support to industries that would go broke due to this shock. President Trump has called for Congress to authorize an additional $50 billion in subsidies for loans to SMEs through the SBA. This could free up a few hundred billion dollars in loans; however, it's not clear whether this measure will garner congressional Democrats' support. Thus far, meaningful debt supports to industries that would go broke due to this shock have been absent (other than SBA-subsidized loans, which look to be small). It is helpful that many

companies have tapped pre-existing lines of credit at banks. While this may not be what the banks want (I doubt they want to take on more credit risk when the economy is deteriorating), it is one way that money gets to those businesses that are squeezed. Getting money to targeted businesses is a task the Fed is ill-suited for, but it can provide liquidity to the banks to fund those loans if needed. Still, not all of the squeezed companies have pre-existing lines of credit, so large gaps are likely to remain. Perhaps it is expected that these companies will keep operating through the bankruptcy process, though this could be debilitating and would have undesirable knock-on effects because monetary policy will be ineffective and the political fragmentation will be large and potentially volatile. If handled badly, this could become a big political and social issue. If I were in President Trump's shoes, I'd be generous and empathetic, especially as the news will become increasingly bad at this politically sensitive time.

As for the Federal Reserve, it said it would provide at least $500 billion in three-month loans, beginning immediately, with another $500 billion in three-month loans and $500 billion in one-month loans on Friday. The Fed also said it would broaden its $60 billion Treasury purchase program to bills of all maturities, including 30-year bonds.

The Fed can't do much more than provide plenty of liquidity and focus on how to use its macroprudential policies well. It can and likely will cut another 50bps, which won't do much, and its purchases of bonds won't mean much. There is some talk of buying other assets, like stocks, but that won't fly because it's very controversial, questionable at best under the Federal Reserve Act (it likely requires Congressional approval), and it wouldn't have much of an effect anyway.

In Europe:

The European Commission is expected to grant maximum flexibility from the EU rules, most importantly the fiscal rules associated with the Stability and Growth Pact. Consistent with this, the fiscal responses in Europe are generally targeted at supporting health services and hard-hit geographies, sectors, and SMEs. The measures include tax and fee cuts, debt service forbearance, and employee compensation for shortened work hours. The hard-hit sectors most mentioned are tourism, transportation, and autos, though supports are likely to be much broader than these. Both France and Italy have been pushing for more concerted efforts at the intergovernmental and supranational level. However, there is now little consensus on policy direction or a willingness for the mutualization of deficit spending. The European Commission just proposed a modest €25 billion EU investment fund to be used for targeted measures: healthcare, SMEs, and labor-market support. It is funded by the EU Commission reallocating €7.5 billion from its budget (specifically from the Structural and Cohesion funds), which the EIB, in turn, will lever up to €25 billion. Steps toward greater policy coordination are likely to emerge from the next formal meeting of the Eurogroup (EMU finance ministers) on March 16.

The ECB kept rates at -0.5% and launched a package of measures to alleviate the economic impact of the coronavirus, announcing that it would buy €120 billion ($133.9 billion) more bonds by the end of the year and launch a new program to offer cheap loans to banks (at rates as low as -0.75%, below the ECB's sub-zero deposit rate). But it made clear that it isn't going to do anything much other than add liquidity because it can't. It can't because it is a justifiable worry that pushing rates lower than where they are now (-0.5%) will be more harmful than helpful, and the Northern Europeans are against lower rates and modifying the limitations on sovereign purchases. ECB President Christine Lagarde said her officials are looking to provide "super-cheap" funding and ensure liquidity and credit don't dry up. Still, she stressed that the response to the coronavirus needed to be "fiscal first and foremost," noting that the spending pledges so far from Eurozone governments amounted to only €27 billion ($30 billion) in total, and that central bank measures can only work if governments throw their weight behind them, too, with steps to ensure banks keep lending to businesses in affected areas. The ECB is likely to consider raising liquidity for small and medium-size enterprises, possibly by repurposing an existing TLTRO or a new program like that, but that won't do much.

