Economics – transition homework – part B

The second half of the transition homework is a real challenge!

On the pages below I have copied a long article form the Guardian newspaper by Adam Tooze – one of the world's top economic historians.

It is about the economic impact of the Coronavirus pandemic and how the economies of the world have been shut down.

It describes the actions taken by Governments and central banks (like the Bank of England) to keep the economy going and stop the recession caused by the lockdowns from becoming a Great Depression.

I have edited the article to make it easier to read. You can read the full version here:

https://www.theguardian.com/business/2020/apr/14/how-coronavirus-almost-brought-down-the-global-financial-system

You can also LISTEN to the article as a podcast:

https://www.theguardian.com/news/audio/2020/may/04/coronavirus-global-financial-collapse-prevented-podcast

Read and listen to the article slowly. Take your time – it is challenging.

Then answer the eight questions in the boxes below as you complete the article. Each set of questions relate to what you have just read, but it will take some thinking!

We will discuss this article in our first lesson of macroeconomics (theme 2) in September!

Good luck!

Mr Inniss

How coronavirus almost brought down the global financial system

BY ADAM TOOZE

In the third week of March 2020, while most of our minds were fixed on surging coronavirus death rates and the terrifying scenes in hospital wards, global financial markets came as close to a collapse as they have since September 2008. The price of shares in the major corporations of the world plunged. The movement of the markets was so erratic that major banks withdrew from trading.

Meanwhile, the value of the dollar surged against every currency in the world, squeezing borrowers from Indonesia to Mexico. Whilst consumers hoarded toilet paper, those businesses that could scrambled to draw down every available credit line. Trillion-dollar markets for government debt, the basic foundation of the financial system, lurched up and down in terror-stricken cycles. At the low point on 23 March, $26 trillion had been wiped off the value of global equity (Shares) markets, inflicting massive losses both on the fortunate few who own shares and on the collective pools of savings held by pension and insurance funds.

What the markets were reacting to was an unthinkable turn of events. After a fatal period of hesitation, governments around the world were ordering lockdowns to contain a lethal pandemic. The global economic machine was being brought to a screeching halt. In 2020, for the first time since the second world war, production around the world will contract (fall). It is not only Europe and the US that are shutdown, but once booming emerging market economies in Asia.

Raw material exporters from Latin America and sub-Saharan Africa face collapsing markets.

It is now clear that we can, if circumstances demand, turn the economy off. But the consequences are catastrophic. Across the world, hundreds of millions of people have been thrown out of work. From the street hawkers of Delhi to the personal trainers of LA, the service sector – by far the most important employer in the modern economy – has been stunned. Never before has the global economy suffered a shock of this scale all at once. In the US alone, at least 17 million people have lost their jobs in the last three weeks. A severe global recession is now inevitable.

Question 1: What happened to the world economy once the pandemic started? Why was the recession started deliberately? (Hint: think about Lockdown).

The crucial question now is how much of the world economy will survive the lockdown and this depends on the availability of credit (lending or borrowing). Business runs on credit. The bits of the economy that do continue to function, the warehouses, the cell phone and internet firms, they all need credit. Wage bills for those still working are paid through credit. Even greater is the need of those that are not working. If they can't get loans, bills will go unpaid, which spreads the pain. To survive the lockdown, millions of families and firms around the world are relying on grants and loans from the Government. But tax revenues have collapsed so states need credit too. Across the world we are witnessing the largest surge in deficits and government debt since World War II.

But who do we borrow from? Banks, financial markets, and money markets provide the financial fuel of the world economy. Normally, that credit is sustained by the optimistic promise of growth. When that snaps you face a self-reinforcing cycle of collapsing confidence, falling credit, unemployment and bankruptcy which spreads a poison cloud of pessimism. Like an epidemic, if left uncontrolled, it will sweep all before it, destroying first the financially fragile and then much else besides. It is not for nothing that we speak of financial contagion.

Question 2: What is credit? Why is it so important?

