(1) The Implications of Hitting the Hard 0% Interest Rate Floor

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Part 1

While I'm going to pass along my thoughts to you, I want to emphasize that I wasn't, and still am not, able to anticipate the most important things happening in the markets because of the extremely rare nature of the circumstances. While what I don't know is much greater than what I know, I will tell you what I think for you to take or leave as you like.

As you know, for some time now I have been concerned that when the next economic downturn would come it would lead to hitting the 0% interest rate floor with a lot of debt outstanding and big wealth and political gaps in the same way that configuration of events happened in the 1930s. The coronavirus was the thing to cause the downturn, which surprised me. While it is an extremely serious infectious disease that will produce many harmful economic impacts, these things alone don't scare me; however, when combined with long-term interest rates hitting the 0% floor, it really worries me.

Long-term interest rates hitting the hard 0% floor means that virtually all asset classes go down because the positive effects of interest rates falling won't exist (at least not much). Hitting this 0% floor also means that virtually all the reserve country central banks' interest rate stimulation tools (including cutting rates and yield curve guidance) won't work. The printing of money and buying of debt assets that central banks are now allowed to buy almost certainly won't work much (because bonds can't be pushed much higher and they are also less likely to be sold to buy other assets of entities that are in financial trouble). Further, with this hard 0% interest rate floor, real interest rates will likely rise because there will be disinflation or deflation resulting from lower oil and other commodity prices, economic weakness, and more credit problems. If that plays out in the typical way, rising credit spreads will raise debt service payments to weaker credits at the same time as credit lending shrinks, which will intensify the credit tightening, deflationary pressures, and negative growth forces. God help those countries that have these things and a rising currency, too.

I am trying to imagine how this will play out. To do that, I (with my great team) are taking existing market prices and visualizing what will happen if things stay exactly where they are. For example, I think about pension funds and insurance companies and others that have long-term liabilities that are funded with these equity and equity-like assets. I do the mark-to-market accounting of what this situation will be like for them by taking the present value of liabilities and looking at the expected returns of the assets that they have to fund their liabilities. They will come up short. I imagine what they will have to do—i.e., sell assets to make payments. I think about oil producers (countries and companies), see that their expenses are much greater than their revenues, and imagine what they will have to do—i.e., slash spending and sell assets. I imagine many others in similar circumstances and what that will mean for economic activity and market prices, and that's seriously worrisome. These are only a couple of things that I'm thinking about and I'm sure what I'm thinking about is only a small percentage of the financial disruptions that will happen. Remember that most investors and businesses are long (i.e. holding assets hoping that they will go up in price) on a leveraged basis (financed with debt) so that the declines in asset prices that we are seeing will have even bigger financial effects than the unlevered price declines that we are seeing.

Contrary to popular thinking, the markets will have a bigger effect on the economy than the economy will have on the markets. For that reason, calculating who is in what positions and figuring out what they will need to do because they are in those positions (e.g., cut expenses, sell assets, etc.) is most important. That's what we are struggling hard to do and are doing inadequately.

However, what I'm damned sure about is the following:

Part 2

Big Fiscal Stimulation with Monetary Cooperation Is Needed, Low-Risk, and Isn't Yet Happening

Our biggest economic risk comes from the possibility that our elected officials (who are the ones who control fiscal policy) will handle it badly. That is because it's tough enough to know what to do during a big crisis and then do it boldly even when there aren't divisive politics. With the divisive politics it might be impossible. While some fiscal stimulation measures are being put into place, they're not large or targeted enough to neutralize the contagion of the economic and market effects of the virus, and they are being argued about. However, there are some emerging signs that some important policy makers might move to a "whatever it takes" posture. If so, then we will have to see if works given the previously described circumstances being so limiting. More specifically, in a nutshell, here is what is going on:

In the US:

Thus far the fiscal and monetary reactions have been too little too late but there are indications that some parties are moving into the "whatever it takes" mode. What will happen is still being worked out. Things are changing by the minute. Here's where things now stand.

