April 9, 2020

Navigating public debt perspectives amidst the COVID-19 crisis

The
COVID-19 pandemic – and the global response to it – presents a serious threat, not only in terms of public health, but also to our communities, our economies and our investments.

With the US
economy facing as many jobless claims in the last two weeks as it did for the entire duration of the 2008/09 financial crisis, the economic effects of the health crisis are unprecedented. With the world in some kind of burn-out, we

are amidst, what is by far, the deepest recession in living memory - it is no wonder that financial markets have faced the fastest bear market of all time.

Government orders effectively halted most of the economy in an effort to “flatten the curve” and ease the strain on healthcare systems. As a result, we saw an unprecedented economic shock which, contrary to what is normally the case, was not caused by the excesses of economic agents. Instead, it was the result of the fact that the majority of activity was brought to a standstill by governments. The pandemic is what economists call an externality. Governments and central banks around the world have responded to it by unleashing enormous fiscal and monetary stimuli and other support measures to ease the burden on workers and the economy. In essence, developed countries have thrown the fiscal rulebook out the window, embracing further unorthodox monetary and fiscal policies, in something which looks like a de-facto nationalization of the credit markets and lifeboat support to citizens and corporates.

While avoiding cynicism, we need to be realistic; easing lockdowns is going to be a complex calibration exercise in managing the trade-off between public health and the economic impact. For now, it is generally assumed that we will see partial and progressive exit strategies that segregate certain clusters of the population or certain economic activities, coupled with mass testing. Another perspective could be the ‘shock and awe’ strategy for which hospitals (perhaps on parameters such as the availability of critical care beds), could drive stop-and go rules for confinement. Clearly, there is no one-size-fits-all strategy and we should expect different opening-up methods across regions. The common thread should be some kind of risk-adjusted modelling, undoubtedly requiring significant shifts in the way society organizes itself.

Macro-economic history teaches us that tepid reactions from authorities have been catalysts of some of the worst recessions, depressions and financial crises. Critics of unorthodox monetary policy have been flourishing since the global financial crisis. From our perspective, those are mostly sterile. Why are people spending so much time and energy trying to figure out alternatives to past history? Re-writing it with what if, or what else, scenarios is useless. It is not the time for “should’ve, would’ve, could’ve”.

Acting as
pain alleviator, public stimuli measures are effectively the monetization of the future deficits. Levels of sovereign debt in terms of GDP will be abyssal and we are clearly observing some transfer of corporate risk to the state.

Yogi Berra
(famous American professional baseball catcher) once said “the future isn’t what it used to be” – this is my favourite reminder that humility is essential when making any kind of prediction. COVID-19 reminds us that money managers are not paid to make forecasts, but to adapt to a perpetually changing context. The day will come when critics will have to digest the quote of Mike Tyson saying that “everybody has a plan until they got punched in the face”. Could governments and central banks have acted differently, protecting the orthodoxy of public finance and money creation? Maybe. But don’t ask us how. Eloquently put: “Any hesitation in throwing everything but the kitchen sink at the health, employment, state aid and financial rescue interventions that are needed will literally kill citizens and destroy the economy.”[1]

European
leaders are still struggling to coordinate fiscal initiatives. Officials have been active in trying to quell highly-controversial comments from the Dutch Finance Minister (who called for an investigation into Spain’s proclaimed lack of budgetary capacity to cope with the pandemic). As the Portuguese Prime Minister put it, this is against the spirit of the EU. The running conflict between anti moral-hazard defenders and financial solidarity supporters is again calling into question the sense of belonging for many European countries. The question raised by the French Finance Minister “are we together or are we not?” sounds quite relevant.

Fiscal and
budgetary measures will allow already-significant deficits to balloon even further, a fact that will be exacerbated by collapse in tax revenues from depressed economic activity. Crossing the Rubicon and breaking the taboos of

orthodoxy is crucial as the war-time analogy goes. “Whatever it takes” strategies could mean that central banks will metamorphose from their role as the lender of last resort, to become buyers of last resort. Similarly, governments could evolve into moratorium courts, insurers and bailout organisations, or more broadly the prominent economic agent of our time, far above corporates and households. For both these bodies, the risk of too little, too late far outweighs the risk of too much, too quick.

In the aftermath of this horrific pandemic, austerity measures will likely be part of the price tag. Peace time will allow us to reassess the risk of using traditional government bonds to buffer equity volatility. But without any doubt, US-Treasuries were among the few places to hide during the “Great Cessation” we are currently enduring.

To conclude with a constructive perspective, we are convinced that creativity will successfully help navigate the public debt burden. Monetary policy has been fertile ground for a couple of years. At the end of the day, don’t be surprised if money printing supplants borrowing for some major economies and supranationals. Let’s wait and see if we will call it a zero-coupon perpetual bond, helicopter money or the inglorious Modern Monetary Theory.

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[1] Vox article «To fight the COVID pandemic, policymakers must move fast and break taboos”

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