

What's the Future Payback for the Stimulus?

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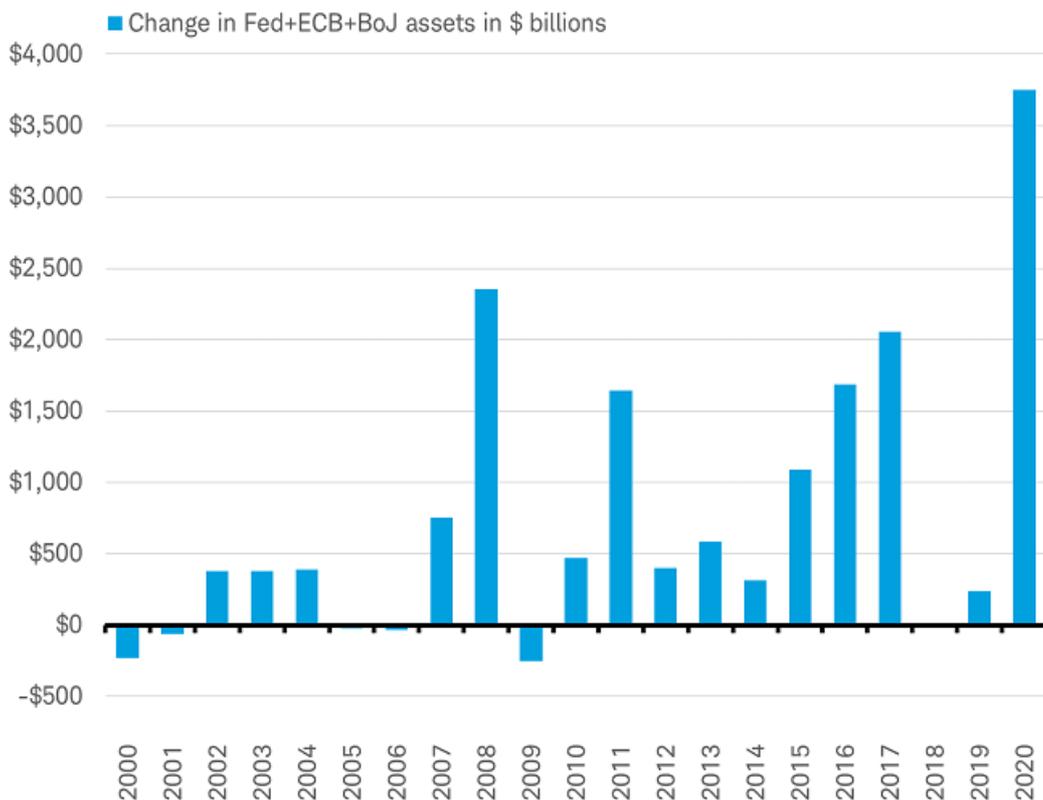
Key Points

- It is becoming increasingly clear that the massive global stimulus is being financed by a rise in money, not debt.
- Debt borrows growth from the future. The biggest difference between a one-time rise in money compared to a rise in debt is a potentially brighter economic outlook.
- The biggest risk may be that this isn't a one-time event. In the future, governments might be more inclined to keep on running big budget deficits financed by central bank money potentially leading to slower growth, weaker currencies, unwanted inflation, and central bank insolvency.



The fiscal costs of the battle against COVID-19 is anticipated to be between 10-20% of global GDP, but could be even higher. To mitigate the economic impacts, central banks worldwide have announced big quantitative easing (QE) programs absorbing debt by purchasing bonds. Although these programs have just begun, the combination of purchases by the U.S.'s Federal Reserve (Fed), European Central Bank (ECB) and Bank of Japan (BoJ) have already set an annual record, as you can see in the chart below.

Combined Fed, ECB, and BoJ buying have already set an annual record for 2020



Source: Charles Schwab, Bloomberg data as of 5/6/2020

More money, not debt

It is becoming increasingly clear that this is being financed by a rise in money, not debt. This is because it is being accomplished through unlimited central bank purchases that recycle the interest payments back to the government.

