Letter n°15

Wall Street against "Main Street". How to manage the crisis?

« An art of living in times of disaster » Albert Camus speech in Stockholm

Savouring the rise of the markets as much as abominating the cause, such is the feeling of many investors. A price recovery that delights as much as it carries scepticism, and almost eclipses the depth of the recession. Some investors who invested as early as the end of March are as happy as they are uncomfortable reading the economic statistics. Never has a recession affected the world so suddenly, so broadly and so deeply, never have financial markets recorded such a rapid recovery in prices and never have the spreads at the heart of the crisis been so narrow despite the divergent financial situations. In the meantime, in the short time between the collapse of the markets and their recovery, central banks and governments seem to have invented what ***Albert Camus***, when he was awarded the Nobel Prize for Literature, described as the art of living in times of disaster.

In the two notes on Wall Street against "Main Street", comparing the evolution of stock markets to that of economies, we will firstly focus on the crisis management and secondly on its consequences. To the disarray caused by the virus (Part 1), governments responded with unprecedented measures, a halt in the economies for two to three months, followed by a massive recovery, financed by budget deficits mostly monetized by central banks (Part 2).

The concern of the countries:

The concerns of countries are budgetary, social, financial.

Budgetary concerns:

Before this crisis, few countries had a budget surplus: South Korea at 2.8% of GDP, Germany at 1.9% of GDP, and of course, Switzerland, the paragon of virtue. Few countries were able to reduce their debt in recent years of growth. The low intervention capacity of already indebted states is noticeable, and this raises the question of support for fragile companies. It is true that private savings have reached extraordinary levels in many countries, but what can be done with these savings in a context of record public debt?

Budgetary measures, as a percentage of GDP, are at unprecedented levels often exceeding 10%, and take various forms: stimulus plans, moratorium on charges, VAT deferral. The aim is to preserve the economic framework. In other words, governments are taking on debt risks in order to ward off high unemployment; public debt/GDP ratios which have risen by 15 to 25%, will reach levels not seen since 1945. But the margin is narrow, because the fundamental issue at stake in this budgetary expenditure, beyond spending to support businesses and the unemployed, should be investing in innovation and education to increase productive potential.

In order to contain public debt, one could imagine that countries would transform loans granted to companies into equity and thus be able to potentially make profits in a few years to repay the debt. This would be equivalent to setting up a sovereign fund that would quickly become profitable, an undeniably attractive idea but this would also give rise to other problems, such as state interference in the management of a private company. This is the state angle and ***Jacques de Larosière*** proposes a comparable measure to allow companies to get out of the debt spiral by converting loans into capital so as not to constrain companies.

Social concerns:

Concerned by social movements, alarmed by widening inequalities between generations with the young having difficulties to find a first job, concerned by possible political unrest, governments are trying all means to erase the effects of a recession, to smooth cycles, to restore confidence and to assist changes in production systems.

In the United States, the recovery in the labour market, with 7.5 million jobs created in May and June, mainly in commerce, seems to be running out of steam. Federal aid of $600/week paid to 25 million workers at a cost of $15 billion a week may have to be extended by Congress beyond the end of July, since 15 million jobs have still been lost since February. Many cyclical companies, heavily indebted through leveraged buyouts, could struggle to pay off their debts, go bankrupt and this would worsen unemployment.

In order to finance these programs, governments are advancing on the crutches offered by central banks. Even German politicians are flouting the objections of their Constitutional Court in Karlsruhe and have authorised Bundesbank to continue buying government bonds. The German government is not skimping on aid, because orthodoxy is less necessary in a context of zero or negative interest rates. Compared to the €60 billion released to help industry in 2008, this year it has announced a first plan of €450 billion, more than 13% of GDP, and a second plan of €250 billion should be implemented. Angela Merkel has also evolved and joined Emmanuel Macron's idea of a €750 billion European rescue plan, of which €390 billion is financed by mutualized debt.

Financial concerns:

Far is the warning of ***Reinhart*** and ***Rogoff*** that government debt in excess of 90% of GDP would jeopardize economic growth. A debatable idea as demonstrated by Japan, thanks to its domestic savings, which seems to bear a public debt at 2.5x GDP; while Argentina, with a debt close to 90% of GDP, is restructuring its debt for the second time in less than twenty years.

