Money in the Time of Coronavirus

E. Saeidinezhad, Is the Monetary System as Systemic and International as the Coronavirus?

March 18, 2020

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The coronavirus crisis has sparked different policy responses from different countries. The common thread among these reactions is that states are putting globalization on pause. Yet, re-establishment of central bank swap lines is making "money," chiefly Eurodollars, the first element that has become more **global** in the wake of the Coronavirus outbreak. This is not an unexpected phenomenon for those of us who are armed with insights from the Perry Mehrling's "Money View" framework. The fact that the monetary system is inherently international explains why the Fed reinstalled its standing U.S. dollar liquidity swap line arrangements with five other central banks **just after** it lowered its **domestic** federal fund's target to zero percent. However, the crisis also forces us to see global dollar funding from a lens closer to home: the fact that the Eurodollar market, at its core, is a domestic **macro-financial linkage.** In other words, its breakdown is a **source of systemic risk within communities** as it disrupts the two-way connection between the real economy and the financial sector. This perspective clarifies the Fed's reactions to the crisis in hand. It also helps us understand the recent debate in the economics profession about the future of central bank tools.

The Great Financial Crisis of 2008-09 confirmed the vital importance of advancing our understanding of macro-financial

linkages. The Coronavirus crisis is testing this understanding on a global scale. Most of the literature highlights the impact of sharp fluctuations in ***long-term*** fundamentals such as **asset prices** and **capital flows** on the financial positions of firms and the economy. In doing so, economists underestimate the effects of disturbances in the Eurodollar market, which provides **short-term** dollar funding globally, on real economic activities such as trade. These miscalculations, which flow from economists' natural approach to money as a veil over the real economy, could be costly. Foreign banks play a significant role in the wholesale Eurodollar market to raise US dollar financing for their clients. These clients, usually multinational corporations, are part of a global supply chain that covers different activities from receiving an order to producing the final goods and services. Depending on their financial positions, these firms either wish to hold large dollar balances or receive **dollar-denominated loans***.* The **deficit** firms use the dollar funding to make **payments** for their purchases. The *surplus* firms, on the other hand, expect to receive payments in the dollar after selling their products. The interconnectedness between the payment system and global supply chains causes the Eurodollar market to act as a bridge between the real economy and the financial sector.

The Coronavirus outbreak is putting a strain on this link, both domestically and globally: it is disrupting the supply chain, forcing every firm along the chain to become a deficit agent in the process. The supply chain moves products or services from one supplier to another and is essentially the sum of all firms' sales. These sales (revenues) are, in effect, a measure of payments, the majority of which occur in the Eurodollar market. A sharp shock to sales, as a result of the outbreak, precipitates a lower ability to make payments. When an output is not being shipped, a producer of final goods in China does not have dollar funding to pay the suppliers of intermediate products. As a result, firms in other countries do not have dollars either. The trauma that the coronavirus

crisis injects into manufacturing and other industries thus leads to missed payments internationally. Missed payments will make more firms become deficit agents. This includes banks, which are lower down in the hierarchy, and the central banks, which are responsible for relaxing the survival constraints for the banking system. By focusing on the payments system and Eurodollar market, we are able to see the “survival constraint” in action.

The question for monetary policy is how far central banks decide to relax that survival constraint by lowering the bank rate. This is why central banks, including the Fed, are reducing interest rates to zero percent. However, the ability to relax the survival constraint for banks further down in the hierarchy depends also on the strength of foreign central banks to inject dollar funding into their financial system. The Fed has therefore re-established the dollar swap line with five other major central banks. The swap lines are available standing facilities and serve as a vital liquidity backstop to ease strains in global funding markets. The point to hold on to here is that the U.S. central bank is at a level in the hierarchy above other central banks

