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The concept of a market economy, with all its narratives and metrics, continues to lie behind the assessment of Europe’s banking and financial markets. And yet with the pandemic, both the basics and the optics on forces driving them have changed. Is the market economy still the viable constant behind the health and activities of banking and securities markets? Or is the growing role of central banks and governments the increasingly relevant vector? Sam Theodore and Keith Mullin debate this topic below.

SAM THEODORE

The way I see it, Keith, the pandemic has led to the second time in as many decades that the market economy has proven unable to ride a major crisis unaided. Only a year ago, right before the pandemic erupted on a global scale, the very idea of free-market economies being kept afloat by massive government and central bank support would have been viewed as bizarre in financial markets.

But, as I noted in “The Wide Angle” last year, “I’m from the government and I’m here to help” are no longer seen as “the nine most terrifying words in the English language” – market capitalism’s mantra famously uttered by Ronald Reagan more than three decades ago.

I continue to believe that financial market transactions will continue to fund businesses, households, and the public sector, preserve economic stability and spur growth and innovation, and create private and public wealth. But when push comes to shove – whether through the GFC’s self-inflicted blow or through the pandemic now – and left to their own devices, financial markets quickly throw in the towel.

Economies, and implicitly the social contract they underpin, would simply have collapsed without prompt and massive public-sector intervention from central banks and governments.

If this is true, it seems to me that the scenario of financial markets regaining full independence and high public confidence, pre-2008 style, is a thing of the past. Objectively, and I would think, increasingly in investors’ minds.

But to a believer in the power and collective wisdom of financial markets this may sound scary. This is not how it was supposed to be! Keith, what say you?

KEITH MULLIN

The points you're making are more political than intrinsically about financial markets, Sam. The pandemic has led governments to do things I suspect even they would have thought unthinkable a year ago. So here we are with the State having taken control of financial and banking markets just as it has put us under varying forms of house arrest and removed our hard-won civil and personal liberties. All with no pushback because of a relentless control-by-fear public policy narrative backed up by a criminalisation agenda attributed to protecting public health systems for our benefit.

When it comes to financial and banking markets, the role of government and public agencies in Western market-led economies is to provide workable and appropriately strict regulatory and supervisory frameworks that protect market integrity and promote investor protection by creating deterrents to predatory behaviour.

After that, price and valuation should be a matter for free-market agents based on the laws of supply and demand i.e. without the crowding-out effects and destruction of price discovery by the public sector that we're currently experiencing.

I take issue with your contention that the pandemic has led to the second time in as many decades that the market economy and the financial markets have proven unable to ride a major crisis unaided. That's simply not the case. The market economy didn't fail. Government forcibly shut it down. They introduced severe restrictions on freedom of movement. They forced people under threat of monetary sanction and worse not to work.

The massive fiscal and monetary government support you reference did not come because the economy failed but because of government action that, by the way, has caused equally massive unemployment and hardship.

And guess who's paying? Taxpayers. "I'm from the government and I'm here to help" may not be the nine most terrifying words in the English language but they veer in that direction. I am very concerned about where we've got to. And how we get out of it.

Let me hand it back to you, Sam. You say financial market transactions will continue to fund businesses, households and the public sector etc". But on what basis? The market is utterly rigged. Money is cheap but on the flip side, negative yields won't fund savings or pensions.

SAM THEODORE

I take your points, Keith. It is certainly true that financial markets failed to prevent the terrible impact of the GFC. Banking systems had to be rescued with new public debt and taxpayers' money (even if US and UK taxpayers ended up being reimbursed). With the painful memory of that, central banks and governments, barely batting an eyelid, stepped in immediately once the pandemic emerged.

Not to prop up the banks, which did not need support this time thanks to stronger regulations and wiser management, but to directly support businesses and individuals, threatened by an unprecedented global life-and-death medical crisis and the prospect of truly scary economic and financial collapse.

Left only to the mercy of inherently profit-seeking markets, faced with a runaway deadly virus killing millions and potentially tearing apart the fabric of our society, many businesses would have cratered. Not myriads of SMEs but also large companies, especially those involved in the services sector which dominates Western economies. Personal savings would have been wiped out, jobs and livelihoods lost, and households evicted because of mortgage or rental non-payment.

Western governments and central banks, notably the EU and the ECB, acted in a timely manner and took the steps they thought were right to ensure that the deadly global pandemic, which a year ago took humanity by surprise with no immediate vaccine or therapeutics at hand, did not take even more human lives, massively overrun our health systems and destroy livelihoods on a mass scale.

Again, with heightened fear of the unknown and with the disappearance of trust, the very fabric of our society could have been torn off. In wars, politicians have to rely on the generals. In pandemics, they have to rely on epidemiologists and other scientists in the field.

According to recent global surveys I saw, most institutional investors believe that a more decisive relaxation of current pandemic-imposed constraints should occur only when a meaningful percentage of the population has been vaccinated, probably by July.

And when it comes to taxpayers, most are also employees or business owners. I could take more issue with taxpayer money helping banks get out of a self-created crisis than supporting the economic survival of businesses and households. And, giving the dire circumstances, I can think of few worthier uses of taxpayer money at this time than that.