Modern monetary theory, which was criticized and dismissed, has suddenly gained an audience. If it has been able to find support from decision-makers, it is because it offers leeway to governments lacking financial resources. "***Nothing stops an idea whose time has come***" said ***Victor Hugo***, debt ratios have continued to deteriorate and diatribes about debt have been denounced. Our societies are driven by a preference for the present, affected by chronic dissatisfaction, characterized by the impatience of populations, and therefore governments have chosen the easier way out by borrowing from future generations. Objection overruled by ***Olivier Blanchard***, who argue that if the cost of debt is lower than the growth rate of the economy, then debt as a percentage of GDP decreases.

Taking a country into debt at a low rate to improve infrastructure, productivity and potential growth is a possible shock absorber for the crisis. Nevertheless, Italy remains penalised under these conditions because, even at a nominal rate of 1.05%, the 10-year real interest rate is higher than the growth rate of its economy over the last twenty years, and therefore its debt ratio is worsening.

Central banks' action:

Ensuring low rates all along the curve:

On the eve of the Covid-19 crisis, nominal official rates were weakly positive in the US and China, negative in Europe, Japan and Switzerland. There were several reasons for this: the permanence of accommodating monetary policies, the structural factors favourable to an increase in savings, the ageing of populations, the worsening of inequalities and the greater propensity of the wealthy to save, the fall in the investment rate, the concern in countries that are not helped by the welfare state to hold precautionary savings, the evolution in China from an industrial economy towards a less capital-intensive service economy. After the advent of the pandemic and deflation, real rates are rising mechanically.

In 1990, the Fed cut rates from 9% to 3%, in 2001 from 6.5% to 1%, in 2008 from 5.25% to zero. This year, the leeway to lower them to zero was even narrower and the Fed did not want to adopt negative rates because they have three major flaws: the fall in savings yield increases precautionary savings, companies may take advantage to buy back shares instead of increasing productive investment, the formation of bubbles is stimulated.

The injections:

Before the crisis, many people were worried about the lack of options for central bank action but that was underestimating innovation or imagination. Between the liquidity on preferential terms granted to banks, the collateral granted for business loans, and the massive repurchases of public and private debts, interventions represented up to 15% of GDP. Another innovation is that central banks have been careful not to forget “Main Street”, helping companies by offering guarantees.

Since February, the Fed has bought $1.7 trillion of federal debt, made a commitment to purchase $750 billion of corporate debt and $500 billion of debt of local agencies and federated entities. In a few weeks, the Fed has bought back as much as it did in the three years after 2008, and its balance sheet, reduced from $4.5 trillion in 2015 to $3.8 trillion in September 2019, reached $7.2 trillion at the beginning of June. It bought as much corporate bonds (€220 billion) as the ECB has bought in 4 years.

According to the Bank for International Settlements, government debt purchases were equivalent to 16% of GDP and the amount of credit to the private sector not financed by the Fed exceeded 10% of GDP. By comparison, the percentages are 11% for both measures in Europe.

The possibility for the Fed to grant loans in "unusual and pressing circumstances" defined under President Hoover during the 1929 crisis, then modestly extended to just over 100 companies, is undergoing a major development this year. A $600 billion initiative of loans made by banks and supported by the Fed (up to 95%) for the 19,000 companies with a turnover less than $5 billion and employing between 500 and 15,000 workers, which interests nearly 40 million American employees. The Treasury has earmarked $75 billion in the event of defaults. This is undeniably a support for the economy, "Main Street".

This program, not intended for companies with too much debt, aims to offer loans at a time when the banks are more restrictive. However, this monetization of corporate debt can also be interpreted as a creeping nationalization of economies and must be temporary.

The ECB has pledged to buy back €1.7 trillion by June 2021, but everything will be spent before then. Its current balance sheet stands at €6.2 trillion and has grown by a third since February.

Faced with the proliferation of bad loans, €500 billion in the banking system, the ECB is thinking about creating a "bad bank", a first that would relieve the banks, but this idea repels the "frugal" countries.

European debt issued after the adoption of the stimulus plan proposed by Angela Merkel and Emmanuel Macron should be at a rate barely more expensive than German debt, which makes ***Georges Soros***' proposal of a European perpetual debt of €1 trillion, at an annual cost of 0.5%, unattractive. England had taken this route during the Napoleonic blockade and at the end of World War I, but it seems more expensive than current conditions.

As a provisional conclusion, while waiting for the next letter, we recall the words of Milton Friedman in his book Inflation and the Monetary System: "***Delegating extensive economic powers to central bank governors seems to me absolutely contrary to liberal principles***". All this seems to have been forgotten, and no one will mind for the time being. Nevertheless, we will debate the potential hazards and answer the question of a possible stock market risk at current prices.

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