Views on the responses to the Covid-19 crisis

Interview with Jacques de Larosière conducted by Didier Cahen on 14 April 2020

How different is this sanitary crisis from the previous financial and sovereign debt crises of the years 2000?

The present crisis is far worse than the one of 2007 – 2008 because, this time, it threatens the lives of citizens worldwide. Covid-19 has disrupted our social and economic order at lightning speed and on a scale unseen in living memory, and the lockdown needed to contain it has affected billions of people. The common trait between the two crises is the unpreparedness of governments:

In 2007- 2008, they underestimated the lack of sufficient equity in the banking sector and the vulnerability on the financial system in the face of huge asset bubbles

This time we are, except for a few countries, unprepared to cope with this massive pandemia because of:

- insufficient preventive and diagnosis devices, which are crucial to limit the confinement measures to people that are affected by the virus,
- insufficient availability of masks and the absence of an effective vaccine, or other medical treatments and
- the very limited capacity in terms of life saving respiratory units.

So, the difference is this: in 2008, the authorities swamped financial markets with liquidity in order to avoid total collapse of the banks and financial markets. This time, governments are closing very significant parts of economic activity because heath services are not able to distinguish healthy and non-healthy individuals and therefore have to lock-in most sectors of the economy in order to avoid any contacts between people.

This method is very inefficient compared to the practice of a few countries that have established systematic testing of all individuals and have kept most their economies functioning. This time it is the public authorities that have decided, given their unpreparedness, to create the conditions for a major depression unseen for 90 years.

How to assess the economic impacts of coronavirus?

The consequence of this global crisis and the lock down measures taken will be huge. Their magnitude will depend on how long it will take to overcome the health problems.

As a very approximative yardstick, if you assume that advanced economies are mandatorily closed at a level of 50%, that means that two months of confinement entails a loss of 8% of GDP. 4 months would amount to 16% of GDP.... Some countries will be far worse hit than others.

The collapse of economic output in the second quarter of this year will be the biggest in modern peacetime history. The impact of gradual exit from confinement is yet no forecastable. But the social and economic consequences of the pandemic are extremely serious and will be with us for many years to come.

The coronavirus crisis is developing at a time when the financial system appears weakened. Does monetary policy have a responsibility in this regard?

The minefield of the world economic and financial system is in a far worse state than we have been prepared to admit.

As a result of monetary policies that have been accommodating for too long, the debt ratio of states and corporates compared to GDP has surpassed all peacetime records. We witness that the growth in overall debt has been 50% since the last 2008 crisis. The asset bubble that was favoured by cheap debt - including the so-called risk-free government bond bubble - is now abating.

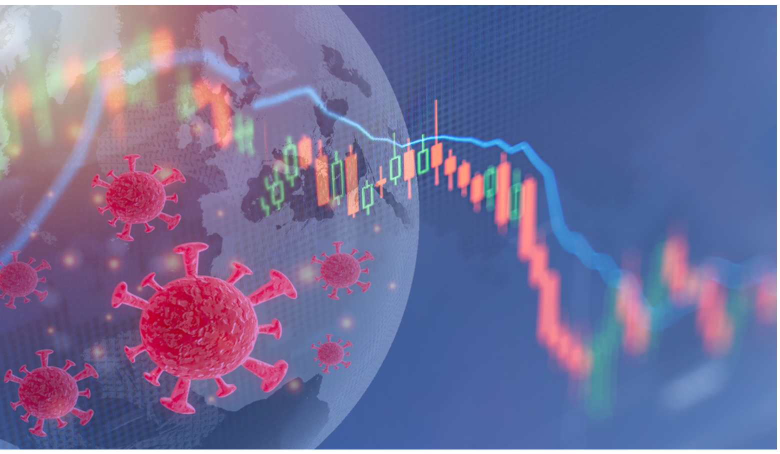
However, the rot has set in. Risk premiums had virtually disappeared in this environment of low or negative interest rates and we have lived with an illusion that assumed this situation would be timeless. As long as some growth was maintained, mediocre - or even downright bad - signatures of all forms 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 markets 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 high-yield 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).

