How will we pay for all that stimulus?

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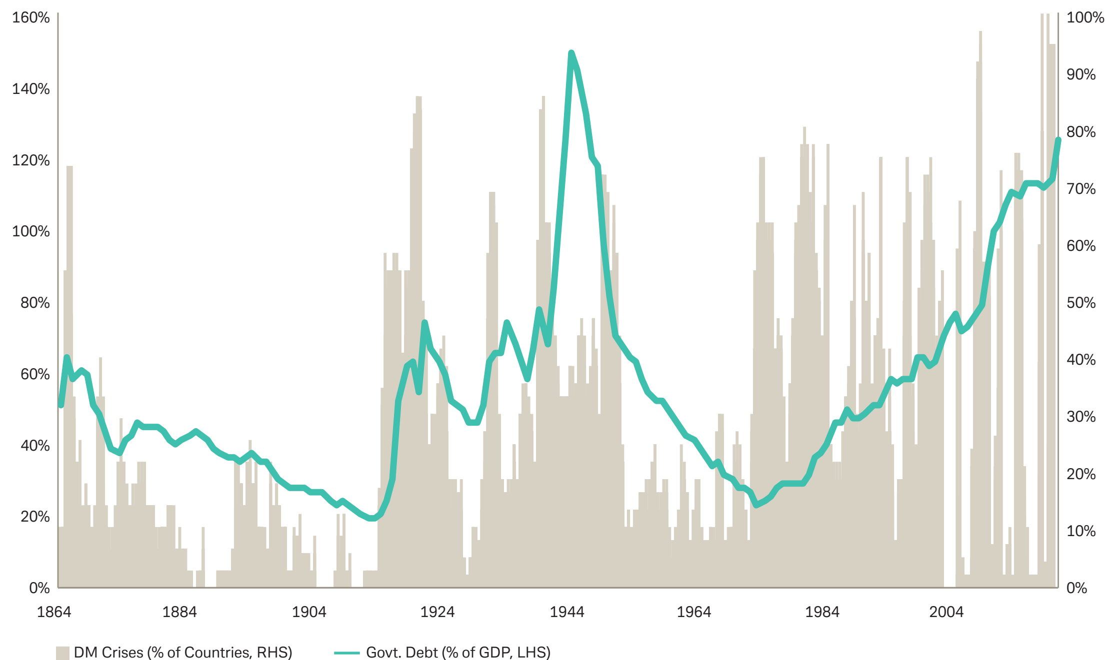
Virtually every country around the world has reeled out significant support mechanisms for their citizens and companies over the last two months in the face of the extraordinary covid-19 shock. Whilst this is admirable and well intentioned it leaves the question as to how they will end up paying for it. After all, if it was this easy to boost public spending in the economy, surely there would always be a blank cheque available to finance it.

There is good news and bad news. The good news is that we live in a fiat currency world where (in theory) there is no constraint on printing money and IOUs. This allows more flexibility in downturns compared with the pro-cyclical tightening of policy that commodity-based (e.g. gold) systems experience, as we found out in the 1930s. The bad news is that we have continuously dipped into the well of the fiat-based system over the last 50 years. So much so that G7 private plus public debt has increased from around 130 per cent of GDP to 270 per cent in 2019. It will likely hit 300 per cent this year – a record high.

As debt increases with the covid-19 crisis, one consequence will be to reinforce the belief that the modern global economic system is prone to regular financial crises. Since the Bretton Woods system collapsed in the early 1970s and we moved into an era of fiat currencies, financial crises have become more regular. The following chart shows average G7 government debt-to-GDP versus the percentage of countries that have seen a financial shock over any 12-month period. Prior to the Bretton Woods system, financial crises existed (often around wars), but the frequency was not as intense as it has been in the post-Bretton Woods world. We should stress that this should not be seen as a reason not to buy financial assets as in this era financial stress brings huge intervention, but it should help raise an awareness to the structural regime we are living through, how it relates to history and how covid-19 will perpetuate this.

Percentage of DM countries in financial stress vs. G7 government debt to GDP



Source: GFD, Bloomberg Finance LP, CBO, Deutsche Bank

The end game?

So financial crises are likely to continue as a feature of our global economic system post covid-19 but so will heavy intervention. In terms of the end game, though, if there is something resembling a V-shaped recovery from what will still be one of the worst recessions of the last century, then government debt-to-GDP will increase by plus or minus 10-15 percentage points for most developed countries this year. This will leave a sizeable scar on public finances but it should not lead to an imminent funding crisis. Taxes will likely have to rise but central banks will do most of the heavy lifting by increasing government bond purchases. As long as we see an economic rebound in 2021, and as long as central banks can keep bond yields comfortably below TREND nominal GDP, then debt sustainability can be prolonged beyond what might appear obvious by simply looking at the debt-to-GDP statistics. Consider Japan over the past two decades. So far so good.

