Comments on

Business Credit Programs in the Pandemic Era

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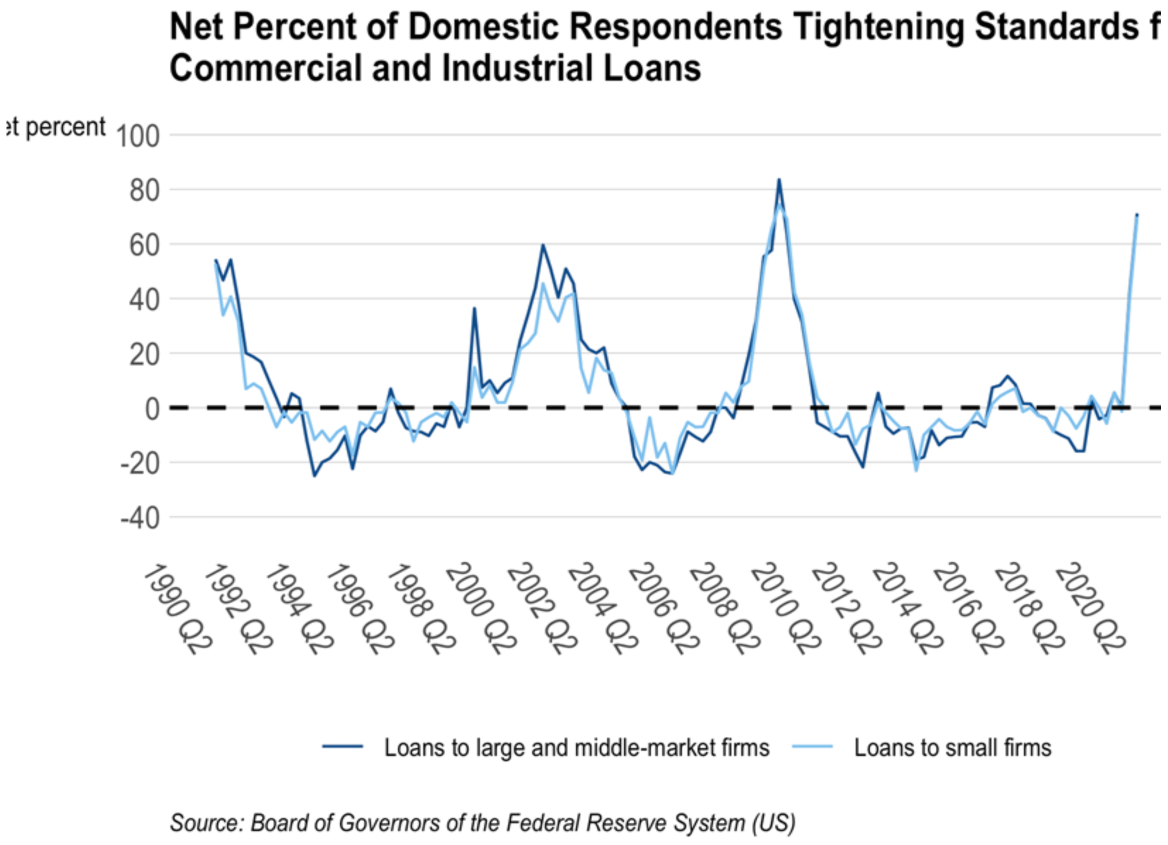
Business credit programs
… and lender of last resort

- Paper: The 2020 pandemic crisis is not a financial crisis
- Government needs to embrace a greater risk of credit loss
- Paper offers two different models for government support in a pandemic crisis to view Main Street and the Corporate Credit Facility
- Discussion: What can the lender of last resort do when there is expected credit risk, since the Fed has separate legal constraints?
  - Borrowers must be solvent
  - “Security for emergency loans is sufficient to protect taxpayers from losses”
- Fed actions can buy time and reduce the potential for a doom loop, but can’t be a substitute for fiscal responses
  - Main Street is an odd fit
  - Corporate Credit is manageable, but the Fed should clarify its objectives

Main Street

- Model with two key frictions that lead to differences in private market and social planner's outcomes
  - Credit market frictions – sharp declines in near-term revenues less informative about long-run viability
  - Positive aggregate demand externalities
- Predictions for government:
  - Invest in riskier firms
  - Expect to lose money on some investments
  - Staged financing – support firms initially only to get to the next stage, especially when aggregate uncertainty is high (not guarantee that firms can survive after a recovery)
- Main Street – Hard to set up, and little take-up so far
  - Fed wants banks to make loans and keep a share
  - Borrowers may not want more debt
- Staged finance may encourage borrowers, but not lenders