Central banks’ main concern is about missed payments of U.S. dollars, as they can deal with missed payments in local currency efficiently. In normal circumstances, the fact that non-U.S. central banks hold foreign exchange reserves enables them to intervene in the market seamlessly if private FX dealers are unable to do so. In these periods, customer-led demand causes some banks to have a natural surplus position (more dollar deposits than loans) and other banks to have an inherent deficit position (more dollar loans than deposits). FX dealers connect the deficit banks with the surplus banks by absorbing the imbalances into their balance sheets. Financial globalization has enabled each FX dealer to resolve the imbalance by doing business with some U.S. banks, but it seems more natural all around for them to do business with each

other. During this crisis, however, even U.S. banks have started to feel the liquidity crunch due to the negative impacts of the outbreak on financial conditions. When U.S. banks pull back from market-making in the Eurodollar market, there will be a shortage of dollar funding globally. Traditionally, in these circumstances, foreign central banks assume the role of the lender of last resort to lend dollars to both banks and non-banks in their jurisdiction. However, the severity of the Coronavirus crisis is creating a growing risk that such intermediation will fracture. This is the case as speculators and investors alike have become uncertain of the size of foreign central banks' dollar reserve holding.

To address these concerns, the Fed has re-established swap lines to lend dollars to other central banks, which then lend it to banks. These particular swap lines arrangements were originally designed to help the funding needs of banks during 2008. However, these swap lines might be inadequate to ease the tension in the market. The problem is that the geographic reach of the swap lines is too narrow. The Fed has swap lines only with the Bank of Canada, the Bank of England, the Bank of Japan, the European Central Bank and the Swiss National Bank. The reason is that the 2008-09 financial crisis affected many banks in these particular jurisdictions severely and their economies were closely intertwined with the US financial system. But the breadth of the current crisis is more extensive as every country along the supply chain is struggling to get dollars. In other words, the Fed's dollar swap lines should become more global, and the international hierarchy needs to flatten.

To ease the pressure of missed payments internationally, and prevent the ***systemic risk outbreak*** domestically, the Fed and its five major central bank partners have coordinated action to enhance the provision of liquidity via the standing U.S. dollar liquidity swap line arrangements. These tools help to mitigate the effects of strains on the supply chain, both

domestically and abroad. Such temporary agreements have been part of central banks' set of monetary policy instruments for decades. The main lessons from the Coronavirus outbreak for central bank watchers is that swap lines and central bank collaborations are here to stay – indeed, they should become more expansive than before. These operations are becoming a permanent tool of monetary policy as financial stability becomes a more natural mandate of the central banks. As Zoltan Pozsar has recently shown, the supply chain of goods and services is the reverse of the dollar funding payment system. Central banks' collaboration prevents this hybridity from becoming a source of systemic risk, both domestically and internationally.

Update: On March 19, 2020, the Fed announced the establishment of temporary U.S. dollar liquidity arrangements with other central banks such as Reserve Bank of Australia, the Banco Central do Brasil, the Danmarks Nationalbank (Denmark), the Bank of Korea, the Banco de Mexico, the Norges Bank (Norway), the Reserve Bank of New Zealand, the Monetary Authority of Singapore, and the Sveriges Riksbank (Sweden).

Special Edition: Money in the Time of Coronavirus

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Prompt for Discussion

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The financial strains brought by the coronavirus outbreak feel strangely reminiscent of 2008, and yet, markedly different. In the United States, at the writing of this prompt, the S&P 500 has crashed 25%, and the federal funds target rate is once again moving towards the zero bound. The treasury securities market is in disarray, and the Federal Reserve is set to increase its repo lending by over one trillion. In Washington, the administration's insistence that concerns were overblown is now replaced with negotiations over the size and shape of a stimulus package. "I don't want to use the b-word", said a senior administration official about plans to support distressed industries, like airlines. The b-word is, of course, bailout.

So far, so 2008. But the monetary dynamics we are witnessing in the time of corona also take us into new territory. The proximate cause of the crisis past came from within the financial system itself: the housing credit bubble and abuses in subprime lending. The corona crisis, on the other hand, emerges from a material threat to human health. Where the 2008 crisis revealed the vulnerabilities of *financial* globalization, the corona crisis is disrupting the global *production* system, upending supply chains, and threatening shortages in essential inventories.

