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Reflections on the health and financial crisis*

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1. Why has the emergence of this virus caused economic and social unrest on the scale we are seeing today?

There is, of course, the novelty of this extremely virulent disease and the fact that it has spread very rapidly, first in China and then to all other regions of the world. Most hospitals are simply not equipped to receive the "peak" of new cases and this is why the hospitalisation curve must be "flattened" by limiting it to the most serious cases requiring resuscitation.

In the absence of a vaccine which some experts feel could take up to one year to develop and deploy and of sufficient screening capacity - which is absolutely essential but lacking in many countries -, it is necessary to use population containment to try to stop the contagion. However, this containment is the most disruptive aspect of the situation. It causes many segments of the economic machine to grind to a halt and acute drops in turnover in fundamental sectors of the economy: air transport, automobiles, tourism, catering, trade, even threatening supply chains.

The extent of uncertainty about this exogenous shock to economic activity is evident across all financial asset classes worldwide.

However, what is said less is perhaps just as worrying.

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2. The coronavirus is not the cause of what is happening to us financially, but it is a powerful amplification factor on ground already heavily mined

For the first time in a long time, the announcement of interest rate cuts and massive bailout plans did not, initially, automatically calm the markets. It took promises of hundreds of billions of fiscal dollars and euros, whipped up by many impecunious governments, to start dissipating the widespread scepticism and concern, bordering on panic from swathes of investors. In Q1 the major stock markets have fallen by at least 20%, most of this fall in the last few weeks.

Why? It is because the economic territory - the “mine field” in which we live and work - is in a far worse position than we have been prepared hitherto to acknowledge.

As a result of monetary policies that have been accommodating for too long, the debt ratio of states and societies has surpassed all peacetime records. We witness that the growth in overall debt has been 50% since the last crisis. The asset bubble that was favoured by cheap debt - including the so-called risk-free government bond bubble - is now abating. We had become accustomed to a situation where the announcement of money creation through massive purchases of sovereign securities by central banks was welcomed by the markets as a source of comfort and a sign of commitment by public authorities. In fact, for quite some time, the value of securities rose as their rates fell below zero, thus favouring borrowers.

However now the rot has set in. Risk premiums had virtually disappeared in this environment of low or negative rates and we lived with an illusion that seemed limitless. As long as growth lasted, mediocre - or even downright bad - signatures of all forms and supposedly adequate ratings were considered by investors to be of sufficient quality and the search for a little yield pushed them to take unwise risks which are concurrently, undervalued by financial markets.

In this context, the risk of a serious crisis was dangerously close even before the virus struck; the slightest sign of economic slowdown was enough to instil fear in the market that the “good times“ were over and the storm was beginning. In fact, the first defaults were already appearing among the most vulnerable borrowers (e.g. issuers of highyield securities and BBB-rated companies, which account for more than half of investment grade corporate debt, companies whose financial cost/income ratio has deteriorated considerably).

To cope with these defaults, fund managers had to sell liquid assets; hence the decline in gold and sovereign securities seen some time ago. There are fears that these movements will be amplified by the rapid deterioration in economic conditions and the huge asset bubbles that have been allowed to swell indiscriminately.

3. The seriousness of the situation requires action despite the weak financial environment

Given the gravity of the situation (there is talk of negative growth of 5 GDP points or more in 2020) and the uncertainty as to its duration (the most common assumption being that the spread of the virus will be reversed in the second quarter of 2020, but this seems increasingly less certain), we must be prepared for a very large economic shock.

Immediate resources are rightly beginning to be deployed: increased bank liquidity, almost unlimited absorption of sovereign securities by central bank purchases, government guarantees granted - in France, Germany, UK, Spain and others in particular - for loans to affected companies, deferred payment for loans, social security contributions, taxes, etc., facilities granted for short-time working, use by banks of their counter-cyclical cushions, etc and most recently strong pressure on banks to jettison dividends and variable pay bonuses this year so as to increase credit supply.

Some of these schemes will be very costly for public finances, notably the financing of short-time working. And this at a time when budgetary and monetary room for manoeuvre is very limited due to the inadequate management of the post-financial crisis of 2008 by a number of States.

