Can the COVID Bailouts Save the Economy?

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Summary

- Very interesting and timely paper
- Extremely useful, transparent, and concise discussion of US policies in support of corporate sector
- Model delivers instructive non-linear effects from multiple shocks
  - Frictions for both corporates and financial intermediaries
- Useful quantification of effects of different measures
  - Reasonable mapping of actual policy measures into model
  - Critical to evaluate policy design

Model Basic Mechanism

- Firms use current profits to pay employees, remunerate capital, and serve their debt,
- Firms hit by sufficiently large negative shock default on their debt
- Liquidation costs imply deadweight loss from defaults
- Financial sector acts as an accelerant of crisis:
  - Bank losses and increased risk lead to higher spreads
  - Higher spreads reduce investment giving crisis a long shadow
- Government debt increases on the back of recession and financial sector support

Characterization of COVID Shock

- Combination of five ingredients (mostly supply-side):
  - Increase in uncertainty
  - Greater dispersion of firm-specific productivity
  - Decline in average productivity
  - Reduction in labor supply
  - Awareness of potential future pandemic

- Demand side could be developed
  - Little role here for direct transfers to households
  - Can we approximate drop in revenue due to demand shock with productivity decline?

A Corporate Liquidity Crisis

- **Key friction**: Firms must service debt before raising new debt/equity
- Forces illiquid firms into bankruptcy
- Friction fully justifies government intervention:
  - Obvious benefits from preventing liquidation of illiquid but solvent firms
- It also makes intervention relatively cheap:
  - Grant element in PPP is the exception
  - Similar to LOLR in banking crises context
  - CBL approach makes sense
  - Can we achieve similar results through forbearance/standstills?

Illiquidity versus Insolvency

- Is this just a liquidity crisis?

- Elements of illiquidity:
  - Knightian uncertainty about pandemic may curtail credit availability
  - Impact on financial sector (but CB policies took care of most of this)

- Immediate solvency problems for sectors most affected by crisis:
  - Transportation, tourism, entertainment,….
  - Pent up demand effects likely smaller than for other industries
  - Capacity constraints

- More widespread issues if pandemic lasts longer than expected

Policy Implications of Solvency Crisis

- Magnified moral hazard issues with liquidity support
- More difficult to justify government intervention
  - Systemic firms/sectors
  - Post-lockdown back to standard macro levers
- Tradeoff between preserving economic relationships vs promoting reallocation of resources
  - Time matters
- Governance:
  - Fiscal costs likely much larger
  - Not really a job for CBs