Bank lending standards



- Banks don’t want to make more loans exposed to the same risk
    - In 2008 couldn’t, now don’t want to
- Agree some proposed adjustments within Fed constraints can help (English and Liang, 2020)
- Staged finance could help, but need more fees to banks to reduce losses
- Or a fundamental change, by Congress
- Loans with conditional forgiveness if macro conditions deteriorate
- Still may not offset political risk for banks

Corporate Bond Purchase Programs

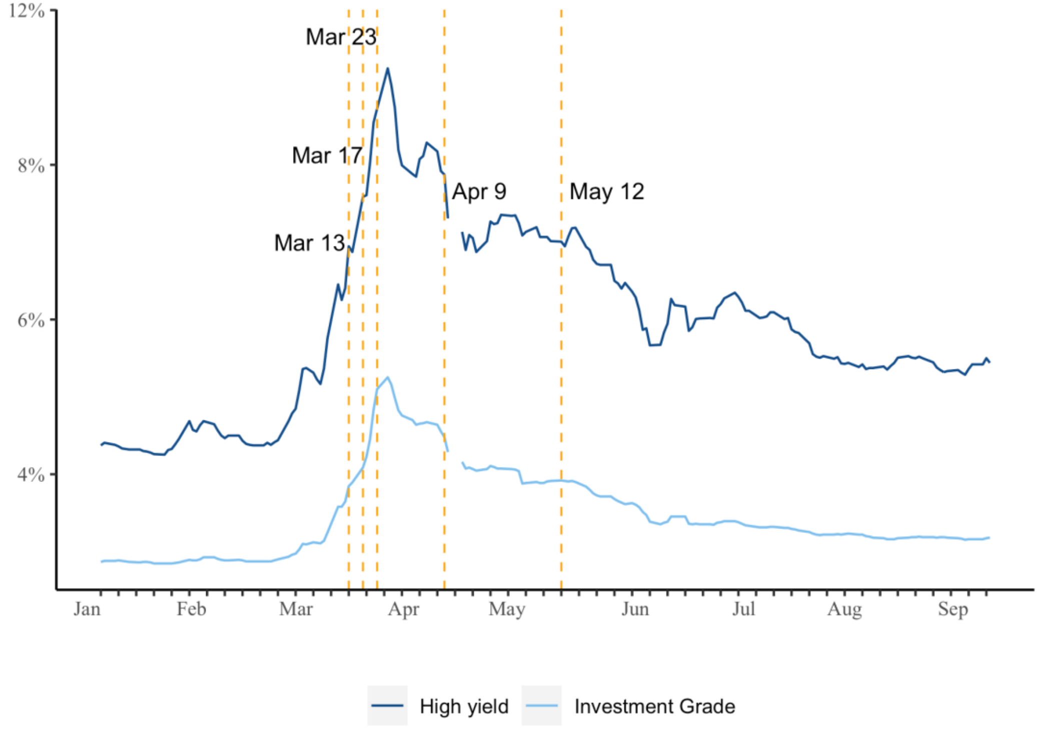
- In contrast, the corporate bond programs dramatically eased credit conditions, even before any bond purchases
- Model suggests still not a credit risk-free program especially if investors mis-perceive the Fed's reaction function
- SMCCF – *support credit to employers by providing liquidity to the market*
    - Suggests aim to fix dysfunction
    - Will also boost asset prices
    - Room for ambiguity about the Fed's reaction function

What is the Fed’s reaction function?

- Traditional LOLR – Fed offsets “technical” factors that push prices away from fundamentals, but does not interfere with adjustment of prices to new fundamentals
    - Still will require the Fed to take on credit risk in some states at t=2 if risk aversion and supply variance is high
- Alternatively, the Fed is pegging the t=2 risky bond price
    - Would need to purchase risky bonds very aggressively in response to negative fundamental news at t= 2
- The paper offers evidence that investors believe that the Fed is focused on prices
    - Spreads are compressed relative to past 25 years, and well below recession levels
- I agree, and offer some evidence to support a traditional LOLR motive

