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Rising deficits and government debt

COVID-19 is having an unprecedented global impact. The contraction in activity will be bigger, and more concentrated than the GFC. Labour market scarring coupled with the structural imbalances point to a drawn-out recovery. Across the advanced economies, the Eurozone appears most at risk to a slow turnaround.

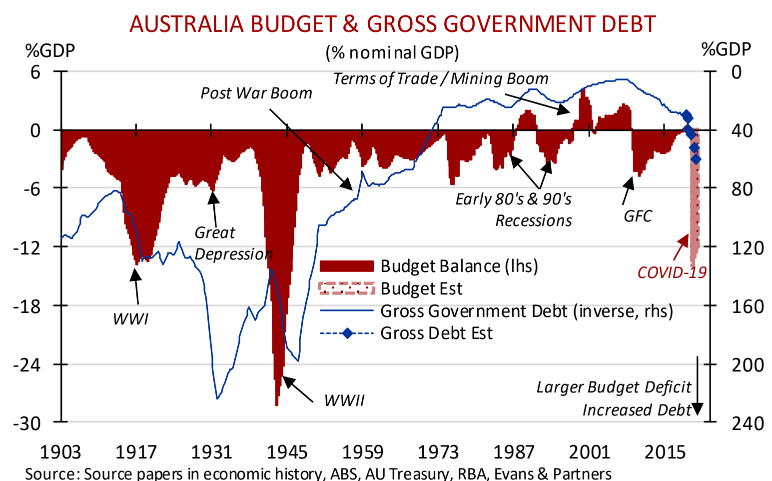
To help cushion the considerable blow a wave of measures has been unveiled. Budget deficits in Australia and the US will rise to peace time records. With traditional monetary levers tapped out, fiscal policy will need to carry more of the burden. Budget deficits will stay large for some time. Indeed, we think more will need to be done to guard against evolving solvency risks, and to support the eventual rebound (e.g. tax cuts, more cash handouts, investment/employment incentives and infrastructure). Government debt will rise sharply. Tackling the debt via austerity (e.g. tax hikes) would stifle any upturn.

Large budget deficits also mean bond supply will ramp up. To keep servicing costs low, and financial conditions supportive, central banks will remain ultra-accommodative for years to come. Some countries could even contemplate moving to 'debt monetization'.

Rising debt has been a driver behind the structural downtrend in interest rates. These forces are growing stronger. With inflation set to remain subdued and central banks active, the 'lower for longer' theme is firmly entrenched. As a result, the 'equity risk premium' (ERP) should remain elevated. From a medium-term asset allocation perspective, a higher ERP means investors should favour holding stocks over bonds.

But in the short-term, we still think investors should remain cautious.

- The swift equity market rebound has eroded a lot of the underlying valuation support.
- Participants appear increasingly complacent around how big the COVID-19 economic impacts could be, the speed of the recovery and/or the potential financial stability risks given the sharp deterioration in labour markets.
- The weak global economy, outlook for more fiscal spending, and already high amount of debt that needs to be rolled over reinforces our negative emerging markets stance.

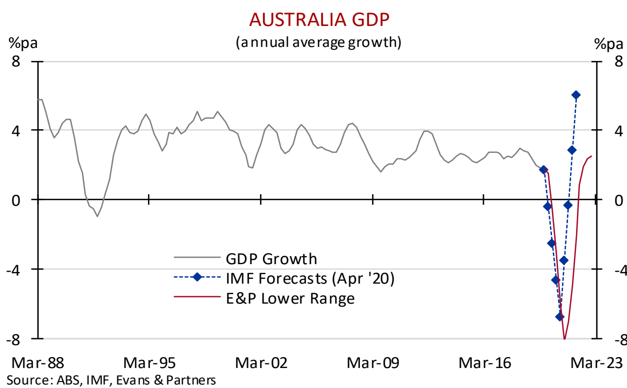


Source: Source papers in economic history, ABS, AU Treasury, RBA, Evans & Partners

