Rescue Measures Are More Urgent Than Stimulus Package[1]

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Abstract: This article is mainly about US dollar liquidity crisis induced by the coronavirus pandemic and pros and cons of China's different coping approaches. The author argues that rolling out rescue measures are more urgent and will be more efficient than launching a stimulus package in easing the impact of the pandemic and restoring normal economic activities.

I. Can Fed's massive intervention resolve the US dollar liquidity crisis?

The novel coronavirus outbreak is a serious global public health crisis. The last public health crisis that similarly threatened the survival of human beings and changed people's lifestyle was the Spanish flu that occurred in 1918-1919, which is said to have caused 50 million deaths. The Spanish flu has certain peculiarities. It occurred before the Great Depression and before the birth of modern macroeconomic theories. At that time, a modern Federal Reserve system had yet to come into shape. This context poses two problems: First, people have limited understanding of how the Spanish flu impacted the macro economy in the short and long term, and the archival records on the pandemic and the research conducted are fragmented and incomplete. The second is that modern macroeconomic theories, and theories on central banking and modern monetary banking have not experienced such a severe public health crisis since they were formed. This has brought tremendous challenges and tests. Now we can see that the system established after the Great Depression has exposed fatal shortcomings on some levels.

For example, in the face of an epidemic, people's natural response is to apply social distancing. Social distancing can cause demand collapse, and the latter will further disrupt cash flow for businesses and individuals. Faced with the risk of broken cash flow, the only and completely reasonable option is to hoard cash beforehand, and the way to do so is to sell off all sellable assets and take the dollar cash home.

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From the perspective of monetary and banking theory, this means that the demand for cash in the economy will explode in a short time. Although in theory a central bank can supply money unlimitedly, in reality it is difficult to do so in an explosive manner in a short time to meet the rapid growth of cash demand. **This is because the central bank's cash supply must depend on credit creation of commercial banks, and the latter is subject to various regulatory constraints, such as capital adequacy ratio, rules on liquidity, and the Volcker Rule.** However, the economy is seeing an explosive growth for cash demand, which puts considerable pressure on the entire financial system.

In the US market, we see that although the Fed has intervened quickly and promised unlimited quantitative easing, this can only solve part of the problems in some areas. **The pressure on the credit market, commercial paper issuers, and high-yield bond market, will not be eased immediately, leaving severe potential problems unsolved. What's worse, this kind of problems can easily produce a secondary contraction effect through financial tightening.**

Another problem is that international trade, investment and financial activities are dominated by the US dollar. Despite the explosive growth in demand for the US dollar, there is no international counterpart of the Fed to provide massive cash supply of the US dollar. The Fed has made it clear that it will not act as the lender of last resort for the international demand for US dollar, causing a USD shortage globally. Judging from the inter-bank lending in the offshore market, the USD shortage is rather serious. From the perspective of market expectations, this shortage will remain massive in the coming months, and will cause a secondary impact on international trade and investment activities. **The limited currency swaps between the Fed and other central banks may help to ease the problem, but will not solve it fundamentally.**

In addition to the Federal Reserve, the International Monetary Fund also can provide dollar liquidity. But the IMF is like an unreliable buddy. When you don't need it, it is everywhere; when it is needed, it would shrug and say, "I can't do anything".

The US dollar shortage will have an impact on China's export chain. On the one hand, the collapse of demand will disrupt companies' dollar cash flow. On the other hand, it is increasingly difficult to extend maturities on companies' debt coming due. For some weaker economies, especially those heavily dependent on external debt and export, there is a risk of USD debt crisis.

In addition to Fed’s large-scale intervention, another approach is to ease people’s panic and reduce the demand for cash through massive fiscal intervention. For example, in the case of a severe US market panic, it can help the market return to normal by reducing the cash demand. However, in the field of international trade, it is doubtful whether every government can provide strong guarantees in the form of US dollars. If most governments fail to do so, with the deterioration of the underlying credit quality, commercial banks can’t create credit, and companies have a strong willingness to hoard US dollars, which explains the market’s great concern—**in Europe, even if the dollar Libor interest rate is lowered, it is difficult to return to the February level. The rate is likely to last for a long time at a very high level, bringing a long-term impact on liquidity shortage. Libor may be more than a hundred points above the normal level, which is equivalent to a substantial interest rate hike by the Federal Reserve.**

Another point of view is also worthy of thinking. In two to three quarters, when the world overcomes the public health crisis, the demand for US dollars will drop sharply. It is doubtful whether the Fed and commercial banks will tighten the USD liquidity in time. We are not sure whether the falling of US dollar demand will be at the same pace of Fed’s tightening USD liquidity.