Thus far, there has been only a very small fiscal response consisting of:

·$3 billion for research and development of vaccines, test kits, and other treatments

·$2.2 billion for the Centers for Disease Control and Prevention to contain the outbreak

·$1.2 billion for the State Department to assist in battling the spread of the virus overseas

·$1 billion for medical supplies, healthcare preparedness, and community centers

·$1 billion authorized for the SBA to make subsidized SME loans

·$500 million for Medicare providers to provide telemedical services

·$300 million to ensure vaccines are delivered to individuals at little or no cost

There is talk of a payroll tax cut which isn't targeted to where the problems are. It's styled after the 2011-12 cut which was about 0.6% of GDP (a similar cut today is estimated at 0.75% of GDP). However we hear President Trump supports a complete payroll holiday until after the November election (it's not detailed, but supposedly it encompasses both employer and employee contributions, estimated at ~$500 billion). This plan probably won't happen because Congressional Democrats and some Republicans don't support it (because payroll tax cuts are regressive and undermine Social Security funding, and the business part of the cut is considered too business-friendly). It is, however, indicative that president Trump might be in favor of a big stimulation, though there are no signs that it will be targeted where it needs to go most or of a size that it needs to be. Regarding his priority of getting elected, he is in serious risk of doing too little too late, and what president trying to be re-elected wouldn't love to have big fiscal stimulation going into the election, so I would think that he would move into the "we will do whatever it takes camp." In time and with further deterioration in conditions, maybe he will support more related tax credits.

For now, there hasn't been much focus on relatively targeted measures, which I believe are most important because specific areas need the most help for this debt/economic problem not to spread. I'm not saying that nothing was created, because there have been some increased subsidized SBA loans to SMEs, paid sick leave for those affected, coverage of most of the cost of virus treatment for the uninsured (potentially tapping FEMA), and increased funds for state and local healthcare services (by tapping emergency and disaster-related funds via FEMA and its Disaster Relief Fund), extension of unemployment benefits, and increased funding of other direct transfers, e.g., food stamps for those in hard-hit areas. The House voted last week on a set of targeted measures (including free testing for the virus, expanded unemployment insurance and paid sick leave for those affected, and subsidized meals for students eligible for free school lunches). But these measures will be relatively small and offer modest support to those with economic problems. They will need to be much bigger.

Thus far, there has not been much debt support to industries that would go broke due to this shock though President Trump has called for Congress to authorize an additional $50 billion in subsidies for loans to SMEs through the SBA. This could free up a few hundred billion dollars in loans; however, it's not big enough and it's not clear whether this measure will garner congressional Democrats' support. Thus far, meaningful debt supports to industries that would go broke due to this shock have been absent (other than SBA-subsidized loans, which look to be small). Probably the best way to do this is for the fiscal policy makers to guarantee the safety of the banks for new lending of a sort that is needed with government protections on that new lending (a politically challenging move). Accidentally we are seeing a bit of this as troubled companies have tapped pre-existing lines of credit at banks. While this may not be what the banks want (I doubt they want to take on more credit risk when the economy is deteriorating), it is one way that money gets to those businesses that are squeezed. Getting money to targeted businesses is a task the Fed is ill-suited for, but it can provide liquidity to the banks to fund those loans if needed. My suspicion is that we will see more of what I will call “protected lending programs” of the sort that the ECB did (like the TLTRO) in which the Fed provides super-cheap money and protections to the banks that lend it. This big usage of credit lines by businesses has a significant hint of this, even though it’s accidentally stumbled into. All those who control the fiscal levers have to do is protect the banks from going broke. Still, not all of the squeezed companies have pre-existing lines of credit, so large gaps are likely to remain, and they will come with significant costs.

