JACK FOSTER

THE CORONA CRASH

ESRA researcher Jack Foster considers the financial aspects of the current crisis.

As the Covid-19 pandemic rages across the globe, analysts and commentators have struggled to find historical analogies for the economic chaos it is causing. For economists, the reference point has quickly shifted from the Global Financial Crisis (GFC) to the Great Depression. But in reality the current crisis is unprecedented in scale. Never before has so much economic activity ground to a halt so suddenly. Estimates indicate that unemployment in some countries may exceed the peaks reached during the Great Depression.[1] In Aotearoa New Zealand, economists are forecasting that unemployment will rise to between 15–30 percent.[2] In the United States, 3.3 million Americans have filed for unemployment in a single week.[3] This will have devastating long-term consequences on many peoples' economic, mental, and emotional well-being. It will also have devastating long-term consequences on economic growth.

In the midst of this economic carnage, financial markets have gone haywire. For the second time in just over a decade the global financial system is on the precipice. Stocks have plunged at record rates, only to rally again at the announcement of government recovery programmes; assets of all kind, even gold and U.S. Treasury bonds, are being sold off, indicating a widespread flight to cash; key funding markets have frozen up; and emerging market economies are experiencing capital flight. Indeed, the stresses in the financial markets have at times been as acute as during the peak of the GFC, and could worsen over the coming weeks. The second great credit crunch of the 21st century is well underway. Indeed, JPMorgan has already dubbed it the 'Great Liquidity Crisis'.[4]

The last thing the world needs at the moment is a full-blown meltdown in the credit system. This would compound the public health emergency and would make for a deeper and longer recession that would hurt working people and the unemployed most. In response to the credit crunch, central banks, the institutions that saved the global financial system in 2008, have rebooted the full suite of GFC-era interventions in a period of less than two weeks. In contrast to the flat-footed public health response to the virus across most of the West, central banks have acted swiftly and aggressively. The doctrine of 'overwhelming force' espoused by Timothy Geithner, former U.S. Treasury secretary under

Obama and key crisis-fighter during the GFC, appears to be the order of the day.[5]

Central banks are ciphers for the way the contemporary financial system functions. Paying attention to the actions of these institutions during financial crises tells us much about the nature of capitalism in the 21st century. But central banking is not widely understood. This is not surprising as finance and monetary policy are both shrouded in technical—and often deliberately obscurant—jargon. But the underlying political economy of contemporary central banking is quite simple. This intervention aims to shed light on some of the key actions taken by the major central banks in recent weeks. It considers what they tell us about the current crisis and the pathologies of the contemporary financial system.

LENDER OF LAST RESORT

Confidence is key in capitalism. Accumulation relies on the realisation of future profits and so the capitalist will be loath to invest or lend if they cannot be reasonably confident of future economic stability. As the former British Prime Minister Lord Salisbury put it: 'When confidence is destroyed capital will not flow, enterprise cannot be created, wages must fall, and commerce must stagnate'.[6] In the current crisis, confidence in almost every part of the economy has evaporated. For the financial markets this means that asset prices fluctuate wildly, stocks plunge, and liquidity evaporates. Liquidity refers to the availability of funding in the financial system, which includes the capacity of firms to sell assets and access cash. With confidence plummeting, firms and investors all rush to get hold of the most liquid form of money possible: cash. The result is a general liquidity crunch in which firms and investors in need of cash are not able to access it.

In such a situation, many firms are at risk of becoming illiquid. Without central bank or government intervention, insolvency will soon follow. A firm becomes insolvent if its liabilities exceed its assets and it is unable to access funding to cover these liabilities. In this respect, the financial system is only operational so long as liquidity exists. The traditional role of a central bank in periods of crisis is to act as the 'lender of last resort' to the banking system, preventing banks that are illiquid from becoming insolvent. But in the contemporary financial system, banks are not the only sources of liquidity. It is the wholesale funding markets that are the lifeblood of the contemporary financial system. Through these markets, liquidity is pumped through the financial system, allowing financial and non-financial firms to meet their short-term funding needs. These markets are particularly vulnerable to liquidity crunches as many of the firms and investors involved lack recourse to a lender of last resort. It was these funding markets that broke down in 2007 and 2008.

