A revealing report on the mid-March financial crisis

Nick Beams
19 November 2020

In its analysis of the COVID-19 pandemic, the *World Socialist Web Site* has characterised it as a trigger event that set in motion and intensified the underlying contradictions of the global capitalist system, impacting on every area of social and economic life.

This analysis has been underscored by a report issued by the Financial Stability Board (FSB), comprised of officials from leading central banks and finance ministry officials, on the crisis in financial markets last March at the start of the COVID-19 pandemic. The report was prepared for a meeting of the G20 to be held this weekend.

The crisis took the form of a "dash for cash" in major global financial markets in mid-March as financial assets were sold off. Its most significant feature was that it struck at the very foundations of the global financial system—the $20 trillion US government bond market—as Treasuries were sold off.

As the *Financial Times* noted in a report on the crisis in September: "The US government bond market is akin to the investment world's bomb shelter, a safe space where everyone can seek refuge when the rest of the financial system is exploding. In March, the bomb shelter itself started to rumble ominously."

According to the FSB report, the crisis was set off when foreign investors, primarily central banks, sold off almost $300 billion worth of US Treasury debt. "Market dysfunction" was then exacerbated by "substantial sales" of US Treasuries as speculative and highly-leveraged trades, based on taking advantage of the difference between the price of Treasury bonds and their futures, became loss-making.

The large-scale unwinding of these trades, amounting to $90 billion during March, was "likely one of the contributors to a short period of extreme illiquidity on government bond markets," the report said.

The storm lasted for a "short period" not because of any self-correction mechanism in financial markets but only as a result of the massive intervention by the US Federal Reserve and other major central banks that prevented a meltdown of the entire financial system going far beyond what took place in 2008.

According to the report, the policy actions taken by central banks were "unprecedented" as they increased their balance sheets "at unparalleled scale."

"Overall, these measures led to a US$7 trillion increase in G7 central bank assets in just eight months" in contrast to the $3 trillion increase in the year following the collapse of Lehman Brothers in 2008.

In the US, the Fed's intervention went across the board with the result that it has become the backstop for all areas of the financial system.

In the lead-up to the mid-March crisis, as the impact of the pandemic became increasingly apparent, central bankers indicated they would support financial markets.

On February 28, Fed chairman Jerome Powell pledged to use the Fed's tools and to "act as appropriate." This was followed by a statement on March 2 by Bank of Japan governor Haruhiko that the BoJ would "provide ample liquidity" and on the same day European Central Bank president Christine Lagarde said the ECB was ready to take "appropriate and targeted measures."

On March 3 Bank of England Governor Mark Carney said the bank was ready to take all "necessary steps" to support the UK economy and the Fed cut its rate by 50 basis points.

These statements were unsuccessful in calming financial markets.

As the FSB report noted, longstanding relationships of prices across different markets, including in the core US Treasuries market, "began to break down." "Usually at times of stress equity prices decline while government bond prices increase. But during the dash for cash both types of assets experienced large price declines."

The report pointed to some of the reasons for the intensity of the mid-March crisis noting that the "COVID-19 shock hit a global financial system that has fundamentally changed over the past decade."

Significantly, however, it did not draw out that the origin of these changes lies in the policies pursued by the Fed and other major central banks in response to the 2008 financial crisis. The reduction of interest rates to ultra-low rates and the massive purchases of government bonds via quantitative easing enabled the speculation that set off the crisis to continue and expand.

But it did point to their effects, noting that "structural changes in the financial system over the past decade" had "increased the reliance on market-based intermediation to finance growing levels of debt." In other words, debt has increasingly been financed outside the banks.

Using guarded language in order to cover up the role of financial authorities after 2008 in creating the conditions for another crisis, it noted that "developments in the lead-up to the pandemic may have contributed to the severity of the reaction in financial markets in March."

"Following a long global recovery from the 2008 financial crisis, the outlook for growth and corporate earnings had weakened by early 2020 and become more uncertain. Real interest rates have fallen over the past decade, with both authorities and market participants predicting a 'lower for longer' environment."

This decline in finance costs reduced debt burdens, encouraged further debt accumulation which, coupled with declining asset quality and lower credit underwriting standards "meant that firms became increasingly exposed to the risk of a material economic downturn or an unexpected rise in interest rates. Investors had therefore become more susceptible to sudden shifts in market sentiment and a tightening of financial conditions in response to shocks."

The report lauded the intervention by central banks saying that unless it had taken place "it is highly likely that the stress in the financial system would have worsened significantly." This is a considerable understatement. What took place in mid-March was a total freeze of the financial markets and had it continued the ability of the US government, along with others, to finance their debts would have been called into question.

However, the report did make clear that nothing had been resolved.

"The measures taken by central banks were aimed at restoring market functioning, and not at addressing the underlying vulnerabilities that caused markets to amplify the stress. The financial system remains vulnerable to another liquidity strain, as the underlying structures and mechanisms that gave rise to the turmoil are still in place," it said.

In fact, there has not even been a return to the status quo ante because, just as took place after 2008, the very actions of the Fed and other central banks have changed the structure of financial markets, creating the conditions for another, even more severe, crisis.

This is because, as the report acknowledged: "The need to intervene in such a substantial way has meant that central banks had to take on material financial risk."

This is another major "structural" transformation in the global financial system. The days are long gone when central banks merely functioned as so-called "lenders of last resort." They are now active participants in an increasingly crisis-ridden financial system.

And their actions in response to the March crisis have only served to fuel the speculation that led to it as evidenced by the rise of financial markets, with Wall Street reaching record highs on Monday, as the destructive force of the pandemic intensifies.

The report also pointed to so-called "moral hazard issues." These arise from the belief by investors and speculators that the "aggressive policy actions" following the March crisis mean the central banks will again intervene to bail them out if their increasingly risky methods of profit accumulation lead to another crisis.

Two conclusions arise from the FSB report. First, that the actions of the central banks in fuelling still further speculation have only created the conditions for another crisis, with even more devastating consequences for the mass of working people.

And second, the case for the taking of the entire financial system into public ownership under democratic control is unassailable.