There have been recession before of course. But what began with the lockdown in Wuhan in January 2020 is more intense and more fast moving than anything we have seen before. In a matter of weeks we have been confronted with an economic outlook that is as grim as at any moment since the 1930s.

But, now imagine something worse. Imagine a situation where on top of the pain of the lockdown and the scenes in hospital wards we also faced a call for austerity (spending cuts and tax increases) because the government could not safely pay for extra spending. Imagine that interest rates were rising and credit card balances were being called to pay up. All of this may still happen. It is already happening to the weaker economies around the world. But it did not happen in Europe and the US, immediately, in March 2020 as the epidemic hit with full force.

What we have succeeded in doing is to flatten the curve of financial panic. We have maintained the all-important flow of credit. Without that, much of our economy would not be on life support. It would be stone dead. And our governments would be struggling with a financial crunch to boot. Maintaining the flow of credit has been the precondition for sustaining the lockdown. It is the precondition for a concerted public health response to the pandemic.

How did we do this? In major crises we are reminded of the fact that at the heart of the profit-driven private financial economy is a public institution, the central bank (like the Bank of England in the UK). When financial markets are functioning normally it remains in the background. But when they threaten to break down it has the option of stepping forward to act as a lender of last resort. It can make loans. Or it can buy assets from banks, funds or other businesses that are desperate for cash. Because it is the ultimate backer of the currency its budget is unlimited. We learned this in 2008. But 2020 has driven home the point as never before.

The last six weeks has seen a bout of intervention like nothing before. Many of these interventions are technical. They had to be done quickly. Some barely made the headlines. But the result is momentous. A giant public safety net has been spanned across the financial system. We may never know what went on behind the closed doors of the Fed, the ECB and the Bank of England in the critical moments in March. So far, only muffled sounds of argument have reached the outside. But as the virus struck, the men and women in those three central banks held the economic survival of hundreds of millions of people and the fate of nations in their hands.

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The financial markets scan the world for risk. Even the slightest disruption in the vast networks of finance, production and trade offers the opportunity for profit or the threat of loss. So the news on 23 January, that the outbreak of an unknown virus was sufficiently serious for Beijing to impose a gigantic quarantine hit the traders on their Bloomberg terminals hard. Hubei province and its capital Wuhan are a major industrial center. The supply-chains of global manufacturing businesses like Samsung and Nissan were going to take a hit. Bank economists struggled to get a grip on the dimensions of the problem. Would this be a minor disruption like SARS in 2003? Or were we facing the nightmare scenario of the Hollywood film, *Contagion*?

In late January, investors began to move more and more money out of things like commodities and shares in companies, and into the relative safety of government bonds. What comforted them was the idea that the virus was a problem contained in China.

The day that illusion burst, the day that investors realised that COVID-19 was becoming a global pandemic, was Monday 24 February. Over the weekend the Italian government had announced that it was imposing a quarantine in parts of northern Italy. It was the first place in the West to do so.

Ever since the financial crisis of 2008 Italy's economy had been struggling. Both its banks and its public finances were in a precarious state. Italy's debt levels were high enough to cause bond markets to periodically panic. Now the country would become the frontline in the virus fight. The coronavirus would test the solidarity of the Eurozone at its weakest link.

At this point, not everyone was taking the threat seriously. The caseload in the US still looked tiny. Donald Trump dismissed the virus as a "scare" and encouraged investors to go bargain hunting on Wall Street.

But investors were now seriously worried. Over the week that began on 24 February, America's main stock market index, the S&P 500, lost ten percent of its value. The chair of the US Federal Reserve, Jerome Powell, was concerned enough to signal that he would soon be bringing forward a cut in interest rates, in order to stimulate consumption and investment. It was a conventional reaction, but COVID-19 was no longer looking like a conventional threat.

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By early March, whatever complacency had prevailed was long gone. Italy moved into Lockdown. Investors around the world started to panic.

