

AA View

Pandemic policy response: *Fiscal is Monetary today*

Summary

- Fiscal promises are surging globally as a response to the growing pandemic crisis. Budget deficits will rise to a multiple of forecasts made only recently.
- Urgent fiscal needs mean that debt is needing to be monetised. Fiscal and monetary policy are converging.
- Restoring zero interest rates and relaunching large-scale QE reflect a need to provide stable and low-cost funding for surging government borrowing needs.
- Central banks want to take control of yield curves and stop any nascent trend towards rising yields.
- There are historical parallels for fiscal needs driving monetary policy – during and after the 2nd world war and the global financial crisis.
- Yield curve management by central banks will, likely, continue and the prospect of any significant yield reversion remains distant.



Fiscal promises explode after virus hit

It is all happening as this is being written. Not a day, sometimes it seems not even an hour, passes, without many tens or hundreds of billions of sterling, euros or dollars being committed to rescue packages to shore up economies buckling under the viral lockdown. The US administration is promising a \$1-2 trillion type rescue package; the UK has made an un-costed, open-ended commitment to pay 80% of wages of all employees facing layoffs, this coming on top of a multi hundred billion sterling loan guarantee scheme; most Eurozone countries have promised large rescues through loan guarantees or wage subsidies too, yes even Germany, with an impressive €500bn package of guarantees and cash. Nobody really knows the ultimate cost of these rescues since ultimate outlays will depend on how bad things get; and the US plan is also short on detail at present.

However, the harsh reality is that the fiscal costs of providing an economic backstop to economies facing double digit drops in national income are bound to be large. Otherwise it will not have much effect in providing an economic cushion.

Fiscal positions will take two hits. First, deficits will automatically increase in the downturn now under way, because of lower revenues and higher spending on social security, so called 'automatic stabilisers'. This always happens in recessions. Then comes the attempted offset to the loss of jobs and incomes. This is much bigger in scale than in normal recessions, partly because this downturn is also certain to be sharper than normal. The wage subsidies and loan guarantees could involve very large amounts. Finally, there is the cost of direct intervention to support whole industries like airlines.

It is worth recalling the recent experience of runaway budget deficits at the time of the global financial crisis as a comparison. Quite likely this time, however, is that borrowing levels will, for a time, rise faster than 2008-9 given the types of fiscal commitments. It would not surprise to see deficits more than double those expected as recently as mid-February before the viral scare hit. With the US deficit already hovering around an annualised \$1 trillion, we are talking about a \$2 trillion + deficit (well into double digits as a share of US GDP) or in the UK case, a deficit that could come to be as large, if not larger than the £150bn+ deficit of 2008/9, a similarly significant share of GDP.

Monetary policy response reflects fiscal priorities

It is in this fiscal context that we need to see the monetary policy announcements in the past fortnight and especially the launch of QE4 (labelled '4' because it comes after three earlier periods of asset purchases since the financial crisis of 2008/9). Cutting policy rates to zero and launching QE at this time should be interpreted as being as much of a fiscal response as it is a monetary one. Why is this? Essentially because governments' financing needs are ballooning, and the job of a responsible central bank is providing the funding conditions to make this borrowing smooth and at low cost. Monetary policy becomes entirely subservient to fiscal priorities at times like this.

The launch of very large asset purchase programmes by the world's leading central banks to purchase government debt are very much intended to ensure that this borrowing can be done without major market disruption. This is really a form of debt monetisation as the central banks purchase what governments issue. It is very similar to what happened after the financial crisis. Then, too, the launch of QE (1) served to mop up a large amount of government debt helping keep governments' funding costs down. It is indeed a bit of history repeating itself.

