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Policy in a Pandemic

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Abstract

This note proposes policy options to address the massive financing deficit faced by both government and industry due the current COVID pandemic. Broadly, we suggest that foreign currency borrowing, and money financing should be seriously examined to finance government spending. For the case of industry, we make the case for the RBI to carry out large scale buying of corporate bonds to alleviate the credit crisis in the private sector.

Keywords: Money Financing, Government spending, Quantitative easing.

JEL classification: E32, E52 G15, G32, G38.

The COVID-19 pandemic is not just a health crisis; it is in equal measure an economic crisis, the consequences of which could be potentially catastrophic. As policymakers scramble to contain the economic fallout from the pandemic, the role of the RBI is likely to emerge front and center.

The conventional recession typically occurs when people in the economy choose to cut their spending. It is usually dealt with by designing a broad-based stimulus package intended to stimulate demand and revive economic activity. Such a stimulus package is not useful in a pandemic induced slowdown where large parts of the economy cannot operate as they are in lockdown. The first order of business is, therefore, for the government to transfer resources into sectors impacted by social distancing measures to help them minimize the cost of the crisis. Conservative estimates suggest that discretionary fiscal expenditure required to address the fallout from the crisis meaningfully would be upwards of 1.5% of the GDP. However, this then begs the question of how the government which has entered the pandemic with limited elbow room, courtesy a higher fiscal deficit and a slowing economy, proposes to finance these expenditures.

The government, as many analysts have pointed out, has already helped itself to the entire amount of household savings. Further borrowing would drive up yields and crowd out already weak private expenditures. Extraordinary times call for extraordinary measures, and therefore, the policymaker must put previously discarded options such as external foreign currency borrowing and money financing of the deficit back on the table. There are legitimate concerns about both these measures. While the former is susceptible to rollover and exchange rate risk, the latter might result in runaway inflation. However, these concerns must be weighed against the consequences of inadequate government response due to lack of mobilized resources.

Both the aforementioned measures, therefore, deserve serious consideration. With zero to negative costs of borrowing prevailing abroad, foreign currency borrowings should be on the table for a cash strapped government. Money financing also needs a look in. Gali (2020), for example, suggests that in an environment where prices are slow to adjust, money financing simulates aggregate demand by lowering real interest rates. The inflation costs are also shown to be modest.

One of the critical functions of a central bank is also to ensure provision of adequate liquidity to industry. India was already in the midst of a full-blown credit crisis at the outset of the pandemic. Corporate bond yields were at elevated levels going into the crisis. The slew of RBI measures, barring the most recent TLTRO operation which mandated corporate bond-buying by banks, did little to alleviate the problem. Lack of adequate credit to industry is likely to result in a fresh wave of bankruptcies. In this context, the central bank must devise robust mechanisms to separate insolvent firms from illiquid firms and provide adequate liquidity to the latter. Failure to do so would mean these illiquid but otherwise efficient firms get driven out of the market. Such an inefficient "shakeout" would have long-term adverse consequences on the supply chain, thereafter, making an economic recovery more difficult.