In times of uncertainty, the things they want are safe haven assets. And what makes a government bond a safe investment is not only the financial standing of the borrower, but the depth of the market in which lenders can sell them if they want to get their money back sooner. There is no deeper market than that for US Treasuries, as American government bonds are known. The greater the demand for safety, the lower the interest rate the US government generally has to pay to borrow. In the first week of March those rates were at record lows.

For the rest of the world economy, this run to safety was an alarming signal. One sector that knew it was heading for trouble was oil. When the global economy slows, so does the demand for energy. The oil industry of the 21st century consists, on the one hand, of large, state-controlled producers – above all the OPEC group dominated by Saudi Arabia and Russia – and, on the other hand, of America's upstart fracking industry. To match falling demand for oil, the Saudis wanted to cut overall production and thus prop up the price. For this they needed the agreement of the other big producers, but Russia refused to go along with them. As Moscow saw it, cutting production with a view to propping up prices was an invitation to America's shale producers to fill the gap. If the politics of climate change meant that the future really would bring a transition away from fossil fuel, winning the end game involved seizing as much of the market as possible for as long as oil was being pumped. So Russia decided not to cut production, but to launch a price war. Not wanting to be outdone, over the weekend of 7-8 March, Saudi Arabia took up the challenge. It announced that it would be maximising production and discounting its prices.

On Monday 9 March, as markets opened, oil prices plummeted. The benchmark Brent crude oil fell 24% by the end of trading. By the end of the month its value had halved. From the point of view of the financial markets, the ferocity of the competition in the oil industry was a harbinger of things to come. Falling demand would force industry after industry to either slash prices or contract production. Either way, it was bad news for profits.

Question 3" explain why there was a collapse in oil prices.

When trading opened on Wall Street that morning, the situation was so bad that the circuit-breakers – automatic stops to trading that are triggered when prices fall by a certain amount – were soon activated. This was supposed to slow a wild sell off. But it sent a message of panic. As soon as trading resumed, everything sold. There were no buyers.

A rout like the one that began on 9 March has a perverse logic. When fund managers face withdrawals from the people whose money they manage, they need cash and have to choose which assets to sell first. They might prefer to sell the riskiest investments, but those can be disposed of only for a large loss. So, instead, they attempt to sell their most liquid and safe assets, government bonds. Their prices fall dragging them into the problem too. That has the knock-on effect of unravelling a basic relationship on which many investors rely: typically, when shares go down, bonds go up, and vice versa. So to protect yourself against risk, you buy a portfolio made up of both. If everything works as it's supposed to, the swings should balance each other out. But in the panic that began on 9 March, this stopped happening: rather than balancing out, the price of shares and bonds were collapsing together. The only thing that anyone wanted to hold was cash, and what they wanted most of all were dollars. The surging dollar in turn spread the pressure worldwide to everyone who owed money in the American currency.

The Fed desperately tried to halt the run. To signal its willingness to support the economy and ease the pressure on the world economy from the strong dollar, it brought forward the interest rate cut that had been expected for the middle of the month. But with the darkening horizon, lower interest rates did little to help. Who would borrow or invest under such circumstances? The desperate demand for dollars was not stanched by marginally less attractive

American interest rates. Confidence was broken. Just how badly would become clear over the following two weeks.

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After five terrifying days of market turmoil, the weekend of 14-15 March was a moment for central banks around the world to coordinate their response. What everyone wanted was dollars, so it was above all the Fed that needed to take the lead. And Powell did. He called an unscheduled press conference for the afternoon of Sunday 15 March. The drama of the moment was somewhat spoiled by the fact that the Fed had problems with its telephone line and some of Powell's remarks towards the end were lost to many of those listening in. But what he announced was remarkable.

With immediate effect the Fed was cutting interest rates to zero – something that it had done just once before, at the height of the crisis in 2008. To stabilise the US Bond market, it would be buying $700bn in a new round of so-called quantitative easing. And it would start big, buying $80 bn by Tuesday 17 March. In the space of just 48 hours it would buy more than the Fed bought in most months in the aftermath of 2008.