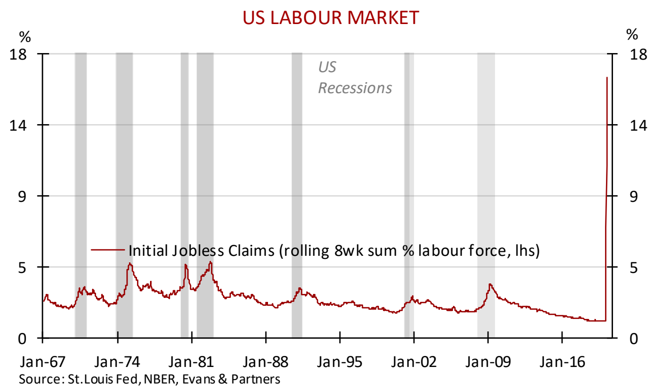
Rising deficits and debt

The COVID-19 outbreak is having an unprecedented impact on the global economy. Unlike country specific shocks or the GFC, this economic downturn has not been brought on by an asset price collapse, or the bursting of a debt bubble in the household or corporate sectors. Rather it has been due to an act of nature. To deal with the health crisis, large parts of society have been shut down, and social distancing measures have become commonplace around the world.

As a result of the sudden stop in activity, the contraction in global economic activity will be far bigger, and much more concentrated than the GFC. The levels of economic contraction we are living through were last seen during the 1930s Great Depression. In Australia, there will be a steep fall over H1 2020. RBA Government Lowe stated that the Bank thinks GDP could decline by 10% over H1, with most of the impact felt in Q2. This is broadly in line with the lower end of the range of possibilities we previously put forward (see "*Navigating through the recession*", 10 March).

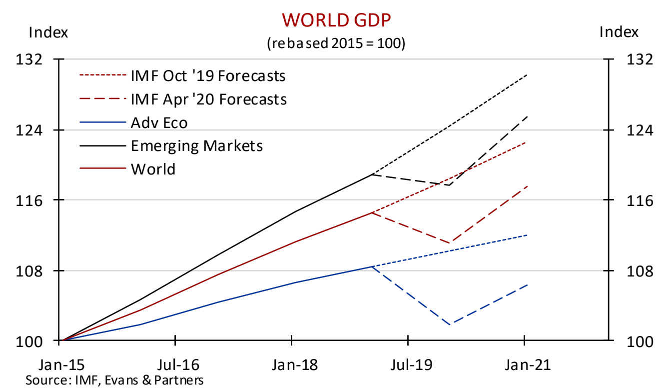


Further illustrating how unparalleled the current situation is, unlike in other business cycle downturns and recessions, the flow through to the labour market is being front-loaded. Globally, unemployment rates will spike substantially higher over the next few months, unlike the drawn-out deterioration that normally occurs.



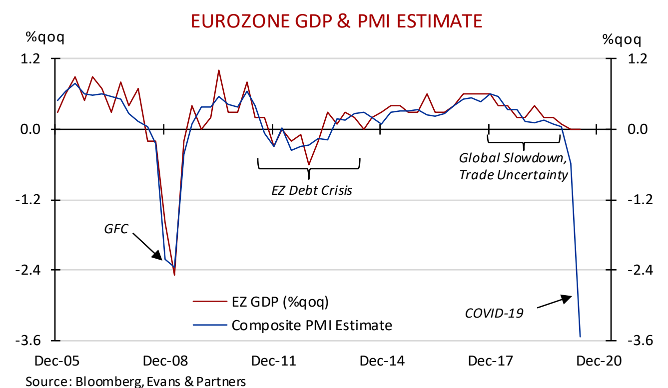
In the US, over the past five-weeks initial jobless claims (i.e. people that have applied for unemployment benefits) have spiked by ~26mn. That is ~16.5% of the US labour force and exceeds the number of net jobs that were added in the decade post the GFC. Similar signals are coming through elsewhere. The new ABS data showed that the number of jobs fell by 6% over recent weeks. The traditional labour force statistics measures people in jobs not the number of jobs. But both should move in the same direction.

Labour markets typically heal far more slowly than they weaken. The global labour market scarring, coupled with the structural imbalances in many economies (such as high household or private sector debt), and likelihood behaviours are changed by the health crisis, are reasons why we think the upturn (once the health risks subside) will be drawn-out rather than a 'v-shaped' snap back. Given the extent and speed of the recent market rebound, we think asymmetric risks could be brewing. In our view, investors could be underestimating the scale and duration of the economic damage (see "*Was that it?*", 20 April).