You have been warning of the dangers of monetary policies that have been accommodative for too long. Can you remind us of those dangers?

The impact of excessively accommodative monetary policy - with interest rates at zero or even negative for a long time - on the stability of the financial system is unfortunately too well documented: incentives to borrow more; weakening of the banking system; deterioration of the accounts of pension institutions whose liabilities remain subject to contractual obligations but whose fixed-income assets no longer yield anything; proliferation of zombie companies in an environment where interest rates no longer play their discriminating "quality signal" role that should be theirs; strong disincentive for governments not to undertake structural reforms since borrowing "no longer costs anything»;

Let us not underestimate the importance of this loss of benchmarks - zero interest rates blur risk premiums (one of the characteristics of the 2008 crisis).



What are the potential economic and financial stability consequences of the massive purchases of securities decided by the ECB and the Fed? Do the issues raise similar risks in the Eurozone and US?

The huge increase in public expenditures to maintain economies during this pandemic crisis will create a massive increase in public debts. This will inevitably raise questions on the sustainability of public debt levels of those countries whose figures are already very high.

The solution to the problem would normally be to raise more taxes and reduce less essential public expenditure. But given the monumental amounts in question, there may well be a temptation to expect central banks to hold them on their balance sheets thereby monetising public debt by monetary policies.

This is a new source of vulnerability and instability of the financial system.

Business survival justifies central banks' role as lender of last resort during the crisis. Central banks must do everything to support the needs of the people. But doing so should not be in conflict with the core purposes of monetary and financial stability. Increasingly using monetary financing will damage credibility and the role of money as well as weakening future control of inflation.

So the future looks very dark.

Both the US and Europe are pursuing the same policies. But the US has an advantage: they issue the international currency. It is less immediately exposed than other countries who do not benefit from this privilege. But, of course, in the very long run, even that US advantage will tend to dissipate, and the question of the fiscal sustainability of debt will arise even for the dollar.

Can this ocean of public debt on the balance sheets of central banks be reduced over time or are we entering an era of perpetual public debt, with maybe even further demands for State protection?

The answer will depend on the outcome of economic behaviour. If central banks and governments continue to forecast a very long period of low growth and zero or even negative interest rates, I do not see how central banks could start selling their accumulated bonds on the markets. The probability of even an increase for a very long time on central banks' balance sheets looks pretty high.

Consequently, a situation of persistently low interest rate will be very disturbing: in such a monetary environment, the market is no more in a position to discriminate among different types of assets due to the asset purchase of the central bank. Indeed, the universal buying of sovereign securities eliminates the normal functioning of market forces between savings and investment and brings interest rates to levels close to zero which, as we have already seen, encourages the holding of liquidity to the detriment of productive investment.

How can free markets assess value in these conditions? How do productive economic projects distinguish themselves from sheer financial profit opportunities in the search for investment capital?

Ultimately, by taking things to extreme, central banks would eventually hold most of the debt and even shares. But, by dint of being taxed, household savings could decline and central banks could become the main actors in the savings/investment equation.

Continuing such monetary policies is a cause of great concern for the future of our economies and our societies.

Are you concerned that this ocean of debt on the balance sheets of central banks will be a brake on the recovery of investment at the end of the economic depression we are experiencing?

Absolutely. The increase in public debt and unlimited money creation are a dangerous spiral for our economies. They will not only act as a brake on the recovery of investment but can also undermine the confidence of economic agents in the currency and the value of money.

The core problem of loose monetary policies is that it drives a preference for liquidity. Since investment by purchasing securities is taxed, investors tend to forgo illusory remuneration and retain liquid instruments which, at least, are not affected by the application of negative rates. But such a preference for liquidity (Keynes' "haunting») diverts savers away from long-term investment. They would be taxed if they invested long-term.

In the traditional investor trade-off between return, risk and liquidity, the notion of return loses its importance with low interest rates. The arbitrage is only between liquidity and risk.

Moreover, with lasting and huge asset purchase programmes, central banks are anchoring in the minds of the markets the idea that interest rates will remain low for an indefinite period. The expectation of low rates for a very long period has a "depressing» effect: economic agents conclude that the growth horizon will be low for a long time and therefore will refrain from making long-term investments.

