

The Economic and Financial Implications of the COVID-19 Pandemic

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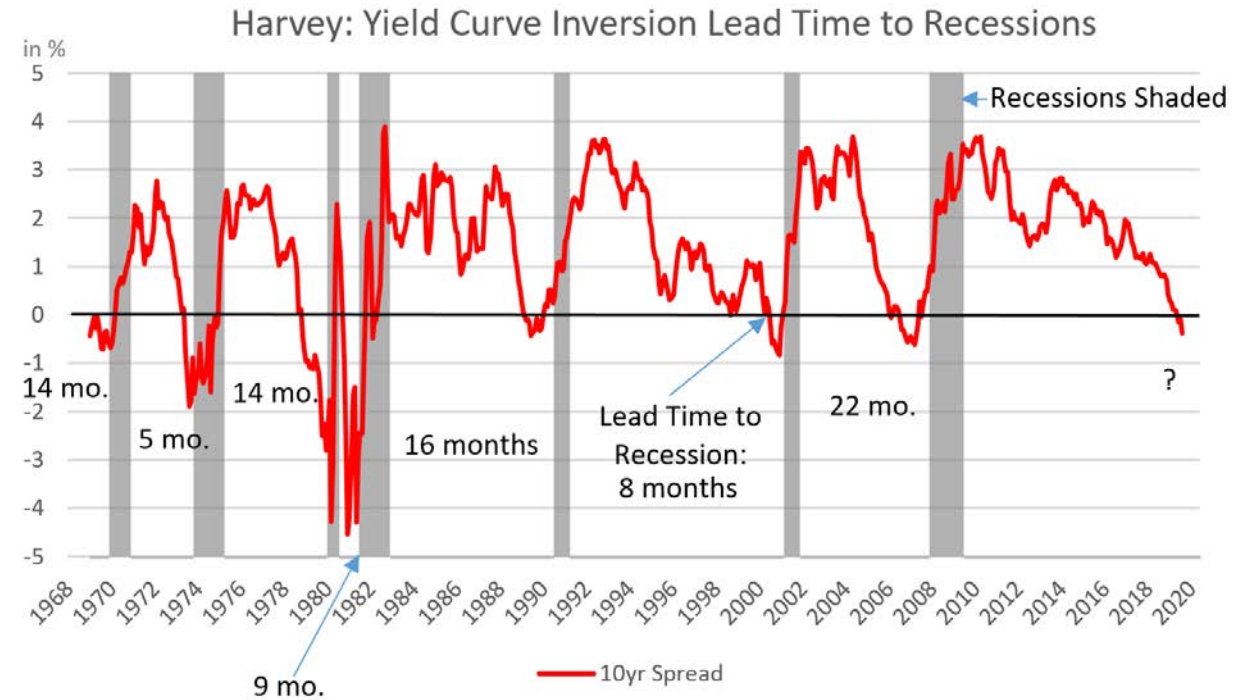


April 2020

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Background

- My 1986 dissertation showed that the yield curve predicted real economic growth.
- June 30, 2019. Yield curve inverted again and I forecasted a recession in 2020.
- I was not alone. Duke CFO survey showed 50+% expected a recession in 2020.
- Then COVID-19 hit.



Systemic risk

- A pandemic falls into the category of systemic risk
- Systemic means that it impacts everyone and is very difficult to hedge (like an all-out nuclear war between the US and Russia)
- However, among the other types of systemic risks, a pandemic is the easiest to mitigate

Systemic risk

- COVID-19 is not a “black swan”
- 1918 saw a (population adjusted) 200 million die worldwide from the Spanish flu
- We have had recent warnings, in particular, with SARS in 2003
- However, others like MERS, Ebola and HIV

Differences from GFC

- GFC caused by mismanagement of financial institutions
- Financial event causing a financial crisis
- Triage necessary for one sector
- “Bailouts” directed to mainly 25 financial institutions