Question 4: Can you explain why the US Central Bank (the Fed) decided to cut interest rates and also buy $700bn of Government bonds?

These were measures for the US economy. But the coronavirus was a global problem. The flight to safety and the ensuing rise in the dollar had put pressure on everyone who had borrowed in the American currency. So to ensure that dollars could be piped to every financial institution in every major financial centre in the world, the Fed announced that it was improving the terms on the so-called liquidity swap lines – deals by which the major central banks agree to exchange dollars for sterling, euros, swiss francs and yen in unlimited amounts.

Powell's emergency announcement was a remarkable intervention. He was deploying the main weapons of the 2008 crisis but with far greater speed than his predecessors ever had. But it was not enough. When the markets opened on Monday the fall was vertiginous. The circuit-breakers are supposed to come into effect if the market falls by more than 7 percent. On Monday morning the fall was so quick that it hit -8.1% before trading could be stopped. The so-called fear index, VIX, a measure of market volatility, surged to levels last seen in the dark days of November 2008.

The fear in the markets was now feeding on itself. If the virus was different, if the Fed's magic of 2008 no longer worked, then what would?

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The foreign exchange market, where currencies are traded, is the biggest market in the world. And the place where the most transactions are booked is the City of London. On an average day, transactions back and forth total $6.6 trillion.

But on Wednesday 18 March, London was in turmoil. Boris Johnson's virus strategy was in disarray and there were rumours that the capital would be locked down. On the terminals there was only one trade: people wanted to sell everything. The only thing they wanted to buy were dollars. Every other currency was falling.

The central banks' failure to calm the markets had set the stage for the worst days of the panic. Coronavirus cases were piling up in Europe more rapidly than at the peak of the crisis in Wuhan. Hedge funds were placing multi-billion dollar bets that the recession in Europe would be protracted. Blue chip companies like Apple were facing stiff premiums to borrow for as little as three months ahead. Even gold, a classic safe haven, was selling.

That Wednesday, on his third day as governor of the Bank of England, Andrew Bailey organised press conference via telephone in an effort at reassurance. But as he was speaking, sterling plunged by 5% to its lowest level since 1985.

In response, the Bank of England Monetary Policy Committee met the next day in emergency session and announced that the Bank would be buying £200bn in gilts. Unlike in 2008 it would not be doing so on a prearranged schedule. As Bailey explained: "We will act in the markets promptly and rapidly as we see appropriate." This was no time for timetables. The central bank was, by its own admission, flying by the seat of its pants.

On an emergency conference call on the evening of 18 March, the ECB executive board decided that it too needed to act. Under a Pandemic Emergency Purchase Programme it announced that it would begin by buying €750bn of government and corporate debt. If necessary that would be increased. But the ECB was willing to go even further than that. It said that, if necessary, it would revise some of its “self-imposed limits”. This amounted to a revolution. Self-imposed limits - inflation targets, rules on which European government’s debt it could buy and in what quantities - are what the ECB lives by. It is clear that some members of the bank’s Governing Council continued to resist such a move. But in the end it was the turmoil in the markets that decided the issue. The ECB needed to send a signal of determination.

By the end of the third week of March, 39 central banks around the world, from Mongolia to Trinidad, had lowered interest rates, eased banking regulations and set up special lending facilities. To ease the pressure on emerging markets the Fed widened the network of liquidity swap lines to cover 14 major economies including Mexico, Brazil and South Korea. This was a remarkable wave of activity. But the epidemic itself was only beginning to bite. Central banks could cushion the financial shock but not address the actual economic implosion, let alone the health crisis.

European governments had been quick to move. Germany had thrown aside its fiscal caution and was committed to a gigantic program of government guarantees for business lending. But this made all the more glaring the gap to Italy and Spain, which were not only hardest hit by the virus but also constrained by the financial legacy of the eurozone crisis. They did not want to risk sliding back into a debt crisis.