Two decades of debt-led growth fuelled by a series of stock-market and asset-market bubbles, the proliferation of derivatives, and a sustained credit boom across the advanced economies culminated in the financial crisis of 2007–2009. In essence, the GFC was a liquidity crisis in the US–European financial system that became a widespread solvency crisis. In turn, this generated a severe global recession. As is well known, the proximate cause of the crisis was the collapse of the subprime mortgage market in the U.S. But one key driver was the fact that U.S. and European banks were dangerously over-leveraged and were far too dependent on the wholesale funding markets. The breakdown of the subprime market and the collapse in value of subprime-related assets generated a panic in these funding markets. Fears over the capacity of counterparties to repay loans, or over the quality of the collateral they could provide, led to runs on these sources of funding and a general breakdown in lending. Fire-sales ensued and balance sheets began to collapse, inducing a widespread solvency crisis. What ultimately saved the financial system was a combination of innovative liquidity support from central banks and capital injections ('bailouts') from governments. The same will be true this time around although the firms in need of support will be different.

THE CURRENT CRISIS

The speed and force with which central banks have reacted to the present crisis is reflective of both the incredible speed and intensity of Covid-19's impact on the financial markets and the legacy of the GFC, which left central banks with a crisis-fighting playbook that they can pull out and dust off. In response to the 'Great Liquidity Crisis', the major central banks have cut interest rates, rebooted a number of emergency lending facilities that distressed banks and other firms can draw upon, relaxed regulatory requirements on banks, and announced huge asset purchase programmes.[7] Perhaps most importantly, the U.S. central bank, the Federal Reserve, has fired up its so-called 'liquidity swap lines' again. Central banks will seek to extend the provision of liquidity beyond the banking sector in the coming weeks and months and will provide 'forward guidance' to the financial markets, signalling they will 'do whatever it takes' to keep the financial system afloat.[8]

The two most important of these interventions are the large-scale asset purchase programmes of the major central banks and the liquidity swap lines that have been activated between the Federal Reserve and 14 other central banks. Large-scale asset purchase programmes are perhaps better known as 'quantitative easing' (QE), which was pioneered by the Bank of Japan during that country's so-called 'lost decade' in the 1990s. QE involves a central bank creating electronic money to buy bonds *en masse* in the secondary market. During and after the GFC, the Federal Reserve and the European Central Bank (ECB)—the central bank of the Eurozone countries—conducted gigantic QE programmes. The Federal Reserve's balance sheet expanded from less than US$1 trillion in 2007 to over US$4.5 trillion by December 2018, while the ECB's balance sheet grew from around €1.5 trillion to over €4.5 trillion over the same period.

The main purpose of QE is not to provide bond holders with money so that they can stimulate economic growth, as is commonly believed. Rather, the goal is to ensure bond holders that they will be able to sell bonds no matter what state the markets are in. Most important is providing a market for the global safe-haven asset: U.S. Treasury bonds. This is the role of the Federal Reserve. In a financial panic, investors and firms typically flock to cash and Treasury bonds. If the market for these bonds dries up, investors will not want to hold anything except cash, causing a collapse in lending both to the private sector and to government. It is therefore crucial that this market remains liquid if global finance is to function.[9] The Federal Reserve's bond buying programme was instrumental in stabilising markets during the GFC. Likewise, QE was the means by which the Eurozone debt crisis of 2010–2012 was finally ended. By pledging to buy the sovereign bonds of stricken Eurozone countries like Greece and Italy, the ECB provided a guaranteed market for these assets, easing tensions in the financial markets and providing fiscal relief to the worst hit countries. Through QE programmes, these institutions are effectively acting as the lenders of last resort not just to bond holders, but also, circuitously, to governments, which are able to continue issuing government debt as a result.

In response to the current crisis, the Federal Reserve has announced it will buy at least US$500 billion worth of Treasury bonds and US$200 billion worth of mortgage-backed bonds over the coming months, although it is likely to end up buying trillions of dollars of these assets over the course of the crisis. Meanwhile, the ECB has announced that it will buy a minimum of €750 billion worth of government and corporate bonds, while similar programmes have been announced by other central banks, including the Reserve Bank of New Zealand, which has pledged to buy NZ$30 billion in government bonds.