However the real curveball comes if this pandemic is extended. While this is not the base case it is an ever increasing risk and we will likely see some elements of it. Social distancing would become the new normal and we could see second or third waves of the outbreak which involve new lockdowns to varying degrees of severity. In this scenario, economies will operate well below their potential for a long period of time and the damage to public finances could become more existential.

In countries like the US and the UK where central banks are independent only by policy choice, the market will largely assume that these central banks will always help to monetise the debt, either by direct purchases or by indirect control over the yield curve. Currencies should fall but in a world where everyone has similar issues, there may be benefits to actually having a solution to the issue.

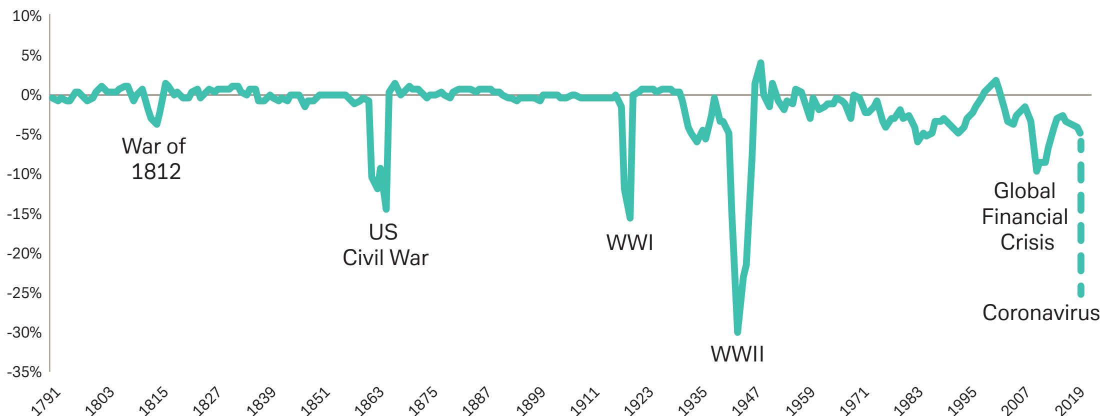
In a protracted pandemic scenario, DB economists see the US economy shrinking over ten per cent in 2020 and being fairly flat in 2021. The budget deficit will then hit a stunning 25 per cent of GDP this year and next. By 2030, debt-to-GDP could rise to 175 per cent, not far from double last year's figure. This level was not previously expected by the Congressional Budget Office until 2049. These are war time type level deficits as shown in the following chart.

US wartime deficits

These already scary debt numbers assume a permanent and sustained low interest rate relative to growth thanks to heavy intervention from the Federal Reserve. If the Fed purchases a large proportion of the extra debt, and interest rates can be controlled, we could kick the proverbial can down the road as we have done so many times since the start of fiat money in 1971.

This high debt/low interest rate outcome is possible if the demand for US securities remains

US Surplus/Deficit (% of GDP)



Source: TBD

strong and if inflation remains low. If inflation does start to rise, demand for these securities will likely fall and central banks will have a much tougher job. The likelihood is that, in a country like the US, the Fed will choose, or will be forced by the government, to monetise the debt by buying US treasuries in even larger size. This could involve not only buying up new issuance but also bonds that free markets no longer wish to own.

If the Fed can keep yields well below inflation, then this will, of course, help to reduce the climb in debt. If inflation is the route chosen it could help manage the debt burden more successfully but this will create periodic bouts of huge volatility in financial markets and ensure turbulent times. Equities prefer low stable inflation and some of the mountain of fixed income will need to find its way from private hands to the central bank balance sheet.

Europe

The picture in Europe is far more complicated. Under the protracted pandemic scenario DB economists see the big four Euro Area debt-to-GDP rising from 92 per cent to 148 per cent next year. Germany's position rises from 59 per cent to 'only' 97 per cent. In contrast, Italy is a concern. The country's debt-to-GDP ratio will likely climb from 135 per cent pre-covid to just over 200 per cent by the end of 2021. If Italy was a stand-alone country outside of the EU then its independent central bank would have to make a decision as to whether to monetise that debt. And the market would have to decide what to do to its currency. Japan is proof that a country can survive with a surge in debt if the central bank buys almost half. In Japan's case, the currency has actually been relatively stable over this period. The good news for Italy is that, like Japan, it has a wealthy private sector and a current account surplus.

The potential problem is that Italy is in the EU and shares a currency with Germany. By the end of 2021, Italy and Germany could both have debt of around three trillion Euros, even though the Germany economy will be around twice as big. At current yields, Italy's borrowing rate is at 2.25 percentage points above that of Germany. This does not seem sustainable.

So how will Europe stay together? The optimistic scenario is that the ECB will increasingly be allowed to deviate from capital keys and buy significantly more Italian debt than for other countries. For this to happen Italy will likely have to commit to rolling conditionality over how it manages its economy. The main threat to this strategy is inflation and politics. Over the last decade, the ECB has purchased government bonds in order to meet its inflation mandate. If low inflation is not an issue, then at some point will it have the political or legal mandate to keep buying Italian debt? Much will depend on the politics. Will northern European countries tolerate the ECB financing of Italy's debt if and when inflation is rising?