But the present hour leaves no choice. It requires action to be taken in spite of the weak financial environment, which is bound to deteriorate further.

All the pins are getting pulled one after the other: in the United States, the monetary financing of the Treasury has become unlimited and private securities are accepted as collateral by the FED. In Europe, the European Central Bank has potential purchases of securities worth 1,000 billion euros. The rules of the European Stability Pact are suspended and, in fact, the national support and recovery plans (Germany 750 billion euros, France 350 billion, Spain 200 billion) are incompatible with these standards.

4. Still, it is necessary to keep reason

So the valves are open. But we must keep and stick to clear principles. The severity of the crisis requires providing the economy with the necessary liquidity to allow the granting of credit, which is essential for economic survival.

On the other hand, the suspension of the rules governing the budgets of the Eurozone Members, compliance with which is the very basis of the viability of the Single Currency, is a decision of major importance. Member States will have to return to this in a coordinated manner based on a more effective fiscal framework if the Monetary Union is to be maintained.

The present situation does not justify helicopter money. In a health crisis such as the one we are going through with the confinement of populations, the priority does not seem to be to give monetary subsidies to consumers who are having a hard time buying anything, but to enable businesses to survive by means of credit. If the poorest and most affected households are to be helped, this should be done through social benefits; in a democracy, money should not be the agent of social policy.

The top priority is to enable companies to continue their business. This may require the use of direct loans from financial institutions, public guarantees for bank loans, extension of maturities and even, where necessary, conversion of non repayable loans into capital subscribed by public authorities. This would be a more efficient way than using helicopter money and could contribute to a healthier and swifter recovery for companies with a sufficient equity base.

The idea that states can compensate for everything by exposing their balance sheets is unfortunately, in part, an illusion. Indeed, most States have fragile balance sheets with monumental debts and the extension - which some would like to see unlimited - of these financial capacities obviously raises the essential issue of the sustainability of deficits - except if one agreed that all incremental expenses were to end up for ever on central banks' balance sheets. However, such an approach would ultimately lead to the systematic monetisation of all deficits, which would affect stability and confidence in the currency. Given the heterogeneity of fiscal performance across euro-area Member States, this approach would most probably be incompatible with the functioning of monetary union. In the longer turn, such a result would mean that the market economy would eventually become an economy largely directed and owned by the central bank, which poses an existential problem.

5. The truth is dark

Of course, the public authorities are once again seeking salvation in an "easing" of monetary and fiscal policy, even if it means increasing the leverage of an already overexposed financial system. Hence the key rate cuts announced by some central banks and the use of new quantitative easing (QE) programmes.

However, given the existence of already very low rates that make these cuts ineffective - in a context where it is less a question of benefiting from lower rates than of surviving the closure of companies - and given the lack of margins for raising taxes, these promises of massive bailouts are tantamount to announcing new issues of debt securities. Central banks can certainly be expected to ensure the success of these issues through their purchases of securities. This, in fact, would be tantamount to wanting to compensate for the real losses caused by the recession (or depression?) through money creation.

Is such a headlong rush viable? Won't the markets one day worry about the inflationary consequences of a new full monetary "put"? Admittedly, inflation is still low and the markets do not expect it to ratchet upwards, but after an accumulation of money creation in the face of reviving consumption, future inflationary pressures seem possible, leading to greater social inequality.

6. Post-COVID19 questions

We must think now about the post-crisis period. A few orders of magnitude on the eve of the crisis provide food for thought:

- World GDP: $85,000 Billion
- Global Market Capitalisation: $20,000 Billion
- Balance sheets of the largest central banks: $18,000 Billion

If we were to assume that governments decided to “compensate“ by additional public spending for let us assume a 3 to 5 percentage point decline in world GDP and that they undertook to counter the stock market crash “à la japonaise“, this would result in central banks’ balance sheets being increased by about half. Certainly, this has already been done in 2008. Can this be repeated over and over again, and what kind of future is there for us?

