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HOW FAR CAN CENTRAL BANKS GO IN RESPONSE TO CORONAVIRUS?

There is always discussion among economists about what will cause the next global slowdown. A private debt bubble, growing trade tensions or an oil price shock were all being mooted as possible causes. A global pandemic, however, was further down the list

But the IMF has already downgraded its global growth forecasts for 2020 in the wake of the coronavirus outbreak, predicting growth in 2020 to be lower than in 2019.

While first and foremost a health crisis, coronavirus poses difficulties for the world economy. The virus is already having a significant impact on the tourism and leisure industries, and global supply chains and stock markets across the world have been hit. It might be many months before the full extent of the economic impact is clear. Therefore, while doctors deploy plans to contain the spread and scientists' race to develop a vaccine, policymakers have to develop plans to mitigate any economic fallout. It might seem callous to be concerned about economics when people's health is at risk. But without measures to support the economy, the risk is that what begins as a public health crisis ends up having a lasting impact on people's livelihoods.

The US Federal Reserve acted in response to what it sees as the 'evolving risks to economic activity' posed by coronavirus. In a surprise move, it cut its federal funds target by 50 basis points on 3rd March. This follows rate cuts by The Reserve Bank of Australia and the Bank of Canada and moves by the People's Bank of China to inject liquidity into the financial system. Markets are expecting further rate cuts by the Federal Reserve.

However, there are those who doubt how effective monetary policy can be in response to a shock such as coronavirus. Initially, the impact manifests itself on the supply-side of the economy: people having to take time off work and disruption to global supply chains. Simply cutting interest rates is not going to mean workers are suddenly able to show up to work. And conventional thinking suggests that simply cutting rates in response to a supply-side contraction is a recipe for higher inflation. But it's impossible to separate supply and demand. As soon as there's an impact on consumer and business confidence - what Keynes called 'animal spirits' - there is a corresponding impact on demand. If households believe they might have to take time off work, they will become more cautious about their spending, saving any extra money. If people do have to take time off work, many won't be entitled to sick pay. This all reduces demand.

Likewise, if firms are worried about their supply chains, they will hold back from any unnecessary investment. This means that any shock that initially affects an economy's supply-side can quickly evolve into a problem of insufficient demand.

It is here where monetary policy can have some effect. Lower interest rates - reducing borrowing costs - mean firms are better able to weather any increase in costs that result from supply chain disruption. A rate cut should also support economic recovery when the disruption caused by coronavirus has subsided. At the moment, there is a feeling that the economy will take a hit in the short term but will then continue on a similar growth path (a "V" shaped economic hit). Rate cuts will support recovery.

There is a need for monetary stimulus to be coordinated across central banks. Without coordination, spillovers across economies can blunt effectiveness (especially if you're trying to deal with global supply chain disruption). While the context is different now, there was a high degree of monetary policy coordination in the wake of the 2007 Global Financial Crisis (GFC).

Besides rate cuts, targeted support for firms affected by the coronavirus can help them deal with short-term cash flow issues. This is a step that the Bank of England's incoming governor, Andrew Bailey, has suggested.

There is also a need for greater government spending, especially given the limited policy room available to central banks. Fiscal policy can be more precisely targeted at those requiring support. Elizabeth Warren, a former Democratic presidential candidate, has proposed a $400 billion package aimed at supporting those affected by the coronavirus outbreak. Measures would include making sure any American without health insurance suffering from the virus can be treated for free.

Others have suggested temporary, highly targeted fiscal relief for households and businesses. Proposals include a temporary cut in payroll taxes, sending households a flat amount in cash, and giving firms a 'short-term tax holiday'. The key is to make sure support is well targeted, timely, and works to minimize any financial difficulties caused by coronavirus-related disruption.

While predominantly a health crisis, economic policymakers need to be taking coordinated steps alongside healthcare professionals. This will help to limit any economic fallout. While monetary policy can help to support recovery, fiscal policy can be more precisely targeted at those that most need support, meaning it should make up the bulk of any stimulus package. This would signal a change in policymaking: since the GFC there has been an over-reliance on monetary policy to rescue the economy.

Should you require further information or advise, please do not hesitate to contact your Clarus Capital relationship manager.

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