Coronavirus: Federal Government and Federal Reserve Come to the Rescue

James A. Kyprios / Originally published by [LA Progressive — March 29, 2020]

The big news is that yesterday the Congress approved, and President Trump signed the Cares Act (Coronavirus Aid, Relief, and Economic Security Act). In anticipation of this, the stock market staged a major rally this week.

Key Takeaways

For those not trained or experienced in economics and finance, some of the details in this article may not be of compelling interest. These are the key points for all to keep in mind:

We are not dealing with typical economic problems. The crisis in 1929 and in 2008 dealt with underlying problems in the economy. Today we are faced with a major existential crisis, unlike any other in the history of the U.S. and the whole world.

The present crisis has massive economic consequences potentially greater than those in the Great Depression.

Traditional methods of dealing with these economic problems are not sufficient.

We are fortunate that both Democrats and Republicans (or liberals and conservatives if you prefer) recognize the magnitude of the problem and are willing to work together for the common good. Treasury Secretary Steven Mnuchin especially worked hard with Senate Minority Leader Chuck Schumer to make the Cares Act into a law acceptable to both sides

Perhaps for the first time in our history, the Federal Government and the Federal Reserve are working in concert "to do what is necessary" in the words of Jerome Powell, Chairman of the Federal Reserve.

The Cares Act authorizes the spending of amounts of money unprecedented in the history of our country. Senate Majority Leader McConnell said this is not a stimulus package, this is emergency relief.

The amount is in excess of $2 trillion, equivalent to 10% of GDP.

It appears that the financial markets approve of the program.

We have no way of knowing now what the medium and long-term consequences of this concerted action by the Fed and the Federal Government will be. We cannot not know what the political reaction to such drastic action will be in the future.

We are truly traveling in uncharted terrain-both medically and economically.

Up until now with the passage of the Cares Act, most of the "heavy lifting" has been done by the Federal Reserve, the U.S Central Bank.

To understand the full import of what the Fed and the Federal Government has been doing, it is necessary to review the evolution of Monetary and Fiscal Policy over the years and also to define these terms. Monetary Policy is the action of Central Banks to influence the economy. Fiscal Policy is the action of a country's government to influence economic activity.

Fiscal Policy is fairly easy to understand. The Federal Government spends money and it "finances" it by either issuing debt or by taxation or a combination of the two.

Monetary Policy

Monetary Policy is more difficult to understand. Traditionally, the Fed has influenced economic activity by creating money and by influencing the level of short-term rates. It has also acted as a lender of last resort for banks which are in need of funds by buying safe, short-term assets from the banks, especially Banker's Acceptances and Treasury Securities.

The Fed's activities have gradually expanded beginning with the reaction to the Great Recession in 2008. In recent weeks, the Fed's arsenal of tools to combat problems have greatly expanded. It now can buy all sorts of debt in the market (including Corporate Bonds, Corporate IOUs, Mortgage Securities, etc.) in unlimited amounts.

The legal obligations of the Fed are to try to maintain full employment and control inflation. More recently, Jerome Powell the Chairman announced that the Fed would do whatever is needed to aid the economy. He placed no limit on the amount of financial assets (i.e., various debt instruments) it would buy. A spokesman from JP Morgan said that the Fed has now turned itself into a commercial bank.

The Fed can now put out money by lending against a wide variety of collateral or by buying a variety of debt instruments. By doing this, it is increasing the liquidity in the money and capital markets and preventing what happened in 2008 when these markets quit functioning. The Fed's role is thus to take make sure that a bad situation is not worsened and that good credits remain good credits. It now does this by, in effect, being the buyer of last resort for the full range of credit worthy debt instruments.

For those familiar with the financial markets, it is quite obvious that there has been a remarkable increase in the power of the Fed to influence the economy. Where in the past it influenced short term rates, it can now influence long term rates by buying or selling huge amounts of long-term government debt. It is possible also that the Fed can help the government "finance" spending programs such as the Cares Act by buying up to (say) $2 trillion in debt. The increased power of Central Banks is a stunning development.

The major reason for these increased powers is that valuable lessons were learned in 2008 when "liquidity" in the debt markets came to a halt. We now know that the Fed can restore "liquidity" in the markets by its actions and it is doing just that now.

There is another element of Monetary Policy which needs to be explored: the plain fact that interest rates have plummeted not only because of pressure from President Trump. The reasons for this are complicated and controversial and will not be explored here.