In Italy:

Thus far, the fiscal stimulus package equals about **0.4% of GDP**; it contains **targeted tax cuts for affected sectors such as transportation, hotels, and exporters; support for healthcare services; and select tax credits for companies that reported a 25% drop in revenues.** To me, this is a good policy that other countries should consider their own versions of, because it is the bankruptcies of good businesses and the second-order effects of them that is threatening economic recovery. The Italian government is also preparing a **structural package of measures designed to encourage FDI and investment.** Because these policies are producing political issues, with the opposition saying more should be done, doing more is clearly politically safer on the domestic political stage. Not surprisingly, reportedly the government now seeks to more than double the stimulus size, totaling up to €25 billion **(1.2% of GDP),** which will bring its 2020 deficit to 3.3%. Although the EU has shown flexibility with regard to Italy deviating from its debt reduction pathway, the amount it borrows will affect its overall debt sustainability. Italy's finance minister touched on this by asking for the ECB's support. We will have to see how all the political players (most importantly the European Commission and Italian government) work this out.

In Germany:

There is little consensus on if and how to take action beyond a few targeted and primarily temporary counter-cyclical measures. These measures thus include employee and employer compensation for shortened hours and liquidity provision via the public investment bank. Key policy makers still doubt that a significant fiscal expansion is needed, though they agreed on a 0.08% GDP annual increase in investment in infrastructure and affordable housing. Political commitments, such as the "black zero" (pledge to maintain a balanced budget), will also constrain the size of any potential stimulus over and beyond leveraging automatic stabilizers and drawing down existing surpluses. The "debt brake," a constitutional provision limiting the structural deficit to 0.35% of GDP, is yet another check. There is, however, some leeway if a majority of parliamentarians determine additional spending is required to address a "natural disaster or extraordinary emergency situation outside the control of the state" for which COVID-19 qualifies.

In France:

So far, the focus is on credit payment assistance and various forms of regulatory relief (e.g., credit payment assistance for up to 70% of loans, removal of late payment penalties on public contracts and tax obligations). However, the finance minister has initiated emergency economic measures. The last time such measures were implemented (during the Yellow Jacket protests), they were used to initiate spending and revenue changes of roughly 0.4% of GDP. France has a more centralized institutional structure than Germany and a less stringent strain of fiscal conservatism in its culture. This means that policy barriers to the provision of assistance are weaker, enabling the government to enforce deeper policy cooperation across the sectors of the economy. However, because France's budget deficit is already large and in breach of EU fiscal rules (3.2% of GDP), there is little talk of a broad fiscal stimulus.

In Japan:

The government's response thus far is targeted to support healthcare services and impacted persons and firms, in particular SMEs. Two recently enacted spending packages totaling ¥450 billion, for example, fund new medical clinics and improvements to medical facilities, provide aid to working parents forced to take leave due to school closures, and support SMEs. In addition, the government is providing ¥1.6 trillion in special financing to aid SMEs and other businesses affected by the outbreak. These measures draw on existing "rainy day" government funds. The government is also seeking legislation empowering the prime minister to declare a state of emergency, if needed. These steps are in addition to ¥13.2 trillion in fiscal stimulus already in the pipeline announced in December. That spending is being phased in over several quarters. The government is reportedly considering a fiscal package for April of some ¥10-20 trillion that may include direct cash handouts to households. The BoJ has so far purchased roughly ¥100 billion of ETFs on each day it has intervened in the market in March, compared to a previous pace of around ¥70 billion. It has also provided ample liquidity to the market via repo operations. It may increase its annual target for ETF purchases at its March meeting.

In China:

There has been a series of announced fiscal measures that have amounted to roughly 1.2% of GDP so far, excluding infrastructure investment. These include waivers and reductions of social charges (e.g., corporate pensions, unemployment and workplace injury insurance), reduced healthcare insurance contributions, lower VAT taxes for some enterprises, and lower electricity and gas fees for corporate users, among other measures. There has also been a series of smaller fiscal support measures (including subsidies) announced at the local level. At the national level, the government has introduced sets of measures to support select industries, as well as regulatory forbearance (such as delayed recognition of some bank non-performing loans). The People's Bank of China has shifted its official stance to "prudent with appropriate flexibility" and introduced 30 measures to support enterprises impacted by the outbreak (with a focus on SMEs), such as relending and rediscounting funding for banks.

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