SINGALLIANCE

Letter n°10

Towards inflation or deflation ?

« Man often knows what he does, but never knows what does what he does » Paul Valéry

In response to this crisis, which has challenged our destiny, central banks, without ambivalence, are innovating, diversifying their fields of intervention and making unprecedented liquidity injections. No one will be able to say that they have been weak and irresolute. Government actions and monetary policies are intertwined and interpenetrated, but Paul Valéry's words come to mind because it is difficult to measure the long-term impact of these policies on a system that is undeniably senescent.

Let us try to be clear because the subject is very repugnant. Basically, the global debt, which was already very high before this crisis, is being increased and we must find a way to finance it without resorting to excessive taxation and without creating mistrust, i.e. a capital flight situation.

Reconciling increasing debt and lowering its cost ?

The debt's drift :

The global debt, public and private, 80% of GDP in 2000, 350% at the end of 2019, has grown rapidly. In 2008, the public debt of the major economies alone reached 75% of GDP, 100% at the beginning of 2020 and according to IMF figures, it should be 120% by the end of the year. Managing the crisis is potentially more challenging than in 2008: budget deficits, with a few rare exceptions such as Switzerland and Germany, are already high and the weapon of interest rates has already been used and abused, because they were already negative in Europe, at zero in Japan and weakly positive in the United States even before the crisis.

In the United States, public debt will increase this year from 110% of GDP to 130%, in the Eurozone from 84% to almost 100% and in Japan from 237% to over 250% of GDP. This deterioration is the result of worsening budget deficits in major countries where the acceleration of the deficit this year will match or exceed its expected decline in GDP. In France, the budget deficit will rise from 3% to 9% while the recession could be as much as 6%. In the United States, the 2020 deficit will increase from 5% of GDP to 15%, outpacing its decline in GDP.

At a time when it is socially difficult to raise taxes, seeking recourse from central banks is an easy thing to do. The injected liquidity finances, one might say, budgetary policies, compensation for partial unemployment and financial aid to businesses. As long as central banks do not reduce their balance sheets and hold acquired debts to maturity, a new measure of debt could be introduced, distinguishing between gross debt, as shown above, and deducting the percentage held by the central bank to calculate net debt.

The objective of rates close to zero :

A result of this deterioration should be higher interest rates, but without inflation to erase the debt, without growth to absorb it, in order to make the cost bearable, care must be taken to keep rates very low. This is the implementation of the Modern Monetary Theory advocated by Olivier Blanchard and a few others, i.e. the financing of the budget deficit by monetary creation at a rate close to zero. It used to be a long time ago when central banks were merely inflation watchdogs. In 2008, with "Quantitative Easing", the liquidity injections had bought back government debt and the debts of very good companies on the secondary market. In 2020, faced with such an accumulation of debt, they are injecting much more and diversifying their interventions. The primary objective of central banks is to prevent long rates to rise, i.e. to prevent a possible distrust from investors. In 2007, the total balance sheet of the three major central banks, the Fed, the ECB and the BoJ, was

$3.4 trillion; this year before the recent crisis, it was a little over $14 trillion, the number will perhaps be close to $25 trillion at the end of this year.

The policies pursued by the central banks :

United States : the Fed, first in terms of interventions' amount.

Before this crisis, the Fed had held $2.5 trillion of public bonds. Since March 16, the Fed has bought $2 trillion in bonds, the equivalent of nearly 10% of GDP, which are infinitely higher than those made at the rate of $85 billion/month between 2012 and 2014. Thus, the Fed's balance sheet, from less than $4 trillion at the beginning of this year, could reach $8 trillion to $12 trillion by the end of the year because of the possibility of unlimited purchases.

The Fed, anxious not to be accused, as in 2008, of having just saved Wall Street, comes to the rescue of the real economy by making $2.3 trillion available as it is alarmed by the deterioration of employment (26 million people out of a working population of 164 million registered unemployed in one month), frightened by the weakness in household savings (25% of the population have less than $400 to respond to unforeseen circumstances), troubled by the worsening of the budget deficit to $3.8 trillion in 2020, worried about the cost of certain bond issues (such as that of Ford, which issued $8 billion of debt at 8.5% for 5-year and 9.6% for 10-year). The Fed is ready to buy local government debt, corporate private debt, including high-yield corporate debt, mortgages, student loans, credit card loans and even investment-grade ETFs. It should also lend or guarantee loans to all shops and restaurants, i.e. the service sector, which employs a large workforce. When the Treasury offers $480 billion to the economy, the Fed could contribute ten times more, leaving the Treasury to bear any losses on partial defaults.

Finally, in order to ensure USD liquidity, the Fed has multiplied its swap agreements with foreign countries to more than $400 billion.

While everyone praises the Fed's swift reaction, many are alarmed by the consequences of these massive injections: is it not likely to be suspected of favouritism towards certain companies? What would happen if municipalities went bankrupt because the implications would be political? What would happen if the Fed interventions prevented bankruptcies of fragile companies? Where would be the moral hazard inherent in capitalism? Wouldn't the Fed be blamed for favouring particular shareholders or private equity funds?

Europe : the ECB as the secular arm.