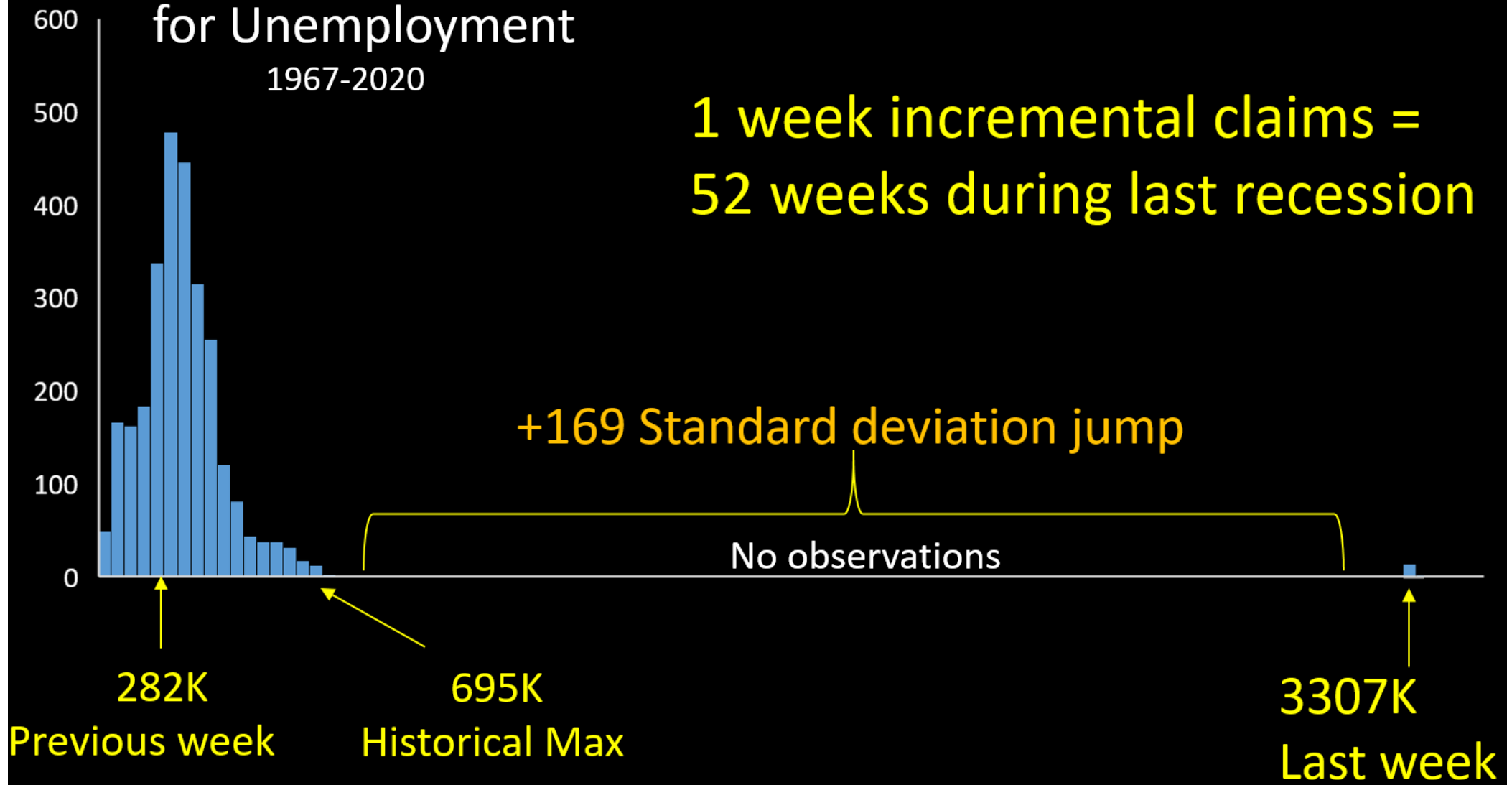
Differences from GFC

- COVID-19 is better thought of as a “natural disaster”
- There is no sector to point to for blame; no structural problem
- The companies in trouble were not being mismanaged
- Different type of hard hit firms: restaurants, bars, retail
- GFC large firm problem, COVID-19 small firm problem (which is relevant because there is a different demographic impact for workers) and much more difficult to manage logistically