There is a possibility that when the demand for US dollar falls, Fed’s liquidity withdrawal takes place at a slower pace, at least in the early stages. In this process, the world will be flooded with US dollars. In the wake of the pandemic, we may see troubles such as a huge influx of dollars into the Chinese market, a sharp increase of pressure for RMB appreciation, and the emergence of asset market bubbles. From the perspective of market transactions, above-mentioned problems won’t wait until the pandemic ends, but will soon manifest themselves when the disease hits a plateau or sees a turning point. By then, we will face new policy challenges. Concerning long-term economic and financial policies, it is necessary to be vigilant to the extent to which the dollar exchange rate will experience a depreciation trend in consideration of fundamental factors.

Ⅱ. Rescue measures are more urgent than stimulus package

Let’s describe the issue with a metaphor, which may not be exactly accurate, but it will help make the issue easier to understand. The impact of the coronavirus outbreak is like the collapse of a reservoir dam. When it happens, the city is flooded immediately and requires emergency rescue. Although the situation is dire and fast changing, the sequence for carrying out rescue still is clear:

The first is to repair the dam and speed up drainage, which refers to the treatment and intervention of public health policies. At the same time, oxygen masks and survival kits should be provided to people who remain under water. This refers to directly providing cash subsidies to businesses and individuals to ensure that their cash flows are not being disrupted.

The second is to get as many trapped residents as possible onto lifeboats, and choose an opportunity to take them to higher places. This refers to resuming as soon as possible economic activities essential to the nation and the livelihood of its people, such as transportation, food, electricity, and communications. In areas where spread of the disease is well controlled, efforts should be made to resume normal economic activities as soon as possible.

Finally, post-disaster reconstruction. As the flood subsides, reconstruction will begin simultaneously. This refers to the comprehensive recovery of economic activities.

The difference between the pandemic and a financial crisis is that the former is like a flood and the latter an earthquake. Floods are terrifying, but they wane soon and reconstruction is relatively easy, whereas earthquakes destroy buildings and machines and take many lives, making reconstruction much more difficult.

So the focus and scale of policy intervention for the two will greatly differ.

In addition to public health expenditures, I believe the current policy focus should be on providing relief through compensating the affected enterprises and low- and middle-income residents and helping them maintain a healthy cash flow. After all, the virus outbreak is beyond their control, nor is it their fault. But if they are forced to close their stores and factories, it will cause long-term damage to fixed capital and human resources.

Compared with the idea of driving the economy through infrastructure construction, I think rescue measures can achieve much greater effects with relatively limited costs. Plus, it can help stabilize employment.

For example, suppose the economic value of the fixed capital stock of a small business is 10 million yuan, the epidemic lasts 4 months and the company suffers a loss of revenue of 3 million yuan during the time. If there is no bailout policy, this small business will have to close down due to cash flow disruption, leading to a loss of 10 million yuan of effective capital stock in the economy. This amount of capital stock can be saved if financial assistance of 3 million yuan (including bank loans, etc.) is provided to this small business.

If the 3 million yuan is used for infrastructure construction, the newly increased capital will be exact 3 million yuan; but the bankruptcy of the small enterprise will cause a loss of 10 million yuan. As a result, capital stock will decrease by 7 million yuan. In reality, providing support for small businesses have more advantages as they are more bound by market constraints, more efficient in resource allocation and capital utilization, and more dynamic in job creation.

On the surface, the government subsidizes small enterprises, which doesn't create direct infrastructure demand and makes no contribution to the expansion of capital stock. However, the overall benefit the economy receives is actually greater thanks to the powerful effect of the bailout policy.

In addition, the epidemic is a one-time short-term shock. **In order to avoid long-term market distortions, policy intervention is preferably reversible, that is, can be withdrawn immediately once the epidemic ends.** The bailout policy undoubtedly satisfies such standards, while it is difficult for measures such as infrastructure construction to be reversed in the short term, thereby causing long-term distortions. But there is an exception: for infrastructure construction that is needed whether the epidemic occurred or not, early action is actually more advantageous.