The three-headed crisis: pandemic, economic and financial

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On the financial markets, the “black swan”, feared by those who, like me, thought that the possibility of the occurrence of a powerful financial crisis was singularly on the rise, has taken the form of the coronavirus.

And since, through the almost global confinement measures, this pandemic alone has abruptly brought production to a standstill, it has submerged us in a crisis of unprecedented violence taking the shape of a pandemic crisis, an economic crisis and a financial crisis.

It has arrived against a backdrop of extreme financial vulnerability, the result of an accumulation of high risks over the last few years on the part of lenders and investors alike. The latter trend itself owes to an overly long period of extremely low interest rates. All of which makes the financial crisis resulting from the coronavirus that much stronger and dangerous.

As a result:

- The money market has shut down and banks can no longer finance themselves, even for three-month periods, except for central banks, which fortunately are taking action;
- Securitisations are no longer being invested and the conduits of investment banks carrying securitised assets are no longer financing on the money market, requiring them to finance their “warehousing” themselves and carry all the risks that they involve;
- More and more investment funds are no longer able to respond to margin calls and some are going bankrupt. And I am afraid this is just the start;
- It is pointless commenting on the equity market, which appears bottomless thus far;
- Meanwhile, risk premiums on bonds, after being far too low, are now increasing rapidly, making life hard for many investors.

Numerous businesses that previously were over leveraged are finding it difficult to refinance. In the United States, this has been reinforced by share buybacks by the companies themselves, which has become a common practice for generating artificial returns for shareholders.
In addition, shale gas firms, generally small and highly leveraged, are being brought to their knees by the oil prices on the international markets. Which in turn is seriously impacting the banks and funds that have provided them with substantial financing.

A vicious circle is emerging that I have pointed to as a threat since my conferences last summer on the clearly visible rise of financial vulnerability and the preparation for the future financial crisis. Given the violent deterioration in company cash flows and the very high pre-existing debt levels of numerous

businesses, the ratings agencies have begun to downgrade corporates across the board. Around half of the companies rated in the OECD countries are in the BBB category. If these businesses lose a grade, they drop out of the investment grade category and into the speculative category. This will necessarily require a number of funds committed to holding only corporates with investment-grade scores to sell them, leading to an ever-steeper rise in spreads.

And this will generate further contractions in share prices. Fortunately, the central banks have committed to buying considerably more corporate bonds. Hopefully, this will suffice to quell the vicious circle.

The central banks have acted soundly and swiftly, even though I ascribe the strong financial vulnerabilities that have significantly heightened the current financial crisis to the fact that they failed to exit their unconventional policies in time and thus pushed the financial cycle upwards owing to extremely low interest rates for far too long, “to low for to long”. They encouraged borrowers and lenders/financiers, including numerous investment funds, pensions funds and insurers (more on average than banks), to take reckless risks.

We are also fortunate that governments are reacting well on the whole in terms of shouldering the cost of this unprecedented decline in production, while protecting as much as possible the financing of businesses, i.e. the financing of their temporary operating losses. To avoid layoffs and bankruptcies as much as possible, governments are supporting the cost of work at companies that, with little or no revenue, can no longer pay their employees.

Governments are temporarily suspending the monetary constraints, which in normal times are vital to the efficient functioning of the economy, applying to the various economic agents, businesses and households. But this monetary constraint would be completely catastrophic if it were to apply in such a period. For their part, the central banks have momentarily(?) suspended the monetary constraints of countries, while endeavouring quite rightly to ensure the liquidity necessary to the entire economic and financial system.

Let us hope that this transitional phase is as short as possible, though it is clear that the recovery will be difficult and far from immediate, as supply chains – and value chains –cannot instantly resume their correct functioning. The lifting of confinement measures, either country by country or all countries at the same time, will probably not happen at once or in simultaneous fashion.

Furthermore, once the health crisis is truly over, the exit from the exceptional suspension of monetary constraint will not be an easy matter. It will be long and hazardous. We must avoid causing a flight from currency, the latter having value only if trust is placed in the effective exercise of monetary constraint, and thus trust in banks and central banks which are supposed to enforce it.

The end of confinement could also be accompanied by high risks of mistakes in economic policy that, under the influence of emotion and pressure from public opinion, could seek to return to orthodoxy either too swiftly or too slowly. Moreover, at a time when all purchasing power needs to be harnessed and when we need everyone’s energy and entrepreneurial spirit to stimulate both supply and demand, it would be politically unsound to generate a massive increase in taxes, either on income or wealth. A strong policy of structural reform, one that increases the potential growth level rather than decreasing purchasing power, will be essential, along with a policy on bolstering demand.

We will need to accept budgets with very gradual reductions in deficits and monetary policies that will transition back from their unconventional practices slowly and on a cautious basis. And all of this with a sufficiently clear time frame to maintain trust in country debts and currency.

This, then, is my analysis, offered with all the modesty called for in this entirely unprecedented situation.