Can we pretend that money creation can exempt our societies indefinitely from having to face the question: “who will pay?” Can moral hazard be institutionalised and perpetuated as many reckless actors wish? Guaranteeing to any market player that they will never make a loss and that the result of their investments, however imprudent, will always be favourable would be a dangerous solution to the problems.

Do we seriously believe that unlimited issuance of sovereign securities will never come up against fundamental questioning of the markets as to the solvency of States? Some say so, but who will believe them? One of the consequences of this exacerbation of public debt is obviously the increase in taxes with the problems of tax competition between states, competitiveness of companies and saturation of fiscal capacity in many states.

How can we encourage a return to healthy growth in a zero-rate environment that encourages the hoarding of liquidity to the detriment of productive investment, in economies that are often over-indebted and where populations are demanding more protection from the State? Is capitalism at the end of its tether, and how will we face growing calls for the universally protective state?

What is going to happen to the euro zone, where the heterogeneity of deficits and public debt, and therefore of tax margins, is particularly marked and where the sense of solidarity that should prevail in the Union seems once again to have evaporated?

When we think of the complexity of the challenges: normalisation of a monetary policy in deadlock, response to the climate danger, the need to re-establish an international monetary order to avoid competitive devaluations, teaching our fellow citizens that structural reforms cannot be indefinitely postponed through monetary creation etc, one wonders with real concern whether our methods of government and cooperation will be able to rise to the challenge. We are witnessing the self-isolation of States, the random, uncoordinated closing of borders. EU Single Market rules being switched off at will. This is reminiscent of the inter-war period when states engaged in competitive devaluations and tariff protectionism.

7. Outline of initial responses concerning Europe

Interest rate differentials in the euro zone widened with the crisis until the ECB intervened, exposing the fragilities that remain due to the still incomplete European architecture of the Economic and Monetary Union, be it the failure to comply with the criteria of the Stability and Growth Pact since the early 2000s, the lack of symmetry in current account adjustments, or the still incomplete banking and capital market unions etc.

Today we should start with a simple political and ethical principle: EVERYTHING must be done to stop the spread of the virus. Other considerations should be put on the backburner until the health situation has been restored.

It follows from this principle that a number of initiatives should be taken urgently in a spirit of solidarity. For example:

- Finalisation of the agreement - pending for 2 years - on the European Union’s budget (with sufficient resources to deal with the epidemic)
- Issuance of token amount of corona bonds with European signature to finance exclusively the additional health expenditure due to the virus
- Use of the European Stability Mechanism for specific financing of Member States centred on the virus
- Finalisation of the Banking Union and of a real resolution system, making it less vulnerable to economic shocks
- Political agreement on the principles governing “re-entry” after the crisis: implementation of structural reforms which are the only way to increase the growth of our economies, conditional restructuring of public debts which have become unsustainable, restoration of a renewed and finally effective Stability and Growth Pact which should be based on the area’s debt capacity and on effective discipline being practiced by the member countries, etc.

8. And after the pandemic, what societies will we have?

We must not believe that, once the epidemic is over, everything will return to the old order.

We must prepare for a paradigm shift, and it is better to organise this change on a negotiated and cooperative basis than to allow it to be imposed. This was the case with the unfortunate "Washington consensus» that shaped the world from the 1980s onwards and whose dogmatism contributed to the disaster.

8.1 The pandemic will leave traces that cannot be ignored.

- The size of public credits and guarantees offered to enable companies to get through the economic downturn will pose the following problem: a substantial part of these debts will not be able to be repaid at least in the medium term since part of the activities maintained by these credits inevitably will result in unrecoverable losses.
- As a result, treasuries will become capital investors. They will therefore have to answer the question: what type of shareholders will they be? Passive and non-voting or inclusive and willing to play a strategic role at the corporate level?
- The importance of the answer to this question should not be concealed. It is in fact a matter of choosing between a return to traditional liberal capitalism or an active state that would play a decisive role in industrial strategy.

8.2 The overhang of certain public debts will also have to be addressed.

Public debt will, in a number of cases, exceed the limits of sustainability. Some restructuring will therefore be necessary to avoid the growth brakes and market disruptions that come from this excessive debt.