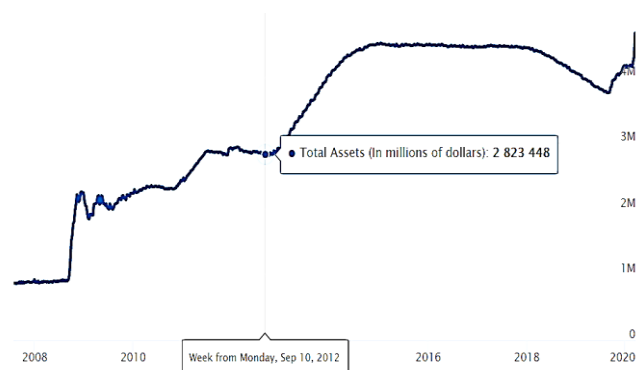
The stakes are arguably higher this time. Deficits could be larger than 2008 as we just noted. More importantly, governments around the world are far more indebted. On average, the ratio of government debt to GDP is twice as high as it was pre-financial crisis in 2007. Given higher debt burdens, the size of budget deficits now likely and the magnitude of debt rollovers needed in bond markets, the sensitivity to market conditions is higher. Should the cost of government debt financing rise markedly, the fiscal implications would be very adverse.

QE measures announced so far

To date, the announcements have seen the US Federal Reserve committing to \$700bn of purchases, the ECB to €750bn and the Bank of England to £200bn. What will be bought and when is still being worked out, though the Federal Reserve has clearly decided that unlike previous QE episodes, the municipal bond

market – becoming rapidly illiquid in the last few weeks – also needs purchases too. The Federal Reserve's balance sheet is once again swelling (see below) rapidly, already beyond previous highs. We should not be surprised if QE4 in the US is extended to assets that have not been purchased before – Municipal Bonds are already a new venture, but this may at some stage extend to buying corporate bonds in the way that the ECB and the Bank of England have in previous QE rounds.

Federal Reserve balance sheet will rise even more strongly



Source: US Federal Reserve

It is also striking that the Bank of England has undertaken to spend its £200bn 'at a materially higher pace' than before, which matches the rhetoric from the US Federal Reserve and the European Central Bank to move on its asset purchase programme quickly. As a share of GDP, the Federal Reserve's roughly 3.5% of GDP currently announced QE purchases may look small against the European Central Bank's 7% of Eurozone GDP and the Bank of England's 9%. However, we are talking about helping governments manage their fiscal commitments, so ultimate QE could easily extend over time to meet the larger and still unknown fiscal commitments currently being made. Indeed, we have just heard that the Fed is making an open-ended 'whatever it takes' type of QE commitment.

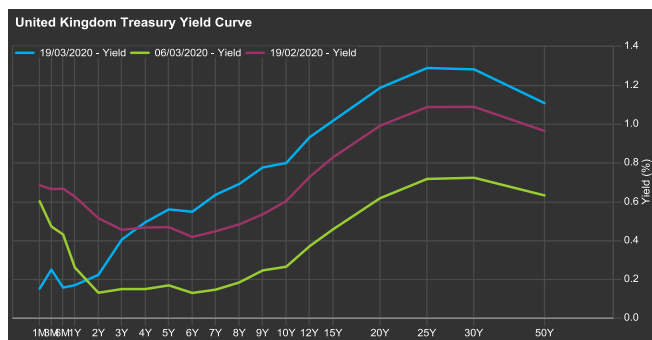
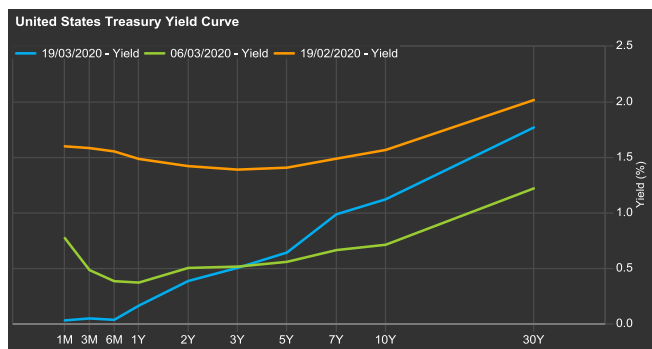
Seizing control of yield curves

There is a significance to the timing of these nearly simultaneous QE4 launches. Yields at intermediate and longer durations were rising in the last week or two. Only late last week (20th March) did yields finally fall back somewhat having risen steadily before. Yield curves had been steepening (see charts for the US and UK yield curves over page). Despite pulling short term rates down to zero, intermediate and longer duration yields had been rising. This is just not supposed to happen with risk assets down so sharply and economic expectations being sharply lowered.

