Letter 38

What about "Whatever it takes"?

"Foolish as we are, we want to conquer everything, as if we could own everything."
FREDERICK THE GREAT

Public debt/GDP ratios were about 45% of GDP in the OECD in 1980 and are close to 140% this year. They have increased steadily since the early 80s, sharply between 2007 and 2011 and even more rapidly since March 2020. But, against all odds for orthodox economists, rates on public debt fell from 14% in 1982 to less than 1%.

In order to absorb the consequences of a sudden shutdown of economies during the Covid crisis, to avoid the social problems, and to prevent a risk of a financial and banking crisis, the states, in the conduct of recovery plans, have endorsed two changes:

On the one hand, the central banks, first the FED, then the ECB, have abandoned the 2% inflation ceiling to tolerate temporary overshoot without having to raise rates. Inflation is temporarily fueled by the supply disruptions in the production chain, the labor shortages in certain service sectors and the recovery in commodity prices (agriculture, metals, hydrocarbons).

On the other hand, attracted by the MMT, Modern Monetary Theory, governments are letting public debt run at zero interest rate, forgetting the European rule of a public debt/GDP ratio of less than 60%, and are envisaging massive investments in climate transition, the digitalisation of the economy and infrastructure. These investments will likely increase productivity and growth potential, but this will come at the cost of ever-increasing debt ratios.

Fiscal policy has been of great help in 2020, particularly in the United States, Japan, Great Britain, and even Germany, because the increase in the budget deficit has been greater than the decline in GDP. This has not been the case in the other major European countries, but government expenditure and guarantees have also been substantial.

Budget deficits will not disappear due to the acceleration of energy transition, the time needed before a return to full employment, and the support of relocation policies. The new needs to be financed are important and are added to the costs of ageing and health spending at a time when tax increases seem difficult or inappropriate.

So, what about this new practice and this Modern Monetary Theory. The appeal is certain but what are the risks?

1. Theoretical Justification : Modern Monetary Theory.

Stephanie Kelton, a professor at New York University, worked for the U.S. Senate Budget Committee in the Democratic camp during the Obama presidency and served as Bernie Sanders' economic adviser for his 2016 campaign. An author of a remarkable book, ***"The Deficit Myth"***, she is revolutionizing the approach to the budget. Her thesis, shared by some, a source of inspiration for others and a scarecrow for monetarists, raises questions and reservations. But, during the Covid crisis that occurred in 2020, it served as an alibi for letting budget deficits slip.

Before expressing reservations about this Theory, it is necessary to immerse oneself in the principles set

out, as some constitute a contribution and provoke reflection under a new light.

According to Mosler, the father of MMT, from as early as the 90s, there is no need for the state to tax the rich more to spend more because the state has the monopoly on issuance.

The taxpayer, writes Mosler, does not finance the state through taxation but the state finances the taxpayer by paying him, if he is a civil servant, and by indirectly providing him with a job, if he places public orders... While taxation does not finance the state, it nevertheless has multiple functions: it aims to create a dependency on the state's currency, it makes it possible to modify the distribution of wealth, it is a means of acting against inflation and it serves to discourage certain behaviors detrimental to the general interest, such as the carbon tax, the tax on diesel or, conversely, incentives to buy electric cars. According to Stephanie Kelton, far from the taboo of balanced budgets, state deficits are not only good for the economy but necessary: the objective of an economic policy must not be a balanced budget but shared prosperity. If the state, she says, still finds the money to cover military spending or bail out banks, then it can a fortiori find money to fund education and infrastructure.

Kelton rejects the idea of a deficit as the cause of a crowding-out effect on private investment and, conversely, she writes, a budget surplus financed by an increase in taxes, creates an upside-down crowding-out effect by taking away part of our financial wealth.

Kelton dismisses the idea of a deficit as a burden on future generations and, on the other hand, sees deficit as a potential to elevate future growth and the public debt, as $ is put in the pockets of consumers without taking them back through taxes.