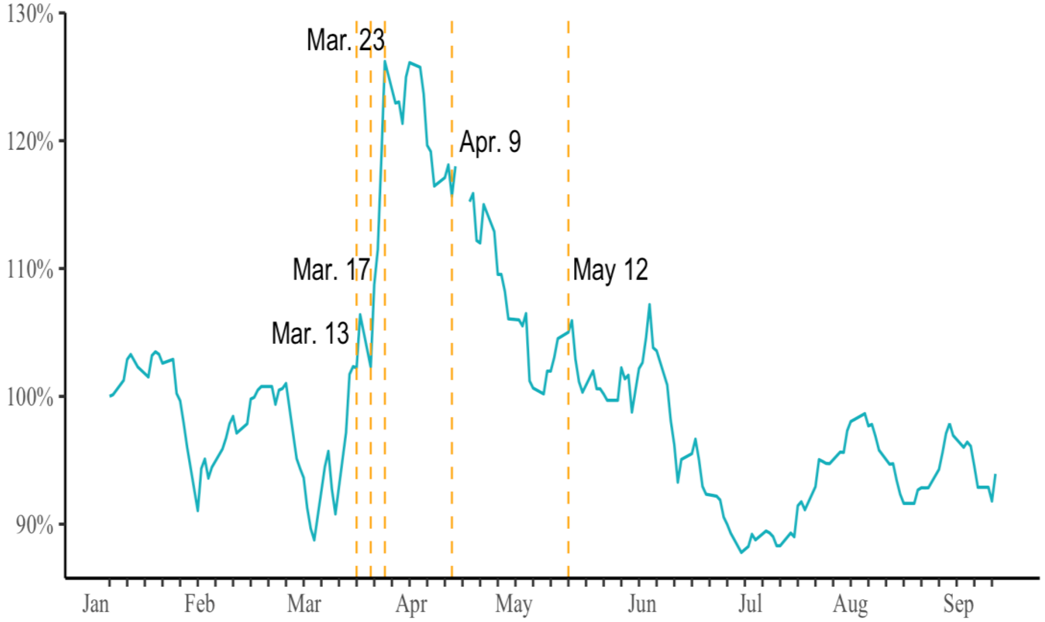
Investment-grade bond spreads rose more

Investment grade and high yield corporate bond spreads



Source: Federal Reserve Bank of St. Louis, Ice Data Indices, High Yield Index Option-Adjusted Spread, US Corporate Index Option-Adjusted Spread.
Relevant dates: Fed announced treasury and MBS purchases (March 13), PDCF (March 17), PMCCF, SMCCF, and additional treasury and MBS purchases (March 23),
Fed expanded PMCCF and SMCCF (April 9), first purchases of bond ETF's (May 12)

Ratio of investment-grade to high-yield corporate bond spreads



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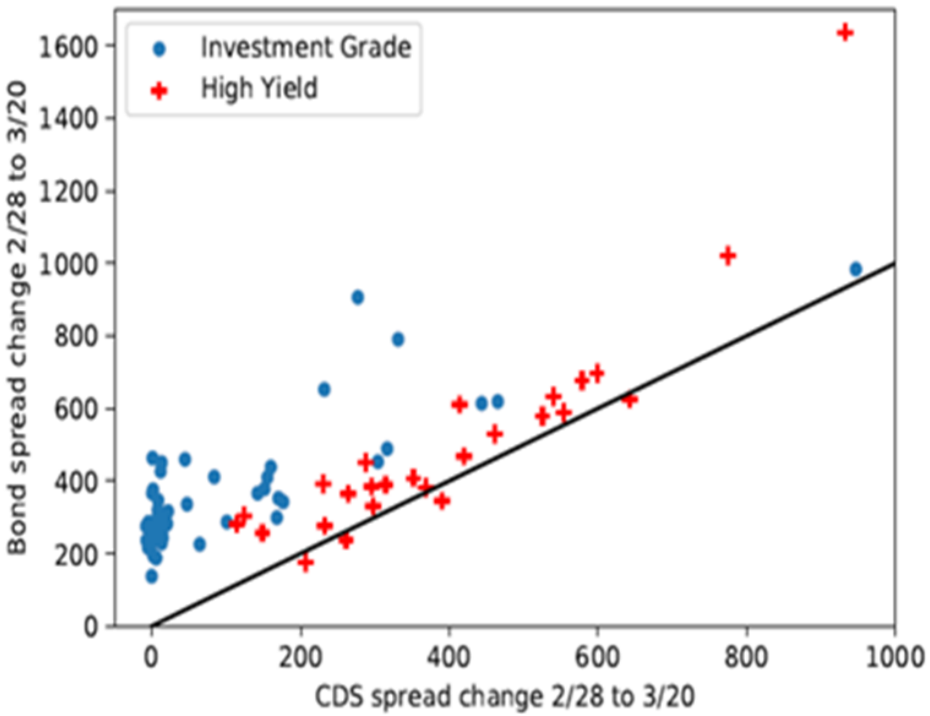
Investment-grade bond market more illiquid

Figure 9: CDS Bond Basis at the Bond Level.