The accumulation of very high public debt, negative interest rates and massive repurchases of public and private securities against the backdrop of an accelerating ageing population has been experienced for many years by Japan (47% of outstanding public debt is held by the BOJ), which shows that it is inseparable from a sharp fall in potential growth.

What do you think of the Eurogroup European agreement of 7 April?

I think this is an excellent and fair agreement that provides for concrete actions. More than half a trillion Euros are now available to shield European Union countries, workers and businesses.

The European Stability Mechanism, the safety net for countries, will provide pandemic crisis support, in the form of precautionary credit lines not subject to macroeconomic policy conditionality. A member state that draws under these Enhanced Conditions Credit Line (ECCL) will commit to using the money only to cover corona-related costs. Each member state could benefit from this support up to the benchmark amount of 2 percent of GDP.

Second, a temporary solidarity instrument (SURE) will be established to support member states to protect workers and jobs in the current crisis. Loans will be provided to member states up to €100bn, building on the EU budget as much as possible and on guarantees from the member states

And thirdly, the European Investment Bank will implement its proposal to create a pan-European guarantee fund of €25bn to support €200bn of EU businesses, in particular SME's, throughout this crisis.

It has also been agreed to explore the setting up of a temporary Recovery Fund to facilitate a robust European economic recovery in all Member States. There was broad agreement to disagree on the financing of the fund, with mutualized debt issuance being favored by some and strongly opposed by others.

All this is still pending the agreement of the European Council.

Could the monetisation of public spending by central banks, if not accompanied by control of public spending by Member States, lead to a break-up of the euro zone?

What threatens the break-up of the zone is the disparity of the economic policies of the Member States and their lack of coordination. This heterogeneity is bound to increase with the further increases in public spending in this crisis.

If Member States whose public debts are already excessive do not make a more serious effort to reduce public expenditure not justified by imperative and urgent needs, the problem of the Eurozone' centrifugal forces will only worsen. We can see how much the policy, particularly in Germany, of reducing the public debt-to-GDP ratio to the level prescribed by the Maastricht rules, has paid off. Starting with 60% of public debt, compared to more than 100% in other countries, Germany has been able to embark on a massive programme of aid to the economy while its neighbours do not have the same margin for manoeuvre.

Moreover, the EU countries that have best managed the 2008 crash and the coronavirus epidemic are not those that have accumulated public expenditure and debt - like France, which is enduring a major shortage of gel, masks, screening tests and fans - but those like Germany - that have a modern state, healthy public finances, a powerful and reactive industry, a sustained research effort and strong social cohesion.

Furthermore, those countries that have controlled best their public finances are also those where research and reactivity have been better in terms of responding to the virus crisis.

How can public debt of the most indebted European states be reduced after the crisis? Is it possible to achieve primary budget surpluses?

Primary fiscal surpluses can be achieved to the extent that the debt-servicing burden would continue to be zero. Still, an effort must be made to reduce the least indispensable public expenditure.

Germany has reduced its public debt in relation to GDP from 80% in 2008 to 60% in 2019 (while Italy's has jumped from 126% to 136% and France's from 90% to 99% over the same period).

Countries that are still in primary deficit must take advantage of low interest rates to achieve a primary surplus to public debt over time.

What should be the characteristics of a renewed and effective Stability and Growth Pact once the crisis is over? Should new rules be added?

The first recommendation would be to apply the rules of the Stability and Growth Pact as they exist and as they were modified with more structural objectives after the 2008 crisis. We can always envisage improvements but the reality is unfortunately very simple: when the percentage of GDP devoted to public expenditure is too high, it must be reduced and brought closer to the average for the euro zone if we want to achieve a degree of homogeneity in budgetary performance, which is essential for the proper functioning of any monetary union.

It is all the more important to strengthen the common discipline that the system has put on the backburner during the crisis. Those rules are the cement that keeps together the Eurozone.

On the institutional front, since national budgets are vetted at the Union level, at one point, it would make sense to move toward a politically binding decision-making process with more substantial federal budget and tougher sanctions for non-compliance.