In the US, the Fed had leapt into action. But where were the politicians? Congress was distracted by the upcoming presidential election. What was needed was an unprecedented rescue package for an economy in freefall. How were Republicans and Democrats to reconcile fundamental differences over health care, unemployment insurance, or the notorious cronyism of the President and his clan? Since the Democrats had won control of the House of Representatives in 2018, legislation had been largely paralysed. Now, in the face of a tsunami of job losses, the two parties had to come to an agreement.

Question 5: The Central Banks had done a lot already using monetary policy, but what could Governments do to help?

As trading began in Asia early on the morning of Monday 23 March, the news from Washington made it clear that there had been no deal on Capitol Hill. For an unprecedented fourth time in succession, the futures market hit the lower buffer and trading was stopped. If it wanted to avoid a meltdown when Wall Street opened, the Fed would have to make another move.

By March 23th Powell had activated all the basic elements of the 2008 repertoire – slashing interest rates, using quantitative easing, support for money markets. But it had not worked, partly because it could not reach the source of the crisis itself, the virus and the lockdown, and also because it was not reaching the bit of the credit system that was most vulnerable in 2020: the borrowing of big corporations.

The Fed has always steered clear of corporate debt. It considered such debt politically sensitive. If you bought individual firms you were vulnerable to accusations of favoritism. If you bought a cross-section of debt you ended up holding many very poor-quality loans. And the higher risk end is where so-called private equity firms make winnings before which the profits of Wall Street bankers pale into insignificance. But by the early hours of 23 March it was clear that something had to be done to stabilise the corporate debt market. Since 2008, bonds issued by nonfinancial corporations have surged from $3.3 trillion to over $6.5 trillion. If their value fell too far, America's corporations would not only face shutdowns and a complete loss of revenue but a crippling credit squeeze.

Ideally, the Fed would have made a grand announcement in conjunction with a Congressional stimulus package. But by the evening of 22 March, it was clear that the package being proposed by the Republicans was unacceptable to the Democrats. It might take days for them to square the difference. The financial markets would not wait.

On 23 March, 90 minutes before markets opened, Powell made his move. He announced that the Fed was setting up legal entities – off the books of the Fed but guaranteed by it – that would have the capacity to buy highly-rated corporate debt, or at least any debt that the ratings agencies were still willing to declare investment grade. In effect the Fed was establishing itself as the backstop to the trillion-dollar corporate bond market. It was taking the risk in the hope that Congress would in due course come to its rescue.

It was an extraordinary move to widen the scope of central bank intervention into the corporate economy. And it was understood as such by the markets. Having lost 30% of their value since the start of the year, the S&P500 and the Dow Jones, as well as the FTSE 100, began to recover that day.

Two days later, on 25 March, backing arrived from Congress when the Senate passed its giant package of $2 trillion – more than twice the size of the stimulus bill passed in 2009. It provided funds to top up unemployment insurance, to support small businesses and America's privatised hospital system. Crucially, it also set aside $454 billion to cover Fed losses. Since most loans would not be expected to go bad, this would enable the Fed to make more than $4 trillion in loans, if necessary.

Question 6: Congress (the US Parliament) spent $2trillion to support the economy – how do you think this money would help?

In the US the public health campaign against the virus was still a shambles. But as far as economic policy was concerned, the full power of the American state was now being deployed behind the emergency program. And the Fed was also acting as a provider of dollar liquidity to the world economy. In the UK, too, the Treasury and the Bank of England were working closely to link the huge increase in government spending to efforts to stabilise financial markets.

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Will the massive financial firewalls built by central banks on both sides of the Atlantic be enough to withstand the bad news that is headed our way over the coming weeks and months? It is too early to tell. But the first test came on Thursday 26 March.

