INCONVERSATION

Hamish Douglass

Kevin Warsh

Hamish Douglass speaks to Kevin Warsh, a former Member of the Board of Governors of the US Federal Reserve System, and presidential adviser on economic policy to President George W. Bush. For his full biography please click here. The pair discuss the economic ramifications of covid-19 and the responses so far of policymakers.

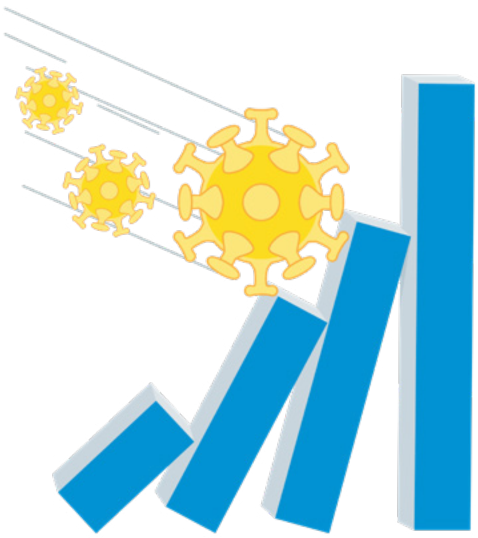
Q1. How different is this situation from other economic downturns? Do you think the economic downturn will be worse than 2008-2009?

The 2020 pandemic-induced recession is fundamentally different in kind and effect compared with the financial crisis of 2008-2009 and other recessions post-World War II. Governments often put their economies in recession but by accident. In this case, the pullback in output and employment is a deliberate choice, ostensibly to protect the population from more dire healthcare outcomes. And unlike the crisis of 2008-2009, this downturn hits 'Main Street' first and most directly, with downstream implications for 'Wall Street'.

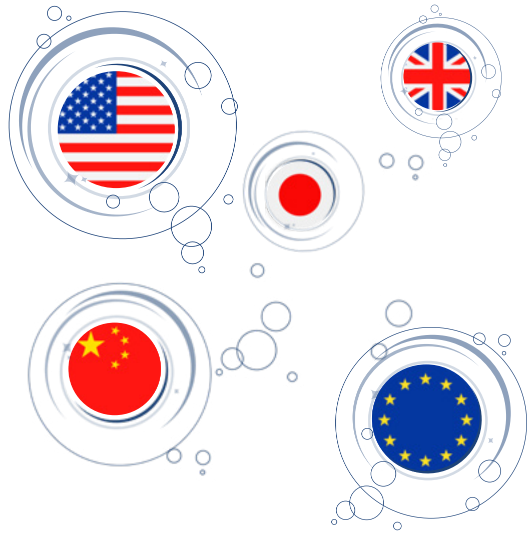
Policymakers have some experience with responding to natural disasters such as hurricanes to which this shock has some passing similarity. But of course, the 2020 pandemic is global in nature and the storm itself looks like it will be staying with us for a considerable time.

The US economy – like much of the rest of the world – is likely to suffer from a considerably deeper, more synchronous and broader downturn than experienced during the last recession. Its ultimate contour will depend on the epidemiology of the virus, the efficacy and timeliness of the medical treatments, the timeliness and efficacy of the economic policy response, and the harm done to the economy from the initial shock.

"... the 2020 pandemic is global in nature and the storm itself looks like it will be staying with us for a considerable time."



Q2. From a policy perspective, how do you evaluate how the major central banks and governments have reacted to date?



After they became aware of the virus's proliferation, most governments and central banks (at least among the advanced economies) acted with remarkable speed in crafting their initial responses. Those policies that are likely to be most constructive at this stage are focused on two objectives: immediate income support for the least well-off among us; and the provision of ample liquidity to all firms that were solvent prior to the crisis. On the other hand, fiscal stimulus – government spending to offset shortfalls in aggregate demand – is likely to be of less value until the decision is made to let most people back to work and until people feel comfortable re-engaging in work and social life.

Given the global nature of the shock, I am surprised that the monetary policy actions were not more coordinated. Almost all major central banks ended up reducing interest rates close to zero, and most announced new programs of quantitative easing. There would be more bang for the buck, in my view, if the actions were announced and communicated together. That's what Sunday nights in a crisis were intended to be used for.

"I am surprised that the monetary policy actions were not more coordinated"

Q3. Do you think they have done enough to get a quick economic recovery?

"Western-style market economies are complex organisms. They aren't akin to pop-up stores."

No. The right policy response is at least as much about program design as program size. Too many economic policymakers and policy thinkers believe that a recovery will come once the shortfall in aggregate demand is addressed. I think otherwise. Western-style market economies are complex organisms. They aren't akin to pop-up stores. Policy responses – at this stage – should be about providing overwhelming liquidity. Job No. 1 for the official sector is to buy time so that the micro-foundations of the market economy can be sustained. Economic policymakers must explain the rationale for their actions. Our enemy cannot read, so businesses and households alike should be made aware of the economic war plan.

Q4. Which countries do you think are best placed to deal with this crisis? How concerned are you about emerging markets?

The countries that are the most dynamic, most transparent, and most resilient will be best able to withstand the shock. And those with deep liquid capital markets and respect for the rule of law are far better situated.

I'd expect the weak recent trend of global trade to turn further to the downside. That is likely to cause China to accelerate its move toward domestic consumption. But the transition is likely to be very challenging. China's economic growth will not be spared by the global recession.

"China's economic growth will not be spared by the global recession"

Q5. How worried are you about the massive increase in government debt that will result from the fiscal measures being put in place in the US and in Europe?

The incursion of large deficits when confronted by an unexpected shock is to be expected. But, when the unprecedented debt issuance gets piled on top of debt incurred in benign times, a country becomes reliant on the generosity of strangers. Historically, high and growing debt levels relative to GDP are often associated with lower growth, lower productivity, and lower average incomes.