But the way I see it, Keith, is that the financial source fuelling government and central bank support is not new taxpayer money (at least not so far) but new issuance of public-sector debt on a massive scale. The markets do not seem to be concerned by this. If you look at public-debt yields, you would be forgiven for thinking that some of these are the same sovereign issuers that only a few years ago were considered on the brink of defaulting. Were the credit markets (and the rating agencies) wrong at that time by being so brutishly harsh? Are they wrong now for being so angelically calm?

The fact that interest rates are where they are now gives the market belief that public-debt service will remain tolerable. Especially since the biggest chunk of new issues ends up with central banks. This is a very plausible argument for central banks not to rush to push interest rates up anytime soon.

Having said that, inflationary pressures, especially if and when economies sprint ahead when the pandemic subsides, may give them no choice. That moment, whenever it comes, will be a moment of truth for the markets. Concerns exist already for the US economy.

The same, by the way, being the case with the banks. I am not that concerned about a pandemic-induced asset-quality crisis. I may be more so if, in a new post-pandemic Roaring Twenties, banks dropped their guards and started taking risks more aggressively.

KEITH

The genesis of the GFC was radically different to that of the pandemic crisis. Blindly following the same policy narrative was a gross error. The sharp pandemic-induced economic recession we are suffering is down solely to the actions of governments forcing their own economies shut.

Were it not for government intervention, Sam, you say businesses and individuals would have been threatened by an unprecedented global life-and-death medical crisis and the prospect of a truly scary economic and financial collapse. But what do you mean? What collapse?

The cratering of economies that has put businesses large and small at risk is 100% the result of government action. Not any private economic or market failure. I don’t think there’s any doubt about that.

Government pandemic support has nothing to do with protecting anyone from profit-seeking markets. Your relating saving failing businesses to avaricious markets is just not relevant in my view. Governments (via central banks) have, of course, been propping up zombie companies through NIRP/ZIRP for years. (The same monetary actions that have wiped out chunks of our personal savings and personal wealth).

What we've ended up because of government pandemic policy is a taxpayer-funded two-step:

1 Government spend our money – taxpayer money –to pay business owners and employees to watch TV all day, via furlough schemes and fully or heavily guaranteed (via big first-loss pieces) State loan schemes, and to provide some sort of livelihood to the mass ranks of the new unemployed. The cost of that is enormous. How do they pay for it?

2 We (the taxpayers) pay for it through higher taxation over time. And via massive government borrowing in the capital markets i.e. money raised in the name of we the taxpayers that will force us, our children and grandchildren to pay for it. Look at how much money European sovereigns have raised in the bond market in recent months with maturities of 40 to 100 years.

Borrowing is cheap. Why? Because governments have flooded the financial markets with liquidity – more of our money – that has had the effect of destroying risk-return and undermining the raison d'être of private markets.

Why don't investors push back, you ask? First because they don't have a choice. Second, because we are in a perverse situation where investors are happy to buy zero and negative-yielding debt because they know there's a buyer of first resort out there.

Investors don't buy negative-yielding debt because they like it. They buy it because there's nothing else out there and there is a limit-free buyer on the back of whom they can generate returns from price appreciation. Think about that: generating positive returns from negative-yielding debt that rises in value!

Where next? Well, oil prices are rising, vaccine rollout is accelerating, escape from lockdown beckons, and businesses will gradually re-open in coming months – that is if Western governments haven't gotten used to their dalliance with autocracy. Inflation is beckoning. Risk-free bond yields are reacting. How central banks deal with that will be fascinating.

My final word: you say you'd be concerned about banks dropping their guard and taking on new risks. How about governments loosening the carefully crafted regulatory rule book and brow-beating banks to lend into the sharpest recession in decades. Risky enough for you, Sam?

SAM

You seem to be no fan of government intervention, Keith, and I respect that. You are in good company there. The way our governments are handling the pandemic crisis will no doubt be adjudicated by history. For me, having as a key goal the protection of lives and livelihoods as a paramount public policy is essential. There was no prior well-trodden path for how to do this, as Covid-19 hit big, deep, numbingly fast and, at the time, with no end in sight.

We all saw how investor confidence dropped like a stone when the pandemic was declared. What brought it back roaring was not the belief that Adam Smith's "invisible hand of the market" will win the day but the reassurance of intervention and support from central banks and governments.

Regarding European banks, I do not see them getting into excessive and reckless lending. The moderate level of new bank credits surprises me a bit, as I would have expected more countercyclical lending to occur. Especially as, thanks to mass vaccination picking up, we are probably in a V-shaped recession. But credit demand across Europe remains more subdued, as has in fact been the case all along after the GFC.

So far, banks' results tell the opposite of a scary story and I do not envisage a 'sky-is-falling' scenario. Supervisors are being vigilant, prudential metrics remain strong, bank strategies remain focused and risk averse. And, importantly, I expect public-sector support to be managed down only gradually after the pandemic, rather than suddenly withdrawn. As I said, I would be more worried if, in a post-pandemic world, banks became too exuberant. I am counting on regulators to keep an eye on that, even after politicians, as some inevitably will, urge the banks to go big.

Where we clearly converge, Keith, is that the pandemic will leave the world with more debt. Especially public debt. Like you, I will be intrigued to see how central banks solve the higher rates-financial stability-economic growth-public debt conundrum. It may not be a pretty picture.

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