I don’t yet know if the president and other fiscal policy makers have done the stress tests of various companies and various sectors of the economy as we have, or whether theirs show what ours show, but I’m seriously concerned by what I see, which is that a number of companies and industries will have debt problems that will likely lead to restructurings. Perhaps it is expected that these companies will keep operating through the bankruptcy process, though this could be debilitating and would have undesirable knock-on effects because monetary policy will be ineffective and the political fragmentation will be large and potentially volatile. If handled badly, this could become a big political and social issue. If I were in President Trump’s shoes, I’d be generous and empathetic, especially as the news will become increasingly bad at this politically sensitive time. I do expect politics to get in the way of doing the best things for the country as, above everything else, the number one goal of each of the sides is to get into power.

As for the Federal Reserve, it just did about all that it can do in being stimulative without moving to doing what I call Monetary Policy 3 (which is working with fiscal policy makers to monetize their deficits). The first (and preferred) type of monetary policy (MP1) primarily uses interest rates as the control mechanism. When that stops working, they go to the printing of money and buying financial assets which I call MP2. When that no longer works, the central government has to run big deficits and sell the resulting bonds to the central bank (which I call MP3). It takes various forms that you can get an explanation of in my book *Principles for Navigating Big Debt Crises* (available free at www.economicprincples.org). We are now at that stage in the long-term debt cycle and we will have to see if fiscal and monetary policy makers can coordinate themselves to do that and then see how it works. There’s not much else that can be done. Theoretically the Fed could buy other assets like stocks, but that won’t fly because it’s very controversial, questionable at best under the Federal Reserve Act (it likely requires Congressional approval), and it wouldn’t have much of an impact anyway. As far as I can see, the best path is to do all these things I just mentioned plus provide support to the banks in conjunction with the fiscal authorities providing fiscal protections that will help the credit get to those who need it most.

In Europe:

The European Commission is expected to grant maximum flexibility from the EU rules, most importantly the fiscal rules associated with the Stability and Growth Pact. Consistent with this, the fiscal responses in Europe that have been announced are generally targeted at supporting health services and hard-hit geographies, sectors, and SMEs. The measures include tax and fee cuts, debt service forbearance, and employee compensation for shortened work hours. The hard-hit sectors most mentioned are tourism, transportation, and autos, though supports are likely to be much broader than these. Both France and Italy have been pushing for more concerted efforts at the intergovernmental and supranational level. However, there still is now little consensus on policy direction or a willingness for the mutualization of deficit spending. The European Commission just proposed a modest €25 billion EU investment fund to be used for targeted measures: healthcare, SMEs, and labor-market support. It is funded by the EU Commission reallocating €7.5 billion from its budget (specifically from the Structural and Cohesion funds), which the EIB, in turn, will lever up to €25 billion. Steps toward greater policy coordination are likely to emerge from the next formal meeting of the Eurogroup (EMU finance ministers) on March 16. My guess is that each country will eventually do “whatever it takes” fiscally for itself but not materially help the others and the ECB will be too constrained to help which will cause serious problems. That means that where there are big fiscal stimulation and deficits there will be a lot more bonds that have to be sold so that, without the ECB buying, interest rates will rise. At the end of last week with the German announcement of its big fiscal stimulation we saw that. God help us if that happens.

The ECB can’t do much because it can’t cut rates and it doesn’t have the authority to buy the quantity it needs to buy. While of course its officials won’t directly say that, they are conveying that message as loudly and clearly as they can through their actions and what they are saying. Christine Lagarde did that in her way on Thursday. More specifically, she kept ECB rates at -0.5% and launched a package of measures to alleviate the economic impact of the coronavirus: providing liquidity and a bit more credit by buying €120 billion ($133.9 billion) more bonds by the end of the year and launching a new program to offer cheap loans to banks (at rates as low as -0.75%, below the ECB's sub-zero deposit rate). But it was made clear that the ECB isn't going to do anything much other than add liquidity because it can't. It can't because it is a justifiable worry that pushing rates lower than where they are now (-0.5%) will be more harmful than helpful, and the Northern Europeans are against lower rates and modifying the limitations on sovereign purchases. ECB President Christine Lagarde said her officials are looking to provide "super-cheap" funding and ensure liquidity and credit don't dry up. And then she appropriately made clear that the response to the coronavirus needed to be "fiscal first and foremost," noting that the spending pledges so far from Eurozone governments amounted to only €27 billion ($30 billion) in total, and that central bank measures can only work if governments throw their weight behind them, too, with steps to ensure banks keep lending to businesses in affected areas. I couldn't agree with her more.