Among the big advanced economies, markets are likely to handle the surge in debt issuance for some time, especially when the world's largest central banks are the largest marginal buyers in the name of quantitative easing. But policymakers should not be complacent. A fiscal transition plan, if not an exit plan, will ultimately prove necessary.

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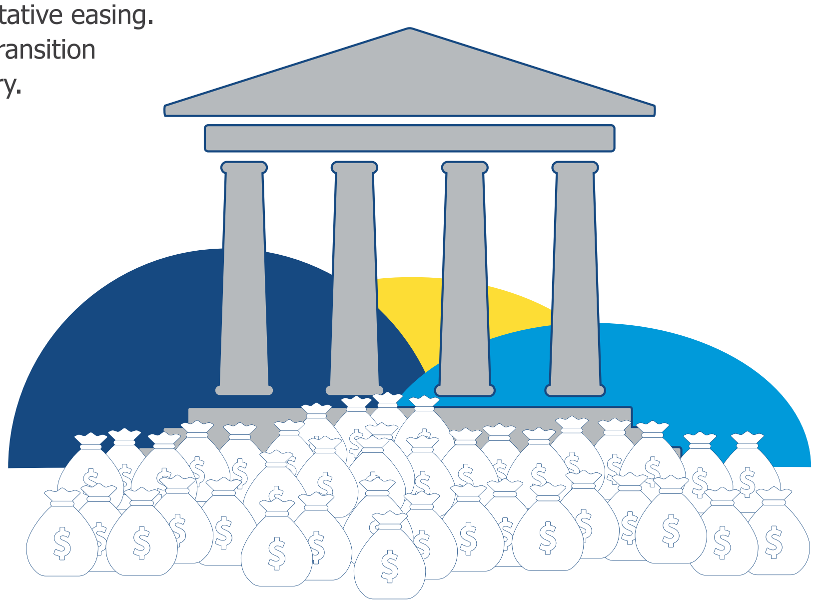

Q6. Should we be concerned about a spike in government bond yields in the US or Europe if investors become concerned about government debt sustainability? How will central banks counteract this concern?

Government bonds are a far less helpful shock absorber today in a typical investment portfolio. But, the world's largest central banks will continue to participate in these markets with a goal of keeping yields low. And the US dollar is a more dominant currency relative to its peers than ever. If funding costs in the US and Europe were to increase, that could be for good reasons (improved economic prospects) or bad reasons (higher-than-expected inflation risks). In the latter case, the world's central banks would need to exercise their powers and judgment and credibility.

Q7. Should we be concerned about increasing inflation as a result of the dramatic increase in quantitative easing (QE) by the Fed and the ECB?

The first-order implication of the 2020 pandemic is disinflationary. I would expect the Federal and European Central Bank to be more worried about prices that are trending too low rather than too high. That doesn't mean, however, that prices in certain parts of the economy won't increase markedly. Our understanding of inflation dynamics is decidedly imperfect. So central bankers should never be complacent about inflation risks.

In the past decade, quantitative easing has become too common as a monetary policy response. So in times of true emergencies like this, QE expansion is decidedly less beneficial than it should be. And it can readily lead to the misallocation of resources across economies and companies, which is no less destructive to economic growth and stable prices.

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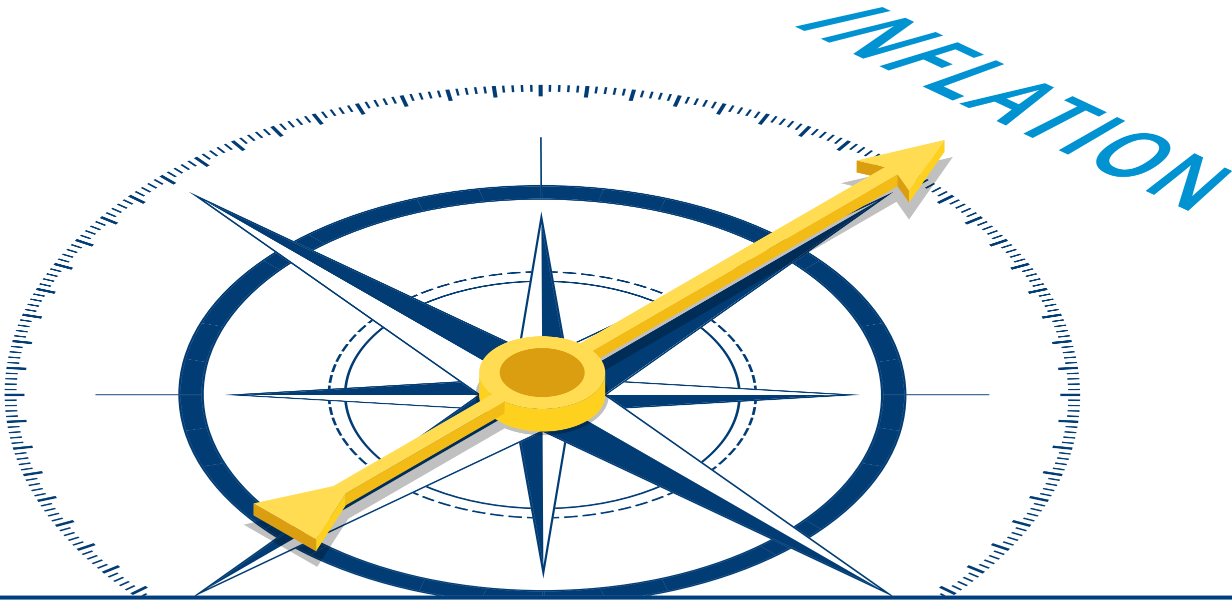

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