This will require a pragmatic restructuring process that should be de-dramatised and carried out in close cooperation with the markets. But if the governance of the restructurings that have become inevitable is similar to the one that brought us to where we are now, the results will be painful.

We no longer have the luxury of pretending that this problem does not exist. However, this restructuring process can only succeed if debtors commit to more prudent financial management.

8.3 The question of globalisation must also be addressed.

Without denying the benefits of an open trading world, the WTO will have to be rethought to enable it to effectively combat the abuses of certain players in world trade, abuses that we have suffered almost without protest for years. World trade needs a binding dispute settlement body that is efficient and fair to all. Otherwise it is the law of the jungle, dominated by the biggest to the detriment of all others.

Relations between Europe and China will have to be rethought by a Europe that has become less tolerant but more aware of its own interests.

8.4 If genuine global cooperation is to be achieved, the international monetary system must also be reorganised.

Indeed, the "non-system" in which we live has a great disadvantage: the absolute freedom that reigns in exchange rate matters raises suspicion.

The easing of monetary policies by some countries is often seen as a disguised way of depreciating their exchange rates. This provokes accusations of exchange rate manipulation and encourages trade wars.

In fact, since the end of the war, we have never been so close to the situation of the thirties ("beggar thy neighbour").

Everything leads one to ask a number of questions that had been lucidly addressed by Robert Triffin:

- How to introduce some stability and order into exchange rate movements (anchoring on a basket of major currencies or on a sample of raw materials)?
- How can we avoid the drawbacks of a system whose supply of international liquidity depends exclusively on a national currency, the dollar?
- How can effective surveillance of the new system be organised around the IMF?

- How can we ensure that the international monetary system is more symmetrical and does not rely exclusively on debtor countries for the adjustment effort?

It is high time to start discussing these issues. So far we have accepted the "non-system"; because the dollar's hegemony has been relatively benevolent.

But now that the world is becoming multi-polar and less consensual and that the United States is increasingly using the dollar for diplomatic and political purposes, an agreement between the United States, China and Europe seems essential for the future.

8.5. Nor will we escape an even more fundamental question: that of the model of growth and society that will have to be developed after the crisis.

Is economic nationalism the way forward? Two factors contribute to this:

- The search for social protection which has manifested itself during the pandemic. Public opinion clearly wants hospital services that are better adapted to major pandemics which, according to many forecasts, will multiply in the coming decades.

- De facto nationalisation implies surreptitiously a monetary policy that would continue to insure all economic actors against the risk of failure. Unlimited repurchase programmes by central banks of securities depreciated by the markets amount to a form of collectivisation of individual companies, and therefore of the risks involved.

These two factors cannot work concurrently. Indeed, if we consider the percentage of public expenditure in relation to GDP reached by a country like France (53% before the pandemic), we may wonder what margin will be available for large additional social infrastructure programmes.

The answer is that if we want to return to a normal situation where interest rates are positive in real terms to ensure productive investment, we will have to proceed "A la Suédoise" in some countries such as France. The Swedish authorities have radically changed, by reducing public expenditure, to eliminate everything that is not essential.

If countries do not undertake these reforms with a minimum of coordination and discipline, the future of the euro will be jeopardised.

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Why this article? Because, even if the "over-financing" of the system leaves us with little choice today, it is essential that we ask ourselves, this time at least, the questions about the "post-crisis". We can no longer afford the luxury, once the shock of the pandemic has passed, of falling back into the same rut of ease, postponing indefinitely the real issues.

Not to think about it now would be tantamount to de facto accepting as a principle - which has led us to disaster - that unlimited money creation is the only way to respond to the fundamental problems, to those of future generations. Otherwise, we will face one recurring crisis after another.

After the war, the first thing to do is to clear the landmines.

About the author

Jacques de Larosière entered the French Treasury in 1958 where he worked mostly on international financial matters. From 1974 to 1978 he was Undersecretary for Monetary Affairs. He was elected Managing Director of the International Monetary Fund (IMF) in 1978, a position which he held until 1987, when he was appointed Governor of the Bank of France. From 1993 to 1998, he was President of the European Bank for Reconstruction and Development (EBRD).

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