In Europe, rates are now often in negative territory which would have seemed inconceivable just a few years ago. Christine Lagarde, the head of the European Central Bank, in the face of the spreading Coronavirus has recently made some rather inelegant remarks indicating that monetary policy has no more fire power left. She undoubtedly had in mind that rates cannot be lowered to stimulate the economy. Her comments caused a furor especially in Italy which she singled out and which is suffering massively from the Coronavirus and the economic and financial consequences of its problems.

If she was in fact referring to interest rate cuts of course she has a good point. Obviously, interest rate cuts can no longer be used to stimulate the economy or in this case, to lessen the economic damage from the understandable reaction to the Coronavirus.

But as noted before, the Fed is no longer relying on lower rates to influence the economy. It is employing the new tools just described. Despite the so-called independence of the Fed, it is cooperating with the Federal Government in the midst of this new crisis. The role of the Fed now is to make sure that the financial system works so that the debt markets can continue to function despite the present crisis. This is important because good companies and state and local governments and even some individuals need to continue their financing activities; and also, buyers and holders of debt need to make sure that their investments are not jeopardized because of a lack of liquidity.

It is not the job of the Fed to bolster the fortunes of distressed companies, governments and people who are suffering from the present calamity. That is the job of the Federal Government

Fiscal Policy

Fortunately, there now is agreement among the two political parties that in the words of Franklin Roosevelt in 1933: "We need action and we need it now." Fiscal policy, as traditionally envisioned by economists in the old days, consisted of the government either increasing spending and/or cutting taxes in order to increase what is called aggregate demand in the economy. Until now, this has always been a controversial position. We have heard over the years all sorts of derogatory comments about deficit spending the rapid increase of government debt.

What is being tried now is new because we do not have a traditional economic problem today - we are dealing with a war. Stimulating an economy (using conventional means) which is shut down because of the virus is not a solution to the problem. The government now needs to deal with very specific problems. It needs to deal with a massive emergency.

This is the genesis of the Cares Act which authorizes the spending of about $2 trillion which will more than double the size of the Federal Budget. The new spending would amount to about 10% of GDP, unprecedented to say the least, for one program. There are discussions going on right now that perhaps this is not enough and there will be further spending authorized.

The Cares Act is a disaster relief program. The $2 trillion needs to be financed by either increasing government debt or by tax increases or a combination of the two. No tax increases are contemplated at this moment. (This is after all an election year). How will the U.S. government be able to sell $2 trillion in bonds? This does not seem to be a problem because there is a "flight to safety" by investors (i.e., they want to put their money in government bonds) and further, the Fed can also participate by buying some or even all of these bonds. (Explaining the intricacies of the financing of government spending is beyond the scope of this article.)

The Cares Act will cause a huge increase in the deficit accompanied by large financing needs (i.e., large increases in government debt). Under traditional economic theory, these deficits should either have an expansionary effect on the economy or to some extent cause inflation. In the shorter term, the increased deficits will most likely have a muted effect on stimulating an economy that is not functioning because of shutdowns.

Nevertheless, some in the government are discussing a multiplier effect of two times the spending. That is, if the government spends $2 trillion this will percolate throughout the economy and cause additional spending (they hope) of $4 trillion. There are now too many unknowns to be able to speculate on such matters.

When the crisis subsides and "things get back to normal," it is to be expected that the medium-term and long-term economic effects of the crisis and the increased spending will have significant and lasting consequences which are impossible to grasp today. Will the huge deficits be sustainable? Will they cause inflation? What will be the political reaction to huge deficits and huge government debt when things "return to normal"? Will Bernie Sanders argue in the future that if we could afford this program today, why can't we afford Medicare for All now that we know how perilous and interconnected an epidemic can be? The simple answer is - nobody knows.

The immediate problem in providing relief had been political. The Republican Senate came up with a program last week to which the Democrats initially objected because, in the view of the Democrats, the proposed plan did not sufficiently take into consideration the needs of smaller businesses and individuals while rewarding bigger businesses; shortchanges front line medical providers as they ramp up to treat the epidemic; and had inadequate strings attached to the financial resources being made for corporate America to weather the economic storm.

On the other hand, some conservative observers including some economists fear that any massive government program will push the economy to the left (i.e., a higher percent of economic activity dependent on government spending) and in their view, give people like Bernie Sanders what they want - that is a massive control of the economy by the Federal government for years to come and maybe irreversibly.