This essentially transforms the cost of the borrowing from government interest payments on debt paid to investors into central bank interest payments on excess reserves paid to banks. Any difference between the interest received from the government by the central bank and the interest paid by the central banks on excess reserves is returned to the government. The methods and timing of this money recycling back to the government differs across countries, but are similar in their effect.

Big differences

What's the point? The outlook for future global economic growth can be significantly different depending on the method of financing economic stimulus: between a rise in money versus a standalone increase in debt.

Positive differences:

- Support by central banks via monetary financing may make governments feel more at ease to pull out all the stops to support the economy, driving a faster recovery.
- Put simply, debt borrows growth from the future. If governments don't worry about paying debt (because central banks are returning those payments), future austerity is less likely. Removing the likelihood of future spending cuts or higher taxes eliminates a potential drag on economic growth.
- If households quickly return to spending, rather than putting money in bonds to finance the rescue efforts, it could aid the economic recovery from the war with COVID-19.
- The rise in money could boost inflation expectations and put an end to the battle against destructive deflation that has been threatening economies for the past decade.

These are big differences brought by a rise in money compared with the "war bonds" of WWII when the costs in the U.S. and U.K. were financed by debt, held by households and led to an extended period of disinflation.

Negative differences:

The biggest risk may be that this isn't just a one-time response to a pandemic. This course of action could lead to a number of potential negative effects.

- Governments might be more inclined to continue large budget deficits on the assumption that further borrowing is costless. The private sector may be encouraged to take on excessive risks leading to a

misallocation of capital.

- Excess inflation could emerge, bringing higher interest rates and lower currency values, risking slower long-term growth or even a return to recession. Governments' inability to contain inflationary tendencies is the reason why independent central banks were established in the first place. In the past, when governments have come to rely on a continual rise in money rather than debt to encourage economic growth, it was difficult to stop the cycle. Examples include 1930s Japan, Weimar Germany, and more recently in Argentina, Venezuela and Zimbabwe.
- Eventually, debt absorption at high levels may lead to the insolvency of the central bank. Central bank effectiveness would be handicapped and eventually require governments to issue still more debt to recapitalize it. Although any central bank could be made insolvent with a steady rise in reserve liabilities relative to assets, this erodes capital and is of particular issue to central banks partially owned by investors and traded on stock exchanges, like those of Japan and Switzerland.
- Central bank authority could be challenged and eroded. For example, Eurozone countries rely on the ECB to provide monetary financing. The recent finding by the German Constitutional Court held that the ECB's QE program in 2015 did not constitute monetary financing of government budgets because of restrictions placed on the program. The total volume of purchases was limited from the outset, were in proportion to the ECB's capital key, were limited to no more than 33% of each bond issue, and were subject to a minimum credit rating. Going forward, these guidelines present limits to open-ended monetary financing of all Eurozone countries, especially for Italy and Greece.

Real world?

Markets seem more willing to focus on the positives and ignore any potential negative payback for the stimulus. Perhaps, they may be relying on Japan's real world experience with monetary financing, which seems to suggest we shouldn't worry about the negatives. Japan has been implementing this type of stimulus for a long time now. Although government debt has soared to a record 250% of GDP and the Bank of Japan is still making purchases, Japan has seen little inflation, no currency devaluation or worries about the solvency of its central bank.

Japan's demographics and uniquely excessive savings rate by businesses and households (high in comparison to many other countries) may have kept the negative pressures in check. However, the growth in government borrowing may soon eclipse domestic savings. Additionally, Japan's GDP growth at less than 2% annually since the Great Recession is nothing to envy. Watching Japan may allow us to glimpse into the future. After all, Japan's central bank was the first to adopt a zero interest rate policy (in 1999) and the first to do QE (in 2001). Perhaps Japan may find another way to continue to extend monetary financing of new stimulus and avoid the above negative consequences. Or, the pressures of growing money may begin to show, and may reveal the limits of this form of financing, and that a payback is coming.

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