Speed

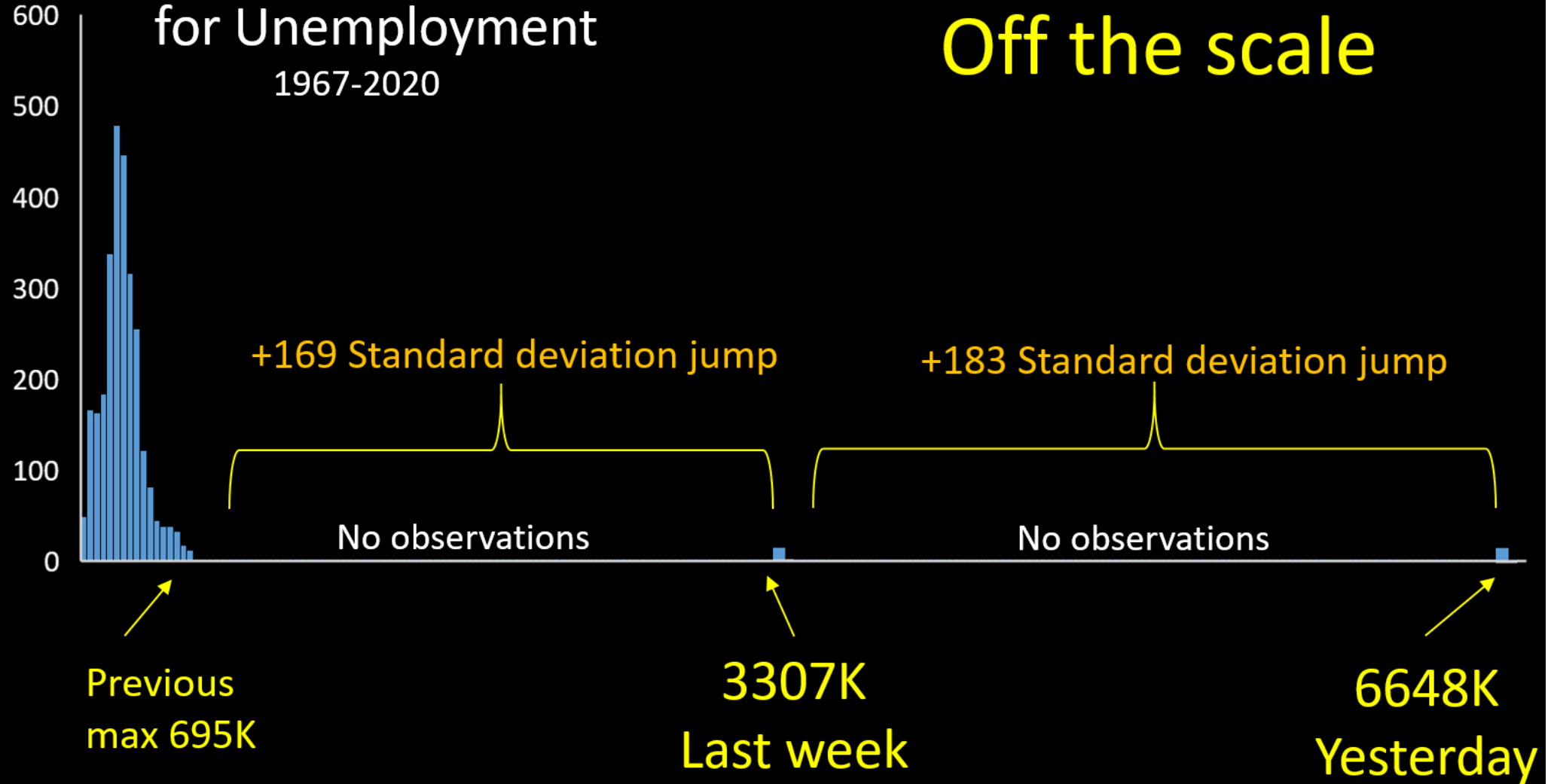
- COVID-19 is better thought of as a “natural disaster” and it strikes quickly
- GFC was a slow moving train wreck – we didn’t know when it was going to end
- COVID-19... I call the “Great Compression”