One of the major impediments which had to be overcome was the provision to spend $500 billion to help distressed businesses. The Democrats believed this gave too much authority to the Treasury Secretary and the fear is that this money will be distributed by the Trump Administration politically rather than on the basis of real need. Amounts spent would have been secret for six months. It has now been agreed that there will be public transparency and approval by a committee for all investments. The Treasury Secretary will make decisions subject to an overview by the Inspector General and an Oversight Committee of five members of Congress. Any investment will be revealed within a week of such investment.

(President Trump issued a separate "Signing Statement" when he signed the Bill stating that he would not be bound by these oversight provisions. There appears to be no "force of law" behind such signing statements and they are not sanctioned by the Constitution. Nevertheless, this may lead to a fight between Congress and the Executive Branch. This has not received much press coverage yet).

There is no doubt by almost all in the government that the Cares Act is crucial because the economic situation is quickly becoming ugly. The likelihood is that the unemployment rate may reach 30% soon, a figure higher than what the economy endured during the Great Depression in the 1930s. GDP will surely go down in the first quarter and by the second quarter it may drop by amounts rarely, if ever seen, in our history. Some estimates are that in the second quarter GDP may decrease from 12% to close to 30%. A recession is defined as a decrease in real GDP (GDP changes not including inflation) for two consecutive quarters. There seems little doubt that we will have a recession. A reduction of GDP by (say) 30% would by anyone's reckoning be a Depression. Of course, no one wants a Depression and if there is one, the hope is that it will be very brief, and the government can cushion the blow. The economic fallout is out of our hands- it will depend on the stubbornness of the Coronavirus.

The Cares Act

The details of the Cares Act in its final form will emerge and will be analyzed by many. A very rough outline of the major elements of the Act is presented below.

Major Elements of the Act

- **Small Business Support –** includes expansion of SBA programs including small business interruption loans.
- **Support for Individuals, Families and Businesses —**
  - Payments to taxpayers
  - Delay filing tax returns
  - Penalties for early withdrawal waived
  - Expand charitable deductions
  - Delay certain tax payments
  - Increase net operating loss deductions
  - Increase deductibility of business interest expenses
- **Assistance to Severely Distressed Sectors of the Economy**
  - Including manufacturing, restaurants, travel and entertainment, airlines, hospitality, and hospitals
  - Economic stabilization through Loans and Loan Guarantees
  - Limitations on employee compensation on high earners
- **Assistance to Hospitals**

To be more specific, the following is a breakdown of the key elements of the Act:

- One-time payments to individuals- $1,200 for most adults and $500 per child. This covers most Americans.
- Four months of Unemployment Insurance for those who would have lost their job but who, under this program, would be furloughed.
- Support for Hospitals and the health care system.
- Financial Support for State and Local Governments

- Support for Small Business
- Support for Corporations
- Tax relief and tax deferrals for individuals and companies

The $2+ trillion will be disbursed as follows:

- $560 billion- Individuals
- $500 billion- Large distressed companies
- $350 billion- Small businesses
- $150 billion- Public Health Care Systems
- $350 billion- State and local governments
- Up to $200 billion- other including education, safety net payments, etc.

What the Cares Act does not Cover

- Those working from home
- Those on sick leave or paid family leave
- New entrants to the job market who have yet to find a job
- Grown up children of parents who still claim them on their tax returns

Good Advice from Abraham Lincoln

In times like this, it might pay to heed the words of the first Republican, Abraham Lincoln, during the Civil War, whose words were approvingly quoted 100 years later by Democrat President John F Kennedy:

"*The dogmas of the quiet past are inadequate to the stormy present. The occasion is piled high with difficulty and we must rise with the occasion. As our case is new, we must think anew and act anew. We must disenthrall ourselves . . ."*

No doubt we are living in perilous even in surreal times. Will our government continue to come together to do the right thing for the country and for the world? We certainly hope so. We must rise with the occasion.

Any program passed now can only be evaluated later in retrospect. There will be opportunities in the future to do that. What we know now is that almost nobody (right or left) is objecting to a big government "bail out" even if those unpopular and politically charged words are not uttered. Last month, these two words were anathema to many on the right and left. Last month, nobody would have believed that the Democrats and Republicans could together craft the biggest spending program in U.S. history. It looks like we have taken Lincoln's advice. And somewhere perhaps, FDR is smiling.

In the meantime, to all of you - STAY SAFE both physically and economically!