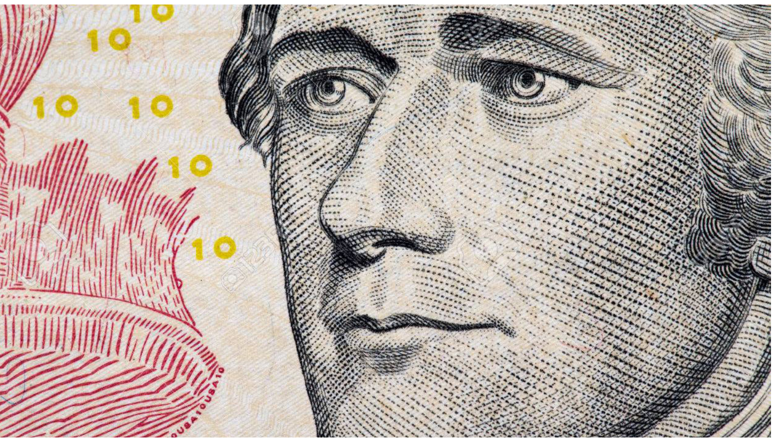
How can we encourage a return to healthy growth in a zero-rate environment, in economies that are often over-indebted, with populations, most of them ageing, asking for more protection from the State?

The first priority is to re-establish financial markets that function on the basis of market forces and not according to the prescription of zero-interest rates. The latter method, which has been practised unsuccessfully for the past decade or so, only encourages savers to hold liquid instruments such as bank accounts and to turn away from long-term securities with negative returns. This liquidity trap, feared by Keynes, largely explains the reduction in productive investment observed in recent years.

The national budget can also be used to promote infrastructure programmes, but to do so, it is necessary to have the means to do so, i. e. to reduce non-productive current public expenditure.

We must stop this psychodrama of so-called austerity, which is said to have weakened certain States of the Union. In fact, it is the fiscally virtuous countries that have best prepared their economies for the challenges of the crisis.

In countries with too much debt, decisions must now be made to stop "walking on their heads»; and to reduce unproductive and inefficient public spending. This is the only way to release the necessary resources to the productive sector. Such a fiscal policy requires a spirit of cooperation among the different political parties and on a bi-partisan basis, examples abound in the Northern European Member States.



Is this Europe's 'Hamiltonian moment'? What is your feeling about 'corona bonds' and /or a separate fund for dealing with the pandemic as suggested by the French government?

Alexander Hamilton understood that a nascent federal state needed a federal budget. Given the heterogeneity of economic performance among the 13 States of the Union, it is understandable that he had great difficulty in imposing this idea. But his vision was that of a federal state in the long term and not that of a group of individual states only weakly bound together only by legal concepts and human rights.

Is it possible to envisage that this American-style late 18th century vision could be born today in Europe?

One possible, Hamiltonian-inspired progress that is not revolutionary, would be to strengthen the Community budget. But the vision of the mutualisation of past or future national debts is of a different nature and is difficult to establish in a political system not united in fiscal terms.

Indeed without a fiscal Federation, it is very difficult to ask the best performers to guarantee the debt of the weakest members because this would be equivalent to a discretionary transfer of resources from some countries to others without the guarantors being able to influence politically the policies of separate states. This is fundamentally different from a fiscal authority. Moreover, Hamilton laid down the principle that the Federation was not responsible for the failure of the States.

Finally a Fiscal Union would be a major political leap that must be explained to the public and which requires democratic accountability and the consent of citizens....

Given the critical situation we face, do you not think that some common, limited financial instrument issued by the Eurozone or the EU as a whole, would be beneficial to the Union?

What could be envisaged in these exceptional times with this huge, exogenous universal shock, is to mutualise exclusively the incremental part of public debt that has to be issued to fight against the pandemia. Indeed, this would not entail a transfer of resources from good performers to more problematic ones. It would just say that to fight this war all countries are in the same boat and that " l'appartenance européenne " counts.

In this regard, the Commission's proposal of the very significantly enlarged common budget is welcome. It entails a borrowing capability in the hands of the European Executive. This would be a "Hamiltonian" step forward. For the first time, such a major budgetary plan would imply a fiscal common entity in charge of issuing euro denominated debt.