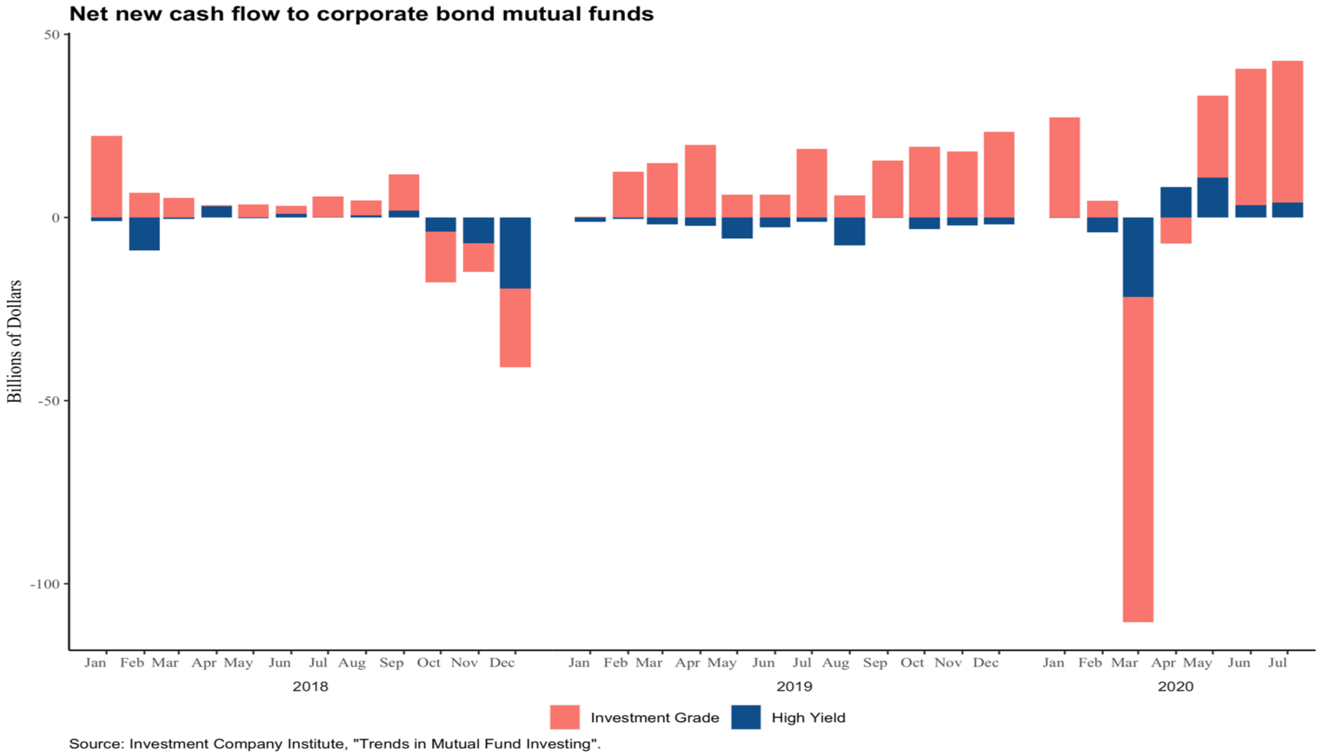


Haddad, Moreira, Muir (2020)

- Inv-grade bond spreads rose by more than CDS for the same bond
- But not for high-yield bonds
- Spreads reflect more than fundamentals
- Bid-ask measures rose more for IG bonds, and were higher than for HY bonds

Corporate bond mutual funds

- Outflows from investment-grade corporate bond mutual funds unusually large



- Implication from investor misperception of the reaction function –
- Prices are too high, and they will fall more if fundamentals deteriorate when investors also have to adjust their perceptions of the Fed’s reaction function
- Fed can clarify their objective function to reduce expected losses if fundamentals deteriorate

Summary

- Main Street – Paper offers additional changes to Main Street from model with credit frictions and aggregate demand externalities
  - Staged financing, but may need fees for banks to participate
  - May instead need a fundamental change, conditional loan forgiveness, with fiscal costs
- Corporate credit – Paper highlights potential high costs even if acting as a traditional LOLR
  - Agree with evidence that reaction function is not well understood
  - Could reduce this misperception, to help ensure the program continues to be successful