These actions are oriented primarily towards stabilising the market for sovereign debt by stabilising bond prices, ensuring that sovereign bonds continue to be bought and sold, and putting downward pressure on the interest that governments pay their creditors. The distributional effects of these policies are horrific. Bond holders are guaranteed access to cash while working people or the unemployed are left out in the cold. But the reality of the global financial system is such that they are necessary if more widespread carnage in the financial markets is to be avoided in the short and medium term. If, for instance, the market for Italian sovereign bonds collapsed, Italy would face insolvency and would struggle to provide the fiscal relief that will be necessary in the coming months.The other crucial intervention in response to the current crisis in the financial markets is the Federal Reserve's activation of liquidity swap lines with 14 other central banks.[10] The U.S. dollar acts as the global reserve currency. It is the means of exchange for about half of global trade, with around $12 trillion in global liabilities denominated in U.S. dollars.[11] In a crisis, investors and firms scramble for cash, with the greenback considered the safest currency to hold. Indeed, in a crisis, dollars are preferable even to U.S. Treasury bonds. Consequently, in a financial panic, access to the dollar dries up and the U.S. currency strengthens. For firms with large dollar-denominated debts this poses a major problem. They find it difficult to access fresh dollars, meaning that they will be unable to roll their dollar-denominated debts. Further, with the greenback strengthening against other currencies, their dollar-denominated debts become more expensive to repay.

These funding pressures can only be eased by the provision of dollars and the only institution in the world capable of creating dollars is the Federal Reserve. Liquidity swap lines allow foreign central banks to borrow dollars from the Federal Reserve. The Federal Reserve will credit the foreign central bank with newly created dollars and receive an equivalent credit in the foreign central bank's currency at the prevailing exchange rate. At an agreed upon date, the credits will be swapped back. This allows foreign central banks to channel dollars into their domestic financial systems.

Over the course of the GFC, the Federal Reserve lent over $10 trillion to foreign central banks, easing the dollar shortage that was threatening to collapse the European banking system.[12] In the current crisis, dollar funding has also come under immense pressure.[13] This time around it is the emerging market economies that are facing acute shortages. Making sure dollar funding is available in countries like Mexico and Brazil will be crucial to ward off debt crises from breaking out in these places. In this context, the Federal Reserve's provision of dollar liquidity to other central banks sees it become the lender of last resort to the world. As of 25 March, over US$200 billion had already been flushed through the swap lines in the space of a week.[14]

Similar to QE, liquidity swap lines aim to ease liquidity constraints in the markets by pumping fresh cash into the financial system. The distributional effects here are less visible, but are nonetheless marked. In effect, by providing dollars around the world, the Federal Reserve allows financial and non-financial firms that have built up risky financial positions dependent on dollar funding to continue operating. In this respect, while it mitigates severe economic distress in the short and medium term, as with QE, it props up a dysfunctional financial system that is chronically overleveraged and unstable in the long term.

PATHOLOGICAL FINANCE

The global financial system was saved in 2008 and 2009 but this came at an immense political cost. For many in the U.S. and Europe, the crisis-fighting actions of governments and central banks during the GFC exposed the economic and political inequalities of the existing regime and the hypocrisy of its ideological justifications. As Adam Tooze puts it in his history of the GFC: 'Though it is hardly a secret that we inhabit a world dominated by business oligopolies, during the crisis and its aftermath this reality and its implications for the priorities of government stood nakedly exposed'.[15]

On the Left, moralising critiques of these policy choices are standard. It is argued that Wall Street got away with murder while Main Street was sacrificed by the political establishment. Yet, however true this is, it ignores the fact that such actions were necessary to prevent a far worse economic collapse. On the one hand, the GFC was successfully managed—at least in the U.S. The actions taken by the political establishment saved the financial system from collapse and prevented a far deeper and longer recession that would have hurt working people and the unemployed the most. On the other hand, these actions exposed how deeply enmeshed the political establishment is with the asset-owning classes and how feeble the foundations of 21st century accumulation are in many advanced economies. It also served to perpetuate a fragile co-dependent relationship between governments and global financial markets in which financial markets are dependent on constant state intervention to remain stable and profitable and states are reliant on liquid financial markets to remain solvent.

The same will likely be true in the liquidity crisis currently racking the global financial system. The GFC taught central banks that fast, decisive, overwhelming force is necessary to curb major panics in the contemporary financial system. It is critical that both QE and the liquidity swap lines, as well as the other forms of liquidity support, are provided by central banks to stabilise the global financial system in the current crisis. Failure to do so will only increase the loss of life and economic distress among the most vulnerable people around the globe. But while such interventions are for the moment wholly necessary, they ultimately serve to sustain a deeply dysfunctional system, a contradiction that is symptomatic of the increasing difficulty of the political and economic elite to satisfactorily marry what is economically 'necessary' with what is socially and politically just—or even palatable—in contemporary capitalism.

To avoid the necessity of such interventions in the future, the foundations of the contemporary financial system must be redesigned. Nothing less than complete transformation is required. Historical precedent suggests that the current crisis could indeed be the catalyst for such transformation. But as the GFC taught us, there is no guarantee that a crisis is generative of fundamental change. Indeed, it may only serve as an opportunity to further lock in regressive and socially destructive policies and forms of politics. From socialists to social democrats, making sure that a better world is built from the ruins of the current crisis is an urgent task for us all.

