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Watch post-coronavirus interest rate path

INSIGHTS *into the* WORLD

By Motoshige Itoh

Economic debate over the COVID-19 pandemic mostly revolves around two questions: First, how can the economy be protected while containing the spread of infections with the novel coronavirus? Second, how will the economic landscape have changed when the COVID-19 situation is over?

Both questions are important, yet there is another key question: Will the economy steadily recover once the pandemic dies down to a certain extent?

In the early stage of the coronavirus' spread in the United States, former U.S. Federal Reserve Chairman Ben Bernanke likened the COVID-19 outbreak to a snowstorm that kept people from going out. He called for policy support to prevent people from running out of provisions during the shutdown.

Bernanke's metaphor apparently reflected an expectation that people's lives would soon get back to normal if they remained patient for a while.

But, given the current state of the situation, the virus crisis is likely to be protracted, and therefore the economy is unlikely to recover anytime soon. In the latest World Economic Outlook report, the International Monetary Fund predicted that global economic growth in 2020 will suffer its worst year-on-year contraction since the Great Depression of the 1930s.

Hearing this, I have the urge to look more closely at the Great Depression for the sake of comparison. The global depression started with the Wall Street stock market crash of 1929 and lasted more than a decade. The devastating economic downturn became prolonged because economic disruptions continued unabated in the wake of the failure of various policies.

In the COVID-19 crisis, countries should try to avert the prolongation of a global economic tailspin triggered by the novel coronavirus.

The Great Depression was protracted for two main reasons. One of them was the tit-for-tat chain of protectionist retaliation moves by some countries, which exacerbated global economic turmoil. Let me describe that situation as the "G issue," for "global." The other reason was the disruption of state finances and financial markets caused by currency devaluation, among other disruptive events, that resulted from failed monetary policies. I refer to them collectively as the "F issue," for "finance" or "financial."

In the COVID-19 crisis, too, it is important to deal properly with the G and F issues. But it does not seem that they are being sufficiently attended to yet.

Growing protectionist pressure

This time, I am not discussing too much about the G issue, except for the fact that the global economic system is obviously heading toward a materially dangerous phase as symbolized by the U.S.-China trade war.

There are many other worrying developments, including the declining role of the World Trade Organization. What matters is that protectionism causes a negative impact on the global economy, while economic disruptions aggravate protectionist trends in return. The longer countries remain in dire economic straits, the stronger protectionist pressure will become.

Protectionist trends had already emerged prior to the outbreak of COVID-19. That is why the issue of protectionism is more serious now. It is often said that "a crisis changes society." I remember reading a line that said, "Two successive crises change society further." That seems to be right.

In the years after the so-called Lehman shock, the world saw the rise of China, which in turn led to the spread of protectionist moves. The coronavirus crisis may accelerate such moves even further.

As the COVID-19 crisis hit a world that was already changed by the global financial crisis stemming from the collapse of U.S. investment bank Lehman Brothers, the change we are now experiencing will certainly end up being a much greater one. This change can be described as related to the F issue as well. Should the coronavirus crisis prompt issues that have been smoldering since the global financial crisis to explode at once, the consequence will gravely affect post-COVID-19 economic recovery.

The main feature of the post-Lehman shock change has been the introduction of massive economic stimulus packages including both fiscal and monetary policies. Notwithstanding such stimulation, the real-world economy's recovery has been slow. This is particularly true in Japan Similar trends have been seen in the United States and Europe's developed countries.

What symbolizes the lackluster economic landscape is the trajectory of long-term interest rates, which have been on the decline for about 30 years. This has a lot to do with "secular stagnation" of developed countries

In their fiscal and monetary responses to the COVID-19 crisis, governments have been mobilizing every possible measure to save their economies. In that sense, they have been more proactive than during the post-Lehman shock period. As a result, long-term interest rates have now fallen farther.

The biggest factor behind a possible interest rate increase will be a rise in fundraising demand from the private sector that will occur in parallel with an economic recovery

Amid such circumstances, financial markets have dramatically recovered ground lost in March, when they were in an incredibly challenging environment. Stock and bond prices are recovering whereas the real economy continues to be in horrible condition. Although there is a big gap between financial market trends and the real economy, it is said that the latter should eventually make a sharp recovery to the extent that the financial markets correctly reflect the real state of the economy.

However, I am not so optimistic.

What has been happening in the financial markets is a "coronavirus bubble," as described by market participants. Once the stimulus effects of emergency fiscal and monetary packages fade, it is possible that stock and bond prices will have to undergo a major correction, a development that is likely to be intensified by a prolonged recession.

'Japanization' of developed economies

In Japan, we have been familiar with a particular situation — in which stock and bond prices are robust even while the real-world economy is stagnant — for a long time, going back to the Lehman shock. The coronavirus shock just makes the situation more conspicuous. The phenomenon that lies beneath this situation is the convergence of "three lows": low interest rates, low inflation and low growth. The reason for low long-term interest rates is weak demand for loans from the private sector, which, as mentioned earlier, reflects drawn-out stagnation.

The scarcity of private-sector demand for loans has continued to be made up for by the government. Indeed, the Japanese government kept posting fiscal deficits year after year with the country's outstanding public debt snowballing every year

Thanks to extremely low interest rates, the swelling of public debt levels has caused a relatively light burden on the state coffers. In other words, the continuous increase in public debt has hardly impeded fiscal management. Against this background, Japan's public debt has constantly spiraled upward.

The three lows are only gathering momentum amid the COVID-19 shock. The situation has now spread overseas with the phenomenon referred to in some countries as "Japanization."

The government is expanding fiscal expenditures in an effort to end the ongoing crisis while the Bank of Japan is backing fiscal expansion with a bold monetary easing policy. Those initiatives help stock prices stay high.

We need to ask if the three-low environment, which emerged following the Lehman shock and is now gathering pace with the coronavirus crisis, will stay in place in the years ahead.

What is worrisome is the trajectory of long-term interest rates. If they show a sharp upside trend, the financial markets could plunge into turmoil. The biggest factor behind a possible interest rate increase will be a rise in fundraising demand from the private sector that will occur in parallel with an economic recovery.

I am keenly looking forward to seeing the Japanese economy getting back on track, but I remain concerned that such a bright outlook will be inevitably accompanied by an excessive reaction by interest rates. It cannot be ruled out that such upward pressure on interest rates may be contagious from abroad, apart from a change of winds within Japan. We need to keep a close eye on how the F and G issues will evolve

(Special to The Yomiuri Shimbun)

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