Frequency of New Claims for Unemployment 1967-2020



Frequency of New Claims for Unemployment 1967-2020

Off the scale



Speed

- 30M work in restaurants, bars, retail
- 37M work in other hard hit industries (like air travel)
- During GFC, increment in unemployment was 10M (max rate 10.6% in January 2010)
- We probably have that already and 25% is feasible

Light at end of the tunnel

- GFC seemed to go on forever. Even after it was officially over, few thought it was over.
- Given this is a biological crisis, the end point is a vaccine and most expect expedited process and wide availability in Q1 2021
- In addition, drugs to mitigate the impact will be available sooner -- blunting any resurgence in the fall
- Finally, widespread testing also mitigates the fall

Light at end of the tunnel

- Hence, in the scenario where not too much damage is done to the economy, we can expect to see historically unprecedented reductions in unemployment
- In 2008, when you lost your job a Lehman, you were not going back there. Many expect to return to their small business

Monetary policy responses

- **March 3:** Fed cuts rate from 1.5% to 1.0%
- **March 12:** NY Fed announces \$1.5T support for repo market
- **March 15:** Fed cuts rates from 1.0% to 0%. Fed agrees to purchase a minimum of \$500B of Treasuries and \$200B of Agency MBS
- **March 17:** Fed announces CPFF (Commercial paper) and PDCF (Primary dealer) both backstopped by \$10B Treasury ESF
- **March 18:** Fed announces MMLF (Money market) backstopped by \$10B Treasury ESF

Monetary policy responses

- **March 19:** Fed expands dollar swap lines to 8 additional central banks
- **March 20:** Frequency of dollar swaps changed from weekly to daily for five key banks; Fed announces that municipal bonds are valid collateral for the MMLF
- **March 23:** Fed says “no limit” on QE; included CMBS in addition to the MBS; PMCCF (corporate credit in primary market); SMCCF (corporate credit in secondary market); TALF (student loans, autos, credit cars, SBA) [all three backstopped by ESF \$30B]

Monetary policy responses

- **March 23:** Main Street Lending Program (MSLP) to complement SBA efforts. No term sheet yet – expected in three weeks. Backstopped by ESF.
- **March 24:** Fed to scale back non-critical oversight
- **March 26:** Regulatory relief for smaller financial institutions

Fiscal policy responses: \$2T CARES Act

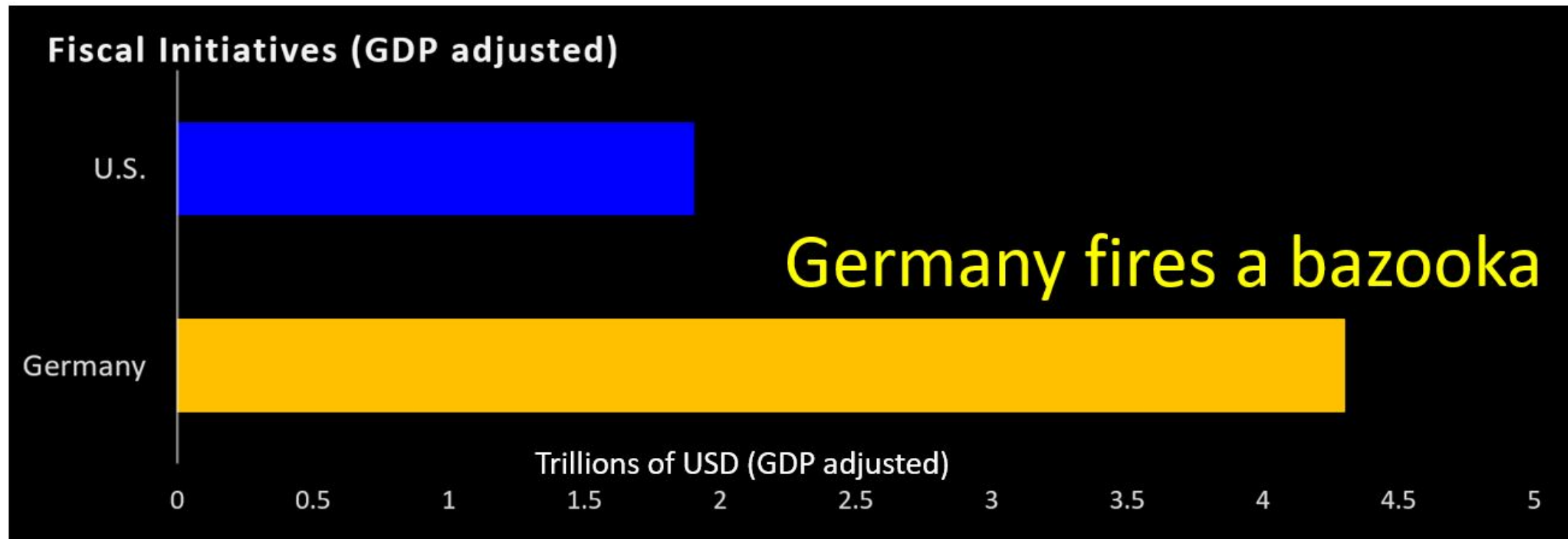
- Direct payments to households: **\$300B**
- Business grants and loans **\$500B**
 - \$50B airlines and national security sensitive industries
 - \$450B to Treasury's Exchange Stabilization Fund
- Expansion of unemployment insurance **\$250B**
- Hospitals **\$150B** including \$25B for vaccine and related research
- Aid to small businesses **\$367B**
 - Administered by banks with Treasury and SBA oversight