We wonder about the extent to which the policy arsenal of 2008

can contain the dislocations currently occurring, and what, exactly, stimulating consumer demand means when the consumer herself is in quarantine. Moreover, the crisis response to the corona crisis is taking place within an institutional setting that was itself reshaped by the 2008 crisis reforms. As corona strains unfold, it remains to be seen whether the promise of financial resilience will be borne out, or whether fundamental design flaws left in place will frustrate reformers' efforts.

In this Special Edition Roundtable, JM invites contributors to provide live analysis of money in the time of corona, here in the U.S., and around the world.

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Contributions

June 29, 2020
Roundtable Wrap-up
Sannoy Das, Harvard Law School

May 21, 2020
Human Capital Bonds and Federal Reserve Support for Public Education: The Public Education Emergency Finance Facility (PEEFF)
Gerald Epstein, University of Massachusetts Amherst

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The Fed Should Bail Out Low-Income Tenants and Not Just Banks and Landlords
Duncan Kennedy, Harvard Law School

April 29, 2020
Getting to Know a Brave New Fed
Oscar Perry Abello, Next City

April 10, 2020
The Problem with Shareholder Bailouts isn't Moral Hazard, but Undermining State Capacity
Carolyn Sissoko, University of the West of England

April 2, 2020
Crises, Bailouts, and the Case for a National Investment Authority
Saule Omarova, Cornell Law School

March 31, 2020
Why the US Congress Gives Dollars to the Fed
Jens van 't Klooster, KU Leuven and University of Amsterdam

March 26, 2020
A Fire Sale in the US Treasury Market: What the Coronavirus Crisis Teaches us About the Fundamental Instability of our Current Financial Structure
Carolyn Sissoko, University of the West of England

March 25, 2020
The Democratic Digital Dollar: A 'Treasury Direct' Option
Robert Hockett, Cornell Law School

March 22, 2020
Derivative Failures
James McAndrews, TNB USA Inc. and Wharton Financial Institutions Center

March 20, 2020
The Case for Free Money (a real Libra)
Katharina Pistor, Columbia Law School

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The Monetary/Fiscal Divide is Still Getting in Our Way
Leah Downey, Edmond J. Safra Center for Ethics at *Harvard University*

March 18, 2020
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March 17, 2020
Here We Go Again? Not Really
Dan Awrey, Cornell Law School

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Nadav Orian Peer, Colorado Law

March 16, 2020
Beyond Pathogenic Politics
Jamee K. Moudud, Sarah Lawrence College

March 15, 2020

Economic and Financial Responses to the Coronavirus

James McAndrews, TNB USA Inc. and Wharton Financial Institutions Center

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Promises All the Way Down: A Primer on the Money View

Author: Elham Saeidinezhad

It has long been tempting for economists to imagine "the economy" as a giant machine for producing and distributing "value." Finance, on this view, is just the part of the device that takes the output that is not consumed by end-users (the "savings") and redirects it back to the productive parts of the machine (as "investment"). Our financial system is an ornate series of mechanisms to collect the value we've saved up and invest it into producing yet more value. Financial products of all sorts—including money itself—are just the form that value takes when it is in the transition from savings to investment. What matters is the "real" economy—where the money is the veil, and the things of value are produced and distributed.

What if this were exactly backwards? What if money and finance were understood not as the residuum of past economic activity—as a thing among other things—but rather as the way humans manage ongoing relationships between each other in a world of fundamental uncertainty? These are the sorts of questions asked by the economist Perry Mehrling (and Hyman Minsky before him). These inquiries provided a framework that has allowed him to answer many of the issues that mystify neoclassical economics.

Saeidinezhad, Elham. “Promises All the Way Down: A Primer on the Money View,” Law & Political Economy, February 28, 2020, Accessible at: https://lpeblog.org/2020/02/28/promises-all-the-way-down-a-primer-on-the-money-view/#more-3296