Dealing with 'troublous times'

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The Federal Reserve has sent up some red flares that require attention. Its semi-annual Financial Stability Report issued on May15 warned that asset prices will be vulnerable to “significant price declines” should the pandemic persist.

It underscored the potential adverse impact on commercial real estate resulting from the decline in revenues, and that some hedge funds have already been “severely affected.” Chairman Jerome Powell also expressed his concern in a speech last week that many individuals and American companies may be heading toward bankruptcy, and that Congress may have to appropriate more money than the $3 trillion already earmarked to fight the financial crisis.

Hopefully, the government is preparing for what Knickerbocker Trust’s CEO, Charles T. Barney, described in 1907 as “troublous times.” As conditions worsen, conventional processes often fail to work. For example, filing for bankruptcy is likely to become a difficult solution in a crisis like this. The Cato Institute’s George Selgin recently explained why the bankruptcy restructuring of many American companies will be a difficult way to reconstruct the American economy that emerges on the other side of the pandemic. He could not be more correct.

The country has experienced about 23,000 business bankruptcies a year between 2013 and 2019. Even if the bankruptcy courts are not overwhelmed by many thousands of new filings by companies seeking relief from their creditors, as George Selgin astutely points out, those companies cannot continue to operate in or emerge from a Chapter 11 bankruptcy without financing. They will have to borrow enormous sums of money, or alternatively go into a Chapter 7 bankruptcy that will depress asset values even more.

The most effective way to deal with such a looming financial debacle is to prevent it from occurring. Even if the courts can handle the deluge of filings and debtor-in-possession financing is available for some companies, a wave of bankruptcy proceedings across the country would further unwind economic relationships and impact the psychological well-being of companies, employees, counterparties, markets and communities. The cascading impact would damage the economy for many years to come.

I have written two op-eds in the last two months arguing for the formation of a Financial Revitalization Finance Corporation to prevent American companies from descending into the fog of bankruptcy, much as the Reconstruction Finance Corporation did in 1932 battling the Great Depression.

The hesitancy to create such an economic safety net that takes preferred stock interests in American companies may perhaps be linked to the hope that a turnaround is just ahead. The mantra that we repeat – the economy was so strong before the virus, it will pop back to life when the virus is gone – becomes more unsupportable each day the virus keeps America shut or at significantly reduced levels of operation and performance.

I have spent the last two years reevaluating every financial crisis in the United States since 1819, including the ones that I worked on since 1976, for my upcoming book on the subject. I have learned that confidence is the most determinative factor of when an economy collapses and when it comes back to life. When certainty in the economy is lost, whether because of reckless behavior or pandemics, credit and money stop moving in traditional ways and everything comes to a halt. Then things get worse as the economy shifts into reverse as credit lines are called, businesses fail and companies and people run to cash and quality. Until confidence is rebuilt, the economy will not return to normal.

In most financial crises, the government takes on the role of rebuilding certainty. There have been some cases, as in 1907, when a banker such as J. Pierpont Morgan stepped up to prevent a crisis from expanding and rebuild public confidence. But whoever plays the role of rebuilding confidence, needs to administer both fiscal and symbolic financial support to stem the tide of economy erosion.

The most effective and least psychologically painful way to cushion the American economy from a devastating economic future of spiraling bankruptcies is to support companies with equity while they still are in business and have their employees and vendor relationships. This would also prevent their losses from eating away the capital of the banks that are supporting them through loans.

This is not a question of creating moral hazard like it was in 2008. We are living through unprecedented times through no fault of the American people and their businesses. It requires the biggest and boldest solutions that policymakers can muster. People are hurting, and we may still be only at the front end of this financial crisis.

How strong the economy was when the pandemic broke out has quickly become irrelevant. It is severely damaged today. If the virus disappeared next week, how long would it take for people to fly, stay in hotels, eat in restaurants, visit doctors and dentists and attend sporting events again? What will happen to the demand for real estate in major cities even after we solve the problem of getting people back into skyscrapers on elevators that can only transport three people at a time?

The Becker Friedman Institute at the University of Chicago predicted last week that some 42 percent of those who lose their jobs will never get them back. With 36.5 million people currently unemployed in America, and the prospect of more than 15 million workers never returning to

their jobs, we should be preparing to confront the worst. In every financial crisis, the depth of economic and emotional pain is impacted by the timing of the solutions that are administered.

If we are going to avoid the troublous times and economic hell that tens of thousands of bankruptcies of American companies can cause, we will need a Financial Revitalization Finance Corporation.

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