As for what might come next, the ECB is likely to consider raising liquidity for small and medium-size enterprises, possibly by repurposing an existing TLTRO or a new program like that, but that won't do much. The most important big test of their willingness to "do what it takes" will be in whether or not they raise their bond buying limits to hold interest rates and credit spreads down. A yes on that will buy some time to help fund the deficit but still won't be enough longer term while a no would be very worrisome.

In Italy:

Thus far, the fiscal stimulus package equals about 0.4% of GDP but they will make it bigger and it should be much bigger. It now contains targeted tax cuts for affected sectors such as transportation, hotels, and exporters; support for healthcare services; and select tax credits for companies that reported a 25% drop in revenues. To me, this is a good policy that other countries should consider their own versions of, because it is the bankruptcies of good businesses and the second-order effects of them that is threatening economic recovery, but it's not nearly enough. The Italian government is also preparing a structural package of measures designed to encourage FDI and investment but that's an issue for beyond the time of this crisis. Because these policies are producing political issues, with the opposition saying more should be done, doing more is clearly politically safer on the domestic political stage. Not surprisingly, reportedly the government now seeks to more than double the stimulus size, totaling up to €25 billion (1.2% of GDP), which will bring its 2020 deficit to 3.3% though my guess is that estimate of the size of the deficit is way too low because the tax revenue will be devastated. Although the EU has shown flexibility with regard to Italy deviating from its debt reduction pathway, the amount it borrows will affect its overall debt sustainability. Italy's finance minister touched on this by asking for the ECB's support. We will have to see how all the political players (most importantly the European Commission and Italian government) work this out.

In Germany:

The Germans started approaching this crisis with their usual frugality that put not creating a lot of money and credit during times of financial stress above all else, but now they appear to be flipping to doing "whatever it takes" which will significantly increase its need to sell bonds. This put the onus on the ECB to buy them to hold rates down, though there are restrictions, mostly by the Germans, that prevents the ECB from buying them. To quote the statement from the finance ministry "The German government is taking decisive and forceful action against the economic impact of the coronavirus." It has been agreed that there will be a "far-reaching package of measures to protect jobs and support companies. The government is setting up a protective shield for employees and companies. The goal is to equip businesses with sufficient liquidity that they will be able to make it through the crisis in good shape." They went on to layout some specifics but a lot more will come. These measures include employee and employer reduced work hours and compensation for these shortened hours and liquidity provisioned via the public investment bank. They also include tax payment deferrals, penalties for late payments being eliminated, etc. It will also create a "protective shield" for businesses that include KD business loans and loan guarantees. To me this looks like an excellent path both in size and focus and it then will require more borrowing to fund it which will put this back in the ECB's court and the ECB needs to hold rates down and do whatever buying is required to do that, which means that controls will have to be lifted (which is doubtful). It will also be interesting to see how Germany handles its own constraints such as the "black zero" (pledge to maintain a balanced budget) to constrain the size of any potential stimulus over and beyond leveraging automatic stabilizers and drawing down existing surpluses. Also it has to deal with the "debt brake" which is a constitutional provision limiting the structural deficit to 0.35% of GDP. There is, however leeway if a majority of parliamentarians determine additional spending is required to address a "natural disaster or extraordinary emergency situation outside the control of the state," for which COVID-19 qualifies.