The ECB balance sheet is at EUR 4 trillion, compared to EUR 800 billion before the financial crisis of 2008. The ECB helps governments, the real economy and the banks. Before the crisis, it held just over 20% of Europe's debt (EUR 2.6 trillion), had planned EUR 1 trillion in public and private bond purchases, the equivalent of 9% of the Eurozone's GDP, and will certainly do more. This is at least an increase of almost 40% in outstanding debt between now and the end of the year, with the aim of preventing a upward drift in long rates, and for the first time, there is the possibility of giving priority aid to the most indebted countries. During the 2008 crisis, it had taken the ECB four years to announce that it would do everything necessary, this time it took just a few weeks. As of end 2019, the ECB held 26% of Germany's debt, 19% of France's debt and 15% of Italy's debt. At the end of 2020, it could be holding 25% of the Eurozone debt, 30% of the German debt, 23% of the French debt and 20% of the Italian debt. Debt pooling, which has been ruled out for political reasons, has yet to overcome the growing heterogeneity of the Eurozone, to reduce the credit spreads of highly-indebted countries such as Italy (trading at a high level of 230 basis points versus Germany), and to avoid debt restructuring, as had been the case during the 2012 Greek crisis. We can anticipate a solicitation of private savings to finance these public debts, especially in Italy, a country rich in private savings with total deposits of EUR 1.5 trillion compared to its public debt of EUR 2.6 trillion. Some dream of doing more, encouraging the ECB to acquire bonds with a maturity of more than 30 years, an operation prohibited by the statutes, and even considering perpetual bonds.

Banks, following the so-called Basel III agreement, are solid and have EUR 300 billion in equity capital, but this may not be enough to support companies in their recovery effort and it is difficult to envisage capital increases at current level. The ECB has therefore decided to lower the refinancing cost of banks with the central bank to -1% and to relax European regulations on bank capital, which has "freed up" EUR 120 billion of additional capital. In concrete terms, capital requirements for market activities are reduced and a reduction in

provisions to be set aside when granting a loan could be decided. It remains to extend government guarantees over time or to envisage the creation of a "bad bank", as an increase in corporate bankruptcies cannot be ruled out. Despite valuation ratios of banks being low, we are not touching this sector's stocks.

Japan and United Kingdom : the two boldest central banks.

Bank of Japan, the boldest of the central banks, because the country is the most indebted, should no longer limit the purchase of public debt to 13% of GDP per year (a huge amount of JPY 80 trillion/year or EUR 690 billion), in force since 2014 but is now open to unlimited purchases. The objective announced in 2016 to maintain the 10-year rate at zero, the so-called "yield curve control" policy, has been a success over the last twelve months, it has only had to acquire JPY 14 trillion to achieve this. One can therefore speculate that other central banks should follow suit. In recent weeks, the Bank of Japan has increased its purchases of corporate debt (bonds and commercial paper) from JPY 7.4 trillion to JPY 20 trillion ($185 billion) and doubled its annual acquisition on the stock market to EUR 100 billion. Since 2013, it is the only one, along with Switzerland, of all the major central banks to buy equities. It already holds more than 5% of the Japanese stock market and will continue to do so, without economic justification, since the stock market does not finance many companies.

In England, Fitch has lowered the country's rating from AA to AA- and placed its debt on negative watch. The Bank of England, after having excluded the possibility in early April, will buy directly, without going through secondary market buybacks, GBP 200 billion of the GBP 260 billion issued by the Treasury (a record compared to the GBP 22 billion injected in 2009/10). It is a good bet that the Fed and ECB will also adjust their status to do so in a matter of time.

Three conclusions can be drawn from these interventions:

Deflationary pressures more than inflation

Notwithstanding the liquidity injections, deflationary pressures will persist and the inflationary threat will remain virtual. There are six reasons for this: households' irrepressible need for precautionary savings, the unspeakable reluctance of banks to lend to more indebted companies, the irreducible low capacity utilisation rates for many months, the irremissible risk of bankruptcies, the inexorable persistence of unemployment and the abysmal weakness of commodity prices. Liquidity is nevertheless abundant and, in the absence of goods' price inflation, asset price inflation will be a reality, volatility will be amplified because there will be bubbles. As has already been mentioned, the factor for a return to inflation would be the choice of protectionism. These two variables would be detrimental to the performance of the already expensive stock markets after the recent rapid recovery in market prices.

The ability of the central banks of the major countries to support the real economy

Following our letter from last week, it emerges that only the major countries and China have the great privilege of quantitative easing, while the others are facing capital outflows, i.e. a depreciation of their currencies and a rise in interest rates, which is holding back growth.

In 2008, liquidity injections helped the financial sector, in 2020 they are also supporting the real economy, this is essential because the OECD estimates that more than a third of households could fall into poverty if the crisis were to deprive them of income for more than three months. Two points distinguish the crises of 2008 and 2020: rapid and massive central bank intervention, and better capitalisation of the banking system that has allowed banks' credit default swaps to not reach levels seen in 2008.

The announced measures should avoid a credit crunch. Nevertheless, if short-term bankruptcies are avoided, debt will be higher and investment capacity may be reduced.

Central bank independence criticised but often illusory

Central banks have done a lot in a short period of time, but they could, if necessary, simulate the Bank of Japan, buy shares and distribute money to households (the famous "Helicopter money"). The U.S. Treasury has taken this initiative by distributing $1,200 to every American. Some will worry about these policies and seek refuge in gold or crypto-currencies, others will resent the unlimited power of central banks, independent

and unelected institutions, but central bank independence is a myth, as we recall Trump's pressure for zero interest rates or Emmanuel Macron's indignation at the initially timid stance of Madame Lagarde at the head of the ECB. In the current economic climate, their action suits everyone and therefore "Don't fight the Fed". But future generations, weighed down by these debts, will not be able to take up ***Mark Twain's*** words: "**Saving is a wonderful reality, especially when our parents practiced it**".

Geneva, May 4, 2020

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