Fiscal policy responses: \$2T CARES Act

- Tax relief **\$220B** (deferral, tax credits, etc.) as well as provisions for: bankruptcy, credit reporting, mortgage payments, retirements and student loans.
- Industry-specific provisions: banking, farming, hotels and restaurants and public transportation
- Special interests. 880 page bill also includes money for special interest projects unrelated to the crisis.

Is the bill enough?

Fiscal policy responses: \$2T CARES Act

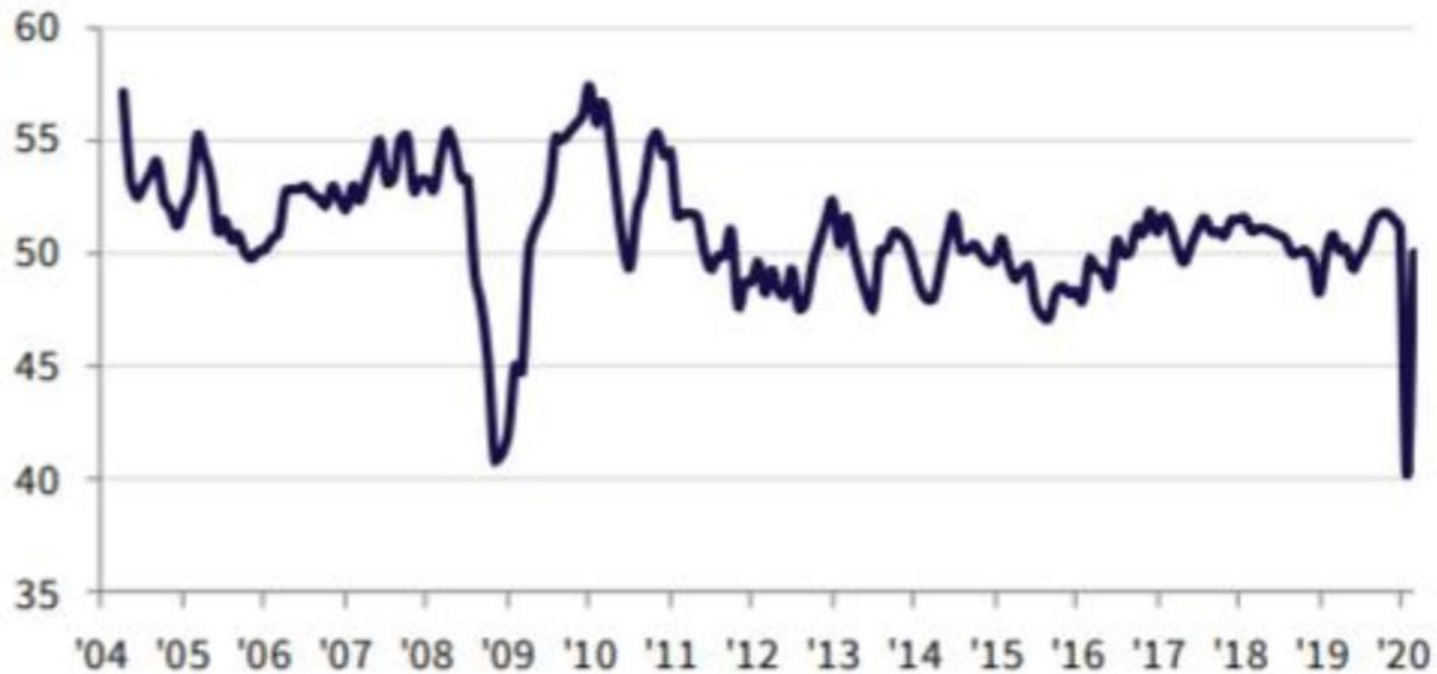


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The Great Compression

Caixin China General Manufacturing PMI

sa, >50 = improvement since previous month



Sources: Caixin, IHS Markit.

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Recession scenarios:

V = optimistic

U = base case

L = pessimistic

I believe a combo of U and V; a skinny U or “test tube” shape



Resources: Follow me on LinkedIn

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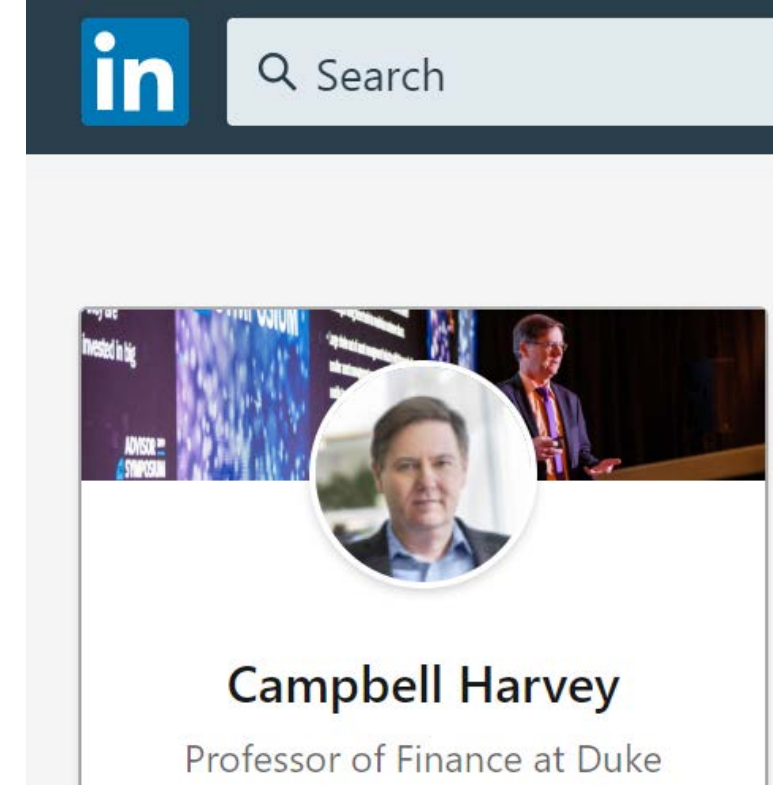
<http://www.duke.edu/~charvey>

Podcasts:

<https://faculty.fuqua.duke.edu/~charvey/Audio/COVID/COVID-Harvey.html>

COVID-19 forecasting:

<https://elsaifym.shinyapps.io/Covid-19/>



Additional issues

- Can the US afford a \$2T stimulus?
- What worries you most about the policy actions?
- What factors work against a fast recovery?
- Has the market bottomed out?
- Do you think we are in a Japan-like liquidity trap?
- What are the major lessons to be learned from this crisis?