Why was this happening? It was partly the result of market dislocation – the sheer magnitude of market moves resulted in forced selling of US treasuries for redemptions, margin calls or forced deleveraging in some bond-focused trading strategies.

Rising yields also reflected some nervousness on the scale of the fiscal response that would be ultimately required to cushion the global economy from the shutdowns being seen. It was becoming apparent to the bond market that the fiscal efforts would have to be large to compensate for the economic growth. Since this borrowing effort was coming on top of existing large fiscal deficits earmarked by the UK and the US, some nervousness in bond markets was to be expected given the mountain of additional issuance that could be expected.

QE4 aims to re-establish 'control' of yield curves



Source: FactSet

All this added up to problems as far as the central banks would see it. The risk of allowing a trend towards higher yields and steeper curves to become established was significant, and could, if it continued, make fiscal costs very difficult to bear. Here is where we get back to yield curves. Central banks are doing QE4 now because of the risks that they lose control of the yield curve and push up the costs of fiscal rescues and outsized government borrowing. Monetary policy and fiscal policy can, of course, operate independently, but at times like this when fiscal outlays are potentially rising steeply from already high levels, borrowing costs become particularly important.

From a fiscal point of view, it has been a godsend that yields have collapsed in the way they have in the advanced world in the last ten years. UK interest costs on its national debt are unchanged over the last decade, despite a very large rise in debt entirely because of this collapse in borrowing costs. Much the same has been observed in the US, where very large deficits at relatively short maturities have been sustained only because

borrowing costs have kept falling¹. Today, with the burdens on the public purse, noted already, this is more important. Central banks and governments know this and are acting accordingly. *Fiscal is monetary, and vice-versa, in this virus-hit world.*

Wartime parallel of 'financial repression'

The global financial crisis has parallels with what is happening now, as noted. Arguably an even better historical comparison is with the conditions during and after the 2nd world war. War spending had greatly bloated the Allies' government borrowing. Thereafter, interest rates, particularly in real terms were held at very low levels for a prolonged period, which provided room for debt ratios to move lower, though not without some inflation for some of the time. This was the origin of the term 'financial repression' which refers to interest rates being held at very low levels in real (after inflation) terms to achieve national objectives. This is a term that will likely, continue, to be used now given increasing use of war-like terminology to describe responses to the damage being caused by the corona virus scare.

Yields will continue to be 'managed'

If we thought that the days of QE and the implied distortion to market interest rates seen in the days of QE1-3 were coming to an end (the last US QE episode ended in 2017) recent events show that this view is badly mistaken. Central banks want to control the yield curve, even more so today as we can see the urgency of the responses after the virus scare.

In a recent note from the Global Asset Allocation Team, it was argued that if fiscal deficits had to rise in an economic downturn, QE would likely come back in to drive yields down². This is exactly what is happening.

Financial repression from central banks as they manage the yield curve is an important reason for expecting yields to still hover at very low levels for the foreseeable future. The virus may come and go but given poor public finances and the likelihood of still high levels of government borrowing for years to come, the risk of higher yields will not be one that the authorities will want to take. This does not mean that yields will not fluctuate. They will. However, there will be every means employed to ensure that yields do not behave disruptively or rise to levels which put fiscal needs into jeopardy.

Overall, it does look likely that this management of yields at relatively low levels will have to continue, quite possibly beyond the end of the outbreak as governments grapple with elevated public debt. Fixed income positions need to reflect this reality, with reversion to much higher yields looking a distant prospect.

¹ AA View: *The US fiscal black hole is now too big to ignore* (March 2019)

² AA View: *Why Japanification is becoming harder to avoid* (December 2019)

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