NOTES

1 Steve Matthews, 'U.S. jobless rate may soar to 30%, Fed's Bullard says,' *Bloomberg*, 23 March 2020: https://www.bloomberg.com/news/articles/2020-03-22/fed-s-bullard-says-u-s-jobless-rate-may-soar-to-30-in-2q

2 Guyon Espiner, 'Covid-19 epidemic could take unemployment from 4 to 30 percent – economists,' *RNZ*, 26 March 2020: https://www.rnz.co.nz/news/national/412638/covid-19-epidemic-could-take-unemployment-from-4-to-30-percent-economists

3 Dominic Rushe and Amanda Holpuch, 'Record 3.3m Americans file for unemployment as the US tries to contain Covid-19,' *The Guardian*, 26 March 2020: https://www.theguardian.com/business/2020/mar/26/us-unemployment-rate-coronavirus-business

4 '"Great liquidity crisis" grips system as banks step back,' *Financial Times*, 24 March 2020: https://www.ft.com/content/bd3c0c-cc-6ce8-11ea-9bca-bf503995cd6f

5 See Timothy Geithner, *Stress Test: Reflections on Financial Crises* (London: Random House, 2014).

6 The Marquis of Salisbury, cited in Tom Crewe, 'The confidence trick,' *London Review of Books* 41, no. 13 (2019): 8

7 The Reserve Bank of New Zealand (RBNZ) is a case in point. In an emergency announcement on 16 March, it cut the overnight lending rate to a record low 0.25 percent. More importantly, it has rebooted the Term Auction Facility, which gives banks access to 12-month loans from the RBNZ which can be secured by a range of collateral. It is also offering liquidity support through expanded repurchase agreement operations. It is deferring a number of regulatory changes to the banking sector to ease pressure on the banks. And in a novel step for this country, it announced on 23 March a large-scale asset purchase programme to the tune of NZ$30 billion in New Zealand government bonds.

8 Such assurances to the markets echo the famous words of Mario Draghi who, as president of the European Central Bank (ECB) during the Eurozone debt crisis, promised in a speech on 26 July 2012 that the ECB would 'do whatever it takes to preserve the euro'. It is widely argued that Draghi's speech is what finally calmed the bond markets and put an end to the acute phase of the Eurozone crisis.

9 Perry Mehrling, *The New Lombard Street* (New Jersey: Princeton University Press, 2011), 53.

10 Unlimited swap lines are currently active with the Bank of Canada, the Bank of England, the Bank of Japan, the European Central Bank, and the Swiss National Bank. Limited swap lines of up to US$60 billion are currently active with the Reserve Bank of Australia, the Banco Central do Brasil, the Monetary Authority of Singapore, the Sveriges Riksbank (Sweden), the Bank of Korea, and the Banco de Mexico. Limited swaps of up to US$30 billion are currently active with the Danmarks Nationalbank (Denmark), the Norges Bank (Norway), and the Reserve Bank of New Zealand.

11 'Why FX swap lines are the most important Fed action thus far,' *Financial Times*, 17 March 2020: https://ftalphaville.ft.com/2020/03/16/1584359069000/Why-FX-swap-lines-are-the-most-important-Fed-action-thus-far/; 'Why the Fed is trying to tame the dollar,' Financial Times, 20 March 2020: https://www.ft.com/content/dca1873a-69bf-11ea-800d-da70cff6e4d3; Iñaki Aldasoro, Torsten Ehlers and Egemen Eren, 'Global Banks, Dollar Funding, and Regulation,' BIS Working Papers, no. 708 (2019).

12 Adam Tooze, *Crashed: How a Decade of Financial Crises Changed the World* (UK: Allen Lane, 2018), 214.

13 Brad Setser, 'Addressing the global dollar shortage: More swap lines? A new Fed repo facility for central banks? More IMF lending?' *Council on Foreign Relations*, 17 March 2020: https://www.cfr.org/blog/addressing-global-dollar-shortage-more-swap-lines-new-fed-repo-facility-central-banks-more-imf; Adam Tooze, 'Crashed to Corona 1: the dollar shortage,' *Adam Tooze Blog*, 22 March 2020: https://adamtooze.com/2020/03/22/crashed-to-corona-1-the-dollar-shortage/

14 Federal Reserve Statistical Release, 26 March 2020: https://www.federalreserve.gov/releases/h41/current/

15 Adam Tooze, *Crashed*, 13.