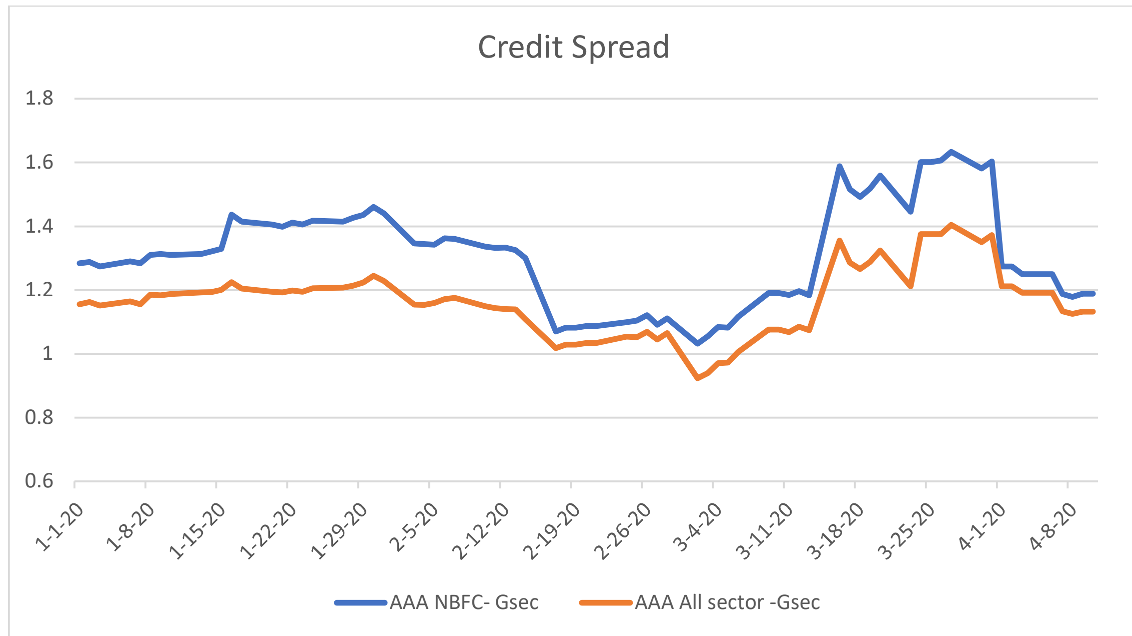

Figure 1: Difference between the yield of ten years AAA corporate bonds and ten years of G-sec bonds in India. Source: Bloomberg and Author's Calculation

It is well understood that the monetary policy transmission in India is weak. To understand this phenomenon, Figure 2 decomposes the yield on a nominal ten years government bond as the sum of two components: (i) investors' expectation over the next ten years of the average level of short-term interest rates, and (ii) a term premium. The term premium is the additional compensation that investors demand for holding a long-duration asset.

Figure 2: Decomposition of 10 years zero-coupon G-sec into the expected rate and term premium. Source: Author's Calculation

It is clear from examining Figure 2 that the term premium largely drives movement in the long-term yield. There is therefore a case for the RBI to carry out large scale purchase of long-term assets, a program popularly referred to as QE, to drive down the term premium. Given the anemic state of credit markets today, an aggressive corporate bond buying program by the RBI is perhaps the much-needed panacea that the market needs.

Unlike government bonds, corporate bonds are high yielding assets. They are not close substitutes for money, making them a better choice for Q.E. The Japanese experience shows that buying long-term government bonds ends up lowering the cost of government borrowings without having any significant impact on credit to the industry.

Evidence from (Zagini, 2019) suggest that corporate bond buying program is that it is likely to drive down yields across the board and not just on the targeted bonds. Essentially, investors facing scarcity of the targeted bonds due to purchases by the central bank rebalance their portfolio with increased holdings of other risky bonds. This rebalancing ends up driving up prices and lowering yields on a whole spectrum of assets. Moreover, a more liquid bond market is likely to free up resources in the banking sector, allowing it to concentrate on lending to small and medium scale enterprises.

Finally, the bond borrowing program must be designed to lower the borrowing costs of those firms and sectors that are likely to have the most significant impact on the economy. One could adopt the model followed in the U.K., where metrics such as employment creation and linkages with other sectors in the economy were used to arrive at the choice of bonds to target.

The unprecedented and unique nature of the economic crisis caused by the pandemic requires us to be flexible in our response and not be wedded to existing frameworks. The medical fraternity has made it clear that a vaccine is a good 18 months away and there is almost certainly a second wave of infections that will come during the latter half of the year. Addressing the economic fallout would require a massive mobilization of resources. The government and the RBI must do what it takes – in other words, follow pragmatic, not dogmatic economics!

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