The only limit to the deficit, according to Kelton, is inflation because it reduces living standards. But she observes that the FED is too cautious in assessing full employment and therefore systematically leaves people unemployed when its policy is tightened.

At this stage of his reasoning, we can follow Kelton. Where we find it difficult to follow his path, is in his proposal to eliminate the $1.5 trillion in student debt carried by 44 million Americans through an additional deficit. It is also in his proposal to create a federal job guarantee at $15/hour to eliminate unemployment. It is also in its desire to entrust the federal state with deficit financing for investments in global warming and infrastructure. This was the ambition of Joe Biden with his initial plan of $1.8 trillion, but he had to revise the target to $1.2 trillion and the plan is still not voted upon. Finally, it is the idea of letting the Bank of Japan buy back all the public debt (it holds half of it). Far from fearing, as Milton Friedman did yesterday, an inflationary seed in such a purchase, she foresees that with such a measure, there will be a fall in prices because savers would be deprived of a modest interest income! While the BOJ has already acquired the public debt to the extent of one time the GDP since 2013, inflation in June is 0.2% excluding energy.

There is a connection with the work of ***Thayer***, an economist known for having demonstrated the occurrence of a recession in the United States in each of the six phases of a desire to reduce American public debt: the first time, under President Jackson in 1837, the last time in 1929, after six years of a policy to reduce the public debt by a third.

2. The opportunity offered by low long-term interest rates :

Monetary policies of liquidity injections or very high budget deficits during crises are certainly the solution of the moment and, possibly, the problem of the day after. During a crisis, the management of social risk takes precedence over financial risk, the restoration of full employment temporarily overshadows the risk of inflation, and the objective of exiting the crisis outweighs the risk of indebtedness. This has been the thrust of the "Whatever it takes" policy implemented by OECD

countries.

- ***The increase in public debt in developed countries is not yet a problem :***

In major countries, central banks manage to influence long-term rates regardless of the level of debt or deficit: the Greek 10-year debt rate is at 0.85%, far from the 34% of 2012, despite a debt ratio currently at 220% of GDP. Significant, too, is the 10-year rate on Japan's debt set at 0-0.10% by the Bank of Japan despite a public debt of 250% of GDP.

Today, budget deficits and expansionary monetary policies go hand in hand. This has not always been the case, but on the whole, fiscal policy is more democratic because it is decided by the elected representatives.

Provisional assessment of the budgetary effort of states to get out of this crisis: according to the OECD, since March 2020, spending has reached 25% of GDP in the United States, 16% in the United Kingdom and Japan, 15% in Canada, 11% in Germany and 8% in France and Spain.

This is disproportionate compared to the stimulus plan implemented after the 2008 crisis. In 2009, the Obama plan, the most audacious in terms of the scale of spending at the time, reached $787 billion. It is a drop in the ocean compared to the spending undertaken by Trump and then Biden. This explains why it took six years to recreate the 8.7 million jobs wiped out by the crisis. This year, the unemployment rate is well on its way down to 5.9%, far from the 14.7% in Spring 2020.

Spending has been partly financed by central bank purchases. At the end of 2020, there was $15 trillion in increased public debt and $10 trillion in purchases by the major central banks to finance it.

This policy is estimated to have lowered long-term interest rates by two percentage points. The ECB has bought 70% of the debt issued in the Euro Zone, the Bank of Japan 75% of the new Japanese debt, the FED almost 60% and the Bank of England 50% of the debt issued.

The FED's balance sheet has thus increased from $4.2 trillion in March 2020 to $7.1 trillion in June 2021, far from the $1.3 trillion balance sheet total in 2009. It initially, in the Spring of 2020, bought $1.5 trillion in two months but since then, it is $120 billion/month including $80 billion in government bonds.

According to ***Gagnon's*** calculations at the ***Peterson Institute***, a debt purchase of 10% of GDP lowers long-term rates by 0.5 percentage points.