Every Thursday morning, the US Department of Labour releases a weekly compilation of data on the number of people signing on for unemployment insurance. The American unemployment insurance is a ramshackle federal structure designed in many cases to deter applicants as much as to provide income support. Nevertheless, as lockdowns came into effect across the United States, this would be the first jolt of news about what was happening to the largest economy in the world. For days, stories had been circulating about the extraordinary surge in applications received by state offices. Several online registration systems had collapsed under the weight of applications. The Trump administration had done its best to embargo the alarming news.

And then, on 26 March, the release hit the wires. In a single week 3.3 million Americans had signed on for insurance benefit. It was completely unprecedented. A graph stretching back over half a century simply turns upwards in a vertical surge. In the next two weeks, another 13.5 million people would be added to the insurance rolls. And there was no end in sight. America is on pace for national unemployment to reach 30 percent by the summer – greater than during the Great Depression of the 1930s.

The shutdown spelt disaster for millions of American families, at least half of whom have no financial reserves to speak of, and businesses up and down the land. How would the markets react? Astonishingly, they ended Thursday 26 March up 5%. The largest surge in unemployment ever recorded in history was met with a relaxed shrug.

Question 7: Why has unemployment risen so much during lockdown?

Why weren't investors more terrified? Because the scale of stimulus made clear that, no matter how divided American politics were, that wouldn't stand in the way of a huge surge of spending. And the Fed, for its part, would make sure that the huge flow of new debt was absorbed, if necessary onto its own accounts. The private credit system, the government budget and the balance sheet of the Fed were welded together in a closed loop.

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In March 2020 what the Fed, the Bank of the England and the ECB managed to do was to prevent the damage being done by the shutdown from being compounded by an immediate collapse of corporate credit. At the same time, by stabilizing sovereign debt markets they have enabled a huge surge in public spending to fight the crisis and cushion its social and economic side effects. To do this they have both widened the safety net to parts of the financial system never before protected and intervened on a scale far greater even than in 2008.

In the final days of March, the Federal Reserve was buying Treasury bonds and mortgage-backed securities at the rate of roughly $90 billion per working day, or roughly $1m per second. On 9 April, at the same moment as the latest horrifying unemployment numbers, it announced another $2.3 trillion in support specifically targeted at municipal debt and lower-grade corporate debt. That same day, the Bank of England adopted an even more radical approach. Rather than going through the process of having the Treasury issue debt which was then bought by the central bank, it announced that it would be offering direct monetary finance to the government, to provide it with whatever funding it needed. This would be temporary and short-term, but it was still a radical move. The government’s current account at the Bank of England would be repurposed to allow, if necessary, tens of billions of pounds in corona spending. Only once before, in 2008, had the British government resorted to this mechanism.

What we have seen in the financial system, over the last few weeks, is a victory of sorts – but it is a defensive one. Once again, we are propping up a fragile, profit-driven system to avoid something even worse. It is also limited in scope.

The advanced economy central banks have managed to ensure that by flattening the curve of financial panic the lockdown is bearable and the public health response to COVID-19 can proceed at any scale that is required. Within Europe there are questions about the equity between Eurozone members. Germany's fiscal response to the crisis is conspicuously larger than that of Italy, Spain. But those inequalities pale in light of the problems facing much of the rest of the world. There the crucial supply of credit is being cut off even before the virus arrives.

It is hitting every part of the world economy. The World Bank is warning of a devastating set back to the economies of Nigeria, Angola and South Africa and along with them the rest of sub-Saharan Africa. By early April 2020 more than 90 countries, almost half the countries in the world, have been forced to apply to the IMF for financial assistance.

If flattening the curve in Europe and the US was the battle of March. The next challenge is to reduce the shockwaves radiating out to the rest of the world. If the last few weeks have seen a remarkable display of energy and imagination in the economist in central banks and Governments. That same level of commitment now needs to be brought to bear in supporting the rest of the world. We cannot either control the epidemic or restore the world economy without it.

Question 8: What do you think needs to happen next? How can Governments' get the economy to recover? Can they keep spending money or are there limits? What do you think?