In terms of domestic politics, will Italy continue to accept some oversight from Europe in return for continually financing its excess debt? Rationally this may make sense but politics over the last decade has shown that populism breeds in troubled times. A more Eurosceptic government ruled in the future by perhaps Mr Salvini of the League Party might take a more combative approach with Europe. Can the ECB still buy an outsized proportion of Italian debt in such a hostile environment? Whatever path is taken, it is a relatively unstable equilibrium and ECB involvement for now is mostly about buying time for a bigger solution. As we go to print the German Constitutional Court has demonstrated that the exit risks also come from the German side. The legal resistance to monetising debt may increase further over time.

The bigger solution

One of the founding fathers of the EU, Jean Monnet, said that the union "will be forged in crisis and will be the sum of solutions adopted in those crises". This sums up the evolution so far. The problem is that the EU is in a permanent identity crisis. Compromise has kept the bloc together while at the same time leaving it vulnerable.

We know what is unlikely to work and that is more austerity after the political and economic carnage that it created post 2010. Default is not a straight forward option either due to the sovereign/banking doom loop where banks have been forced to hold more domestic debt. Also joint liabilities and European bond issuance are unlikely to fly. It would be akin to a direct bottomless fiscal transfer from the northern to southern states and politically near impossible.

There are some options. A decade ago, the idea of a debt redemption fund was raised. Here, an SPV would be formed to purchase all member state public debt above 60 per cent of GDP and financed by joint-and-several bonds. Using the fund entails a commitment to fiscal consolidation and dedicating national revenue streams to the fund. Excessive debt will then be worked off over 20 years.

The possibility of a Covid debt redemption fund has been mooted by Francois Villeroy de Galhau, the influential Governor of the Banque de France. Here, one-off debt inherited from the covid crisis could be ring-fencing into a separate entity, similar to how France created 'Caisse des Depots et Consignations' to absorb the debts from the Napoleonic Wars. This separation would allow a return to "ordinary" fiscal policy once the virus crisis is over.

With a Treaty revision, the EU could create a Pandemic Emergency Recovery and Resolution Corporation (PERRC). This would be an official EU entity, fully under the oversight of the ECJ. Like the ESM, it could issue debt backed by paid-in and callable capital. That is, it would be financed by 'several' but not 'joint' bonds. Treaty revision would allow a carve-out from the Article 123 prohibition on monetary financing. That is, the PERRC would have the ability to finance itself at the ECB.

Consistent with Villeroy's concept of ring-fencing covid crisis debts, the PERRC would consist of two funds. First, a Pandemic Emergency Recovery Fund of up to €1tn would finance a large-scale recovery and investment programme over the next several years. Second, a Pandemic Emergency Resolution Fund would purchase the PEPP portfolio from the ECB. In doing so, it would acquire the liabilities that member states have built up responding to the crisis (including national discretionary policies, cyclical deficits, any use of the ESM pandemic tool, the SURE labour support tool, debt financing for corporate capital injections or nationalisations, etc).

The quid pro quo for the carve-out from the prohibition on monetary financing is that euro area member states agree a constitutional change to implement a covid tax to finance the redemption of the recovery and resolution funds over a long period of time (for example, 100 years). This tax would need to be designed carefully and ring-fenced so as not to be adapted for other uses. Part of the financing could also come from asset sales. The PERRC would absorb the acquired assets as well as the liabilities and the benefit of any ECB-financed equity position can be offset against the total, area-wide cost of covid. And management by an EU-level entity would ensure compliance with the State Aid rules post-covid.

The politics entailed in creating the PERRC will be extremely challenging. Exclusion from monetary financing and limited tax raising powers are highly controversial. Moral hazard is also an issue. Although the covid debt shock was not the result of an economic policy choice and therefore not subject to the usual moral hazard considerations, PERRC would create a precedent and that could need its own offsetting controls.

The EU and EA have had a tendency to find sufficient compromises for ensure survival. That is what the covid debt redemption fund would allow. Without something like this, the risk is that the covid debt shock will prove existential to Europe in its current form.

What is certain is that there will be an astonishing amount of global debt after covid-19 recedes. Inflation and politics will determine how the world manages this though. A global situation that accelerates us closer to the Japanese experience is possible. If we see higher inflation and more fractious politics then the outcome will likely be binary and volatile.

Yet, political fault lines could emerge even without inflation, particularly in Europe with its tensions between the north and south. Regardless, covid-19 has accelerated the day when policymakers will have to decide how to manage what was already a rising debt outlook. While the US and UK will likely choose monetisation, the situation is more complicated in Europe. The ECB may not be legally able to continuing buying into perpetuity. There are certainly no easy choices after years of benign neglect towards ever mounting global debt levels. That will make Europe's propensity to find a compromise more important than ever.