The ECB is continuing its purchase program of €1.7 trillion in bonds that was announced in Spring 2020. It is the equivalent to 12% of GDP, and its balance sheet total is thus €9 trillion.

As for the limit to be imposed on this public expenditure, it is the use of money and, we can adhere to ***Olivier Blanchard's*** thesis to not worry about a public debt whose rate is lower than the rate of economic growth. Financing infrastructure projects, education spending and energy conversion can increase potential growth, offer external savings to businesses, and improve the relative attractiveness of a country, and thus should not pose any problems. Financing current expenditure should not be an option, but the line between expenditure and investment is sometimes very fine.

All these stimulus measures in the United States and all this distribution of purchasing power are exacerbating the American trade deficit. It will reach a record level, but the idea of an American weakness is false.

SINGALLIANCE
SingAlliance (Switzerland) SA | 16bis rue de Lausanne 1201 Genève Switzerland
T: +41 22 518 85 85 | www.sing-alliance.com

Through the deficit, Americans are living off the credit of the rest of the world. The other countries are not complaining because the injections of the $ allow for an easing of rates, weakening of the $, increased American imports, and therefore a stimulation of world growth, since the United States represents 27% of world consumption.

Public debt is rising in the US, but the idea of foreign dependency is false. While Japan and China each have nearly $1.3 trillion in US Treasury bills, in each case it is only 7% of the outstanding debt. If China were to sell its treasury bills tomorrow as a form of retaliation, the US central bank could buy, and US long-term rates would be unchanged. Let us remember the year 2016 when China sold 15% of its assets without affecting rates. This is the expression of the privilege of the $ as a reserve currency of the international monetary system.

- ***The use of debt signals is a distinct advantage for developed countries over emerging countries :***

Stephanie Kelton is right not to worry about a possible increase in Chinese holdings of US treasury bills. Financing a deficit in one's currency is an advantage available to major countries such as the United States, the Euro Zone, China, Japan, Great Britain, Canada...

On the other hand, emerging countries, even the large ones, such as India, Brazil, South Africa and Turkey, are all deprived of the attractiveness of their financial or real estate markets, handicapped by a current account deficit, dependent on external capital to finance their infrastructures, dependent on the $ to pay for their incompressible imports of food products and commodities, partially indebted in foreign currencies, exposed to the rise in rates in the United States which would cause a capital outflow, a weakening of their currency, inflationary impulses, and an increase in rates. They cannot afford to let their budget deficits slip without exposing themselves to a monetary crisis, or even a default. An extreme case for emerging countries is the rise in US rates to 20%, decided by Paul Volcker, the head of the FED at the beginning of the 80s. It was a fatal rise in rates at the time for Latin American countries indebted in dollars. Particularly exposed today are the countries whose currency is pegged to the $ - Argentina and Lebanon come to mind.

- ***Towards a gradual halt in injections throughout 2022 and rate hikes from 2023 :***

Central banks, from next year on, will have to think about how to lighten their balance sheets to have room for manoeuvre in the next crisis. The FED did this in 2018 and 2019, so it is not impossible, but it must be managed to avoid a market collapse.

The Bank of England says it is close to completing its £895 billion, or $1.2 trillion purchase plan. New Zealand has also completed its $750 billion purchase program and Canada, like Australia, is expected to announce a "tapering", a beginning of a reduction in the central bank's balance sheet, in the near future.

Confidence remains the key notion at a time when money creation, the traditional monopoly of states, is competing with the action of individuals with cryptos and, in the future, no doubt, of GAFA who are rich in their databases.

In conclusion, central banks can pride themselves on their independence, but they are hostages to the addiction to low interest rates that has aroused in recent years. Some are worried that future generations may rightly take up the words of ***Corneille*** in ***Le Cid "How many sorrows and tears will our fathers cost us"***. By stopping the injections too early, they would provoke a more serious crisis than the one being erased thanks to their interventions. By prolonging these injections, they could provoke a flight from money and a new crisis. But it is true that, as all the major countries are practising the same policy, the alternatives are few.

