EUROFI VIEWS MAGAZINE - ZAGREB APRIL 2020

Didier Borowski

Head of Global Views, Amundi

That's one small virus for man, one giant leap for economic policy

The global economy has entered the most severe recession since the 1930s. But this is a new kind of crisis by its very nature. Comparisons with the Great Financial Crisis of 2008 or the Great Depression of the 1930s are misleading because at its source, this is neither a financial crisis (there was no bubble burst) nor a debt crisis (even though the world has entered this recession with historically high levels of private and public debts). The collapse in economic activity has not been triggered by the direct impact of the epidemic but by the global lockdowns, which have brought entire sectors of the world economy to a standstill. Half of humanity are confined to their homes, which is unprecedented in modern history.

Two essential things must be kept in mind. First, an epidemic is by its nature temporary. Second, given the characteristics of Covid-19 (low mortality rate in the labour force), potential GDP growth should not be affected in the medium run.

It was therefore necessary first to prevent the economic crisis from becoming a true financial crisis. Governments and central banks were equal to the emergency. Economic policies implemented on both sides of the Atlantic are unprecedented on both the fiscal and monetary policy fronts, with stabilisation plans equivalent to 10% to 20% of GDP (including loans and guaranties) and an expansion of central banks' balance sheets unseen throughout history.

Stabilisation programmes are being carried out in different ways on each side of the Atlantic, but the spirit is the same: the aim is to maintain macro-financial stability, compensate temporary unemployment, and avoid a full blown credit crunch with cascading corporate bankruptcies and defaults. The common goal is to protect the economy as much as possible during the recession in order to allow recovery once the epidemic is under control.

At the end of the day we are witnessing a de facto merger of central bank and Treasury balance sheets. Public debt will de facto be monetised. Debt securities will be purchased by central banks in order to keep bond yields at a very low level. The entire yield curve is now under control. Sovereign debt issuance (net of redemptions and central banks' purchases) will be negative in the major advanced economies in 2020. In the United States, it is the first time this has ever happened. Given the scale of the ongoing recession, public debts will rise very sharply, and bond yields would have soared without central banks' asset purchases. Subsequently, central banks' balance sheets will soar in tandem with public debts. Governments have become the buyers of last resort, while central banks are playing their role as lenders of last resort. Fiscal and monetary policies have become intertwined, and this is not reversible.

A crisis of this nature thus calls for a paradigm shift in terms of economic policy. Historically, economic and financial crises have always given the authorities an opportunity to equip themselves with the appropriate instruments to contain them. Indeed, it was following the crisis of the 1930s that the Fed adopted the statutes that enabled it to deal with the GFC in 2008. And it is thanks to the 2012 sovereign debt crisis that the ECB is today able to support (among other things) the guarantees provided by the governments. Most of the tools mobilised (or that could be mobilised today) in the Eurozone were put in place after 2012 to save the euro.

How long will central banks be able to monetise debts without causing a general loss of confidence? How long can interest rates be kept so low? Can inflation resurface? All these questions will likely remain unanswered for a while. The only certainty is that fiscal dominance has now become a reality among the major advanced economies. And whether we regret it or not, this process is not reversible.

For those who fear that a global debt crisis is looming, it should be remembered that debts owed to the central bank are unique in that they can be spread over time indefinitely, or even partially cancelled painlessly.

Ultimately, the policies that are put in place will inevitably shape the debate once the crisis is over. In Europe, leaders will at some point be forced to recognise that a single federal budget and a single financing instrument for the Eurozone would probably have been more efficient to manage this crisis. The birth of a European budget and a common debt will perhaps be the institutional traces that this crisis will leave in history: a forced march towards the "United states of Europe". ●