In France:

So far, the focus is on credit payment assistance and various forms of regulatory relief (e.g., credit payment assistance for up to 70% of loans, removal of late payment penalties on public contracts and tax obligations). However, the finance minister has initiated emergency economic measures. The last time such measures were implemented (during the Yellow Jacket protests), they were used to initiate spending and revenue changes of roughly 0.4% of GDP. France has a more centralized institutional structure than Germany and a less stringent strain of fiscal conservatism in its culture. This means that policy barriers to the provision of assistance are weaker, enabling the government to enforce deeper policy cooperation across the sectors of the economy. Governments are also more responsive to people's screaming (some would say temper-tantrums) so we should expect more as conditions worsen there. However, because France's budget deficit is already large and in breach of EU fiscal rules (3.2% of GDP), there isn't yet much talk of a broad fiscal stimulus. I do however expect that will come. We are awaiting announcements.

In Japan

The government's fiscal response thus far is targeted to support healthcare services and impacted persons and firms, in particular SMEs. Two recently enacted spending packages totaling ¥450 billion, for example, fund new medical clinics and improvements to medical facilities, provide aid to working parents forced to take leave due to school closures, and support SMEs. In addition, the government is providing ¥1.6 trillion in special financing to aid SMEs and other businesses affected by the outbreak. These look good to me, though not yet enough in light of their total picture. These measures draw on existing "rainy day" government funds. Isn't it great that they have such a fund? The government is also seeking legislation empowering the prime minister to declare a state of emergency, if needed. These steps are in addition to ¥13.2 trillion in fiscal stimulus already in the pipeline announced in December. That spending is being phased in over several quarters. The government is reportedly considering a fiscal package for April of some ¥10-20 trillion that may include direct cash handouts to households.

The BoJ is being even more squeezed than other central banks because it has the same problems plus the strong currency (which adds to deflationary and negative growth pressures). However, it has more flexibility in what it can buy and in what quantities. Its usual bond purchase it has so far purchased roughly ¥100 billion of equities ETFs on each day it has intervened in the market in March, compared to a previous pace of around ¥70 billion. It has also provided ample liquidity to the market via repo operations. It may increase its annual target for ETF purchases at its March meeting.

In China:

The most targeted and appropriately-sized fiscal and monetary responses are coming from China. That is because it is a country that has a greater ability to coordinate fiscal and monetary policies and cut through political disputes more quickly, and it has very smart economic policy makers.

Thus far there has been a series of announced fiscal measures that have amounted to roughly 1.2% of GDP, excluding infrastructure investment. These include waivers and reductions of social charges (e.g., corporate pensions, unemployment and workplace injury insurance), reduced healthcare insurance contributions, lower VAT taxes for some enterprises, and lower electricity and gas fees for corporate users, among other measures. There has also been a series of smaller fiscal support measures (including subsidies) announced at the local level. At the national level, the government has introduced sets of measures to support select industries, as well as regulatory forbearance (such as delayed recognition of some bank non-performing loans).

The People's Bank of China has more room to maneuver because of where interest rates are and because it has more levers to pull in order to make lending increase or decrease where it wants to see increases and decreases. It has recently cut rates, cut reserve requirements, provided liquidity and initiated a $79 billion support package for companies hurt by the virus. Additionally it has shifted its official stance to "prudent with appropriate flexibility" and introduced 30 measures to support enterprises impacted by the outbreak (with a focus on SMEs), such as relending and rediscounting funding for banks. It is in my opinion appropriate in light of the full picture.

In summary, I believe that 1) the 0% interest rate floor and the absence of other effective central bank tools requires much greater fiscal stimulation that is targeted to hit the most important pain points, with the cooperation of central banks holding rates down and providing plenty of liquidity, 2) the response thus far has been inadequate in size, focus, and coordination but that has varied a lot by country, 3) in the last few days there have been signs of fiscal and monetary policy makers moving to much stronger "do whatever it takes" policies, and 4) the wealth and political gaps will test social and political abilities to cooperate and help rather than hurt each other in dealing with these problems.

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