- ***From a country perspective***, Modern Monetary Theory, the ability to sustain a budget deficit or expansionary monetary policy, is reserved for developed countries and China, who have monetary sovereignty. ***Kelton*** goes further and deems the bankruptcy of one of these states impossible because each of them has a monopoly on issuing money. Emerging countries do not have this latitude, and none of them can afford such massive stimulus. In fact, the best American aid to emerging countries is to keep rates low because they benefit from it on their $ debt. To alleviate the inevitable monetary tightening, the IMF will allocate $650 billion in SDRs (Special Drawing Rights) to its members, part of which will benefit emerging countries.

- ***From a debt perspective***, public debt, since 2007, has been a way to buy social peace, a way to compensate for the slowdown in GDP growth and a way to offset the slowdown in private investment. Today, public debt is such that central banks and governments cannot afford to allow interest rates to fluctuate freely. Given the maturity of public debt, a 1-point rise in short-term interest rates has an impact of 0.5 points on the GDP of the major countries. A 1-point rise in interest rates means losses on the portfolios of central banks and an impact on public finances. The problems are all the more acute because public debt is compounded by corporate debt and household debt. However, in the United States, as elsewhere in Europe, there is a desire on the part of some companies to use part of their cash flow to reduce debt, and a desire on the part of American and European households to use part of their accumulated savings to reduce debt.

- ***From a currency perspective***, everyone understands the advantage of monetary sovereignty to enable debt. In other words, states will not allow their currency to be ousted by any cryptocurrency. You can read our Letter on this subject again.

- ***From the point of view of interest rates***, with the generalization of liquidity injections in recent years, the interest rate is no longer a market variable but a political decision. Japan is the most obvious example of this, as the Central Bank has been setting the 10-year rate since 2013.

- ***From the point of view of inequality,*** monetary injection policies increase inequality because the richest, who hold real estate assets and securities, benefit from the appreciation of the markets. On the other hand, by crushing the yield curves, these injections help the most indebted companies to survive, maintain overcapacity, and create deflationary pressures, which penalizes the most successful companies.

- ***From the point of view of savings***, stopping liquidity injections in a few months and raising rates would weaken a number of states, cause the bond bubble to burst, weaken the real estate market or other assets, cause the decline of certain sectors on the stock market, and therefore impoverish many savers and bankrupt many non-viable companies, the famous "zombie" companies. In other words, central banks will adjust their policies later rather than sooner, and investors can still maintain their positions.

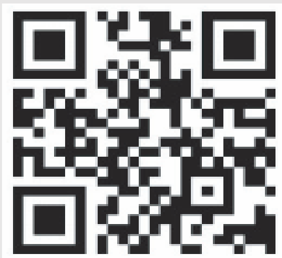
Geneva, 22nd July 2021

Bruno Desgardins

SINGALLIANCE
SingAlliance (Switzerland) SA | 16bis rue de Lausanne 1201 Genève Switzerland
T: +41 22 518 85 85 | www.sing-alliance.com

Bruno Desgardins
CIO
Switzerland

SingAlliance (Switzerland) SA
16bis rue de Lausanne
1201 Geneve
Switzerland
T: +41 22 518 85 85
E: info.switzerland@sing-alliance.com



SingAlliance Pte Ltd
20 McCallum Street
#18-01 Tokio Marine Centre
Singapore 069046
T: +65 6303 5050
E: info@sing-alliance.com

SingAlliance (Hong Kong) Ltd
1205, 12/F Bank of America Tower
12 Harcourt Road, Central
Hong Kong
T: +852 3611 7790
E: info.hongkong@sing-alliance.com

This document does not constitute an offer or a solicitation to purchase or subscribe financial instruments. Information contained in this document has been obtained from carefully selected public sources. Although every care has been taken to ensure that this information is accurate at the time of publication, no representation is made as to its accuracy, completeness, or truthfulness. Any opinion contained herein is subject to change at any time without notice. Past performance is not indicative of future results.