Indeed, we would note that upon closer inspection even the IMF's latest projections, which at face value project a sharp recovery from late-2020, barely have the world economy recouping the H1 disruption by end-2021. Within that advanced economies are forecast to still be smaller than where they finished 2019 in two years' time. The economic shutdowns will result in a historically large loss of output and shift up in unemployment rates.

The Eurozone, which has been plagued by several crises since 2007, has not implemented needed reforms, and has limited policy space, looks at risk of experiencing a weak revival.



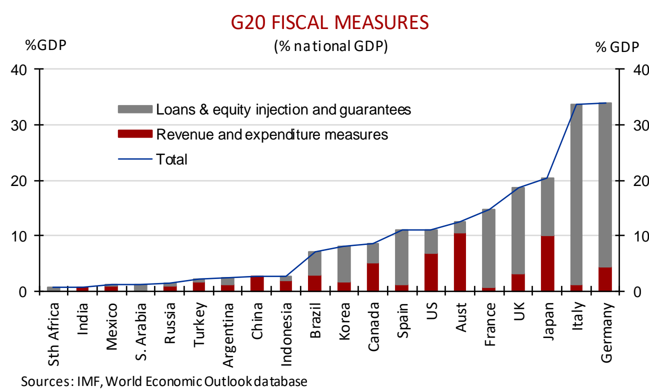
An extraordinary policy response

To help cushion the considerable blow on activity, employment, and incomes, and guard against systemic risks,

global policymakers have announced a wave of aggressive and targeted monetary and fiscal measures.

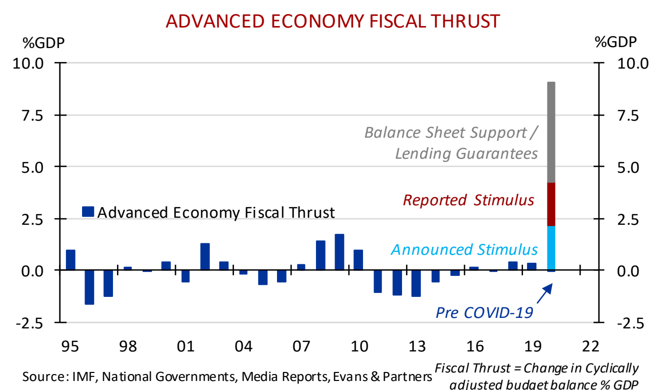
Just as the economic shock will exceed the GFC, so does the policy response (see "*Global allocator, whatever it takes*", Q2 2020). Policymakers are aware that they cannot provide a panacea to the current crisis. The objective of a lot of the initiatives is to help limit the lasting effects, and encourage a more robust normalization than otherwise, once the health risks abate. We think that over time, more will be needed.

The IMF's latest Fiscal Monitor illustrates the scale of the fiscal support being deployed across the G-20. When including both the direct spending programs and loan guarantees designed to help the flow of credit to businesses and households, a rising proportion of countries are committing to spend in excess of 10-15% of national GDP.



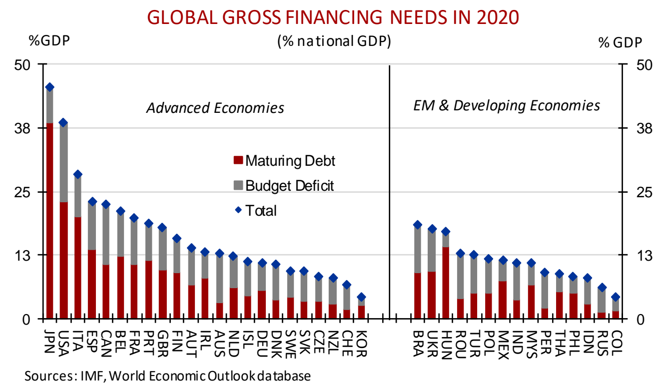
Sources: IMF, World Economic Outlook database

This maps with our earlier figuring that the 'fiscal thrust' (i.e. the year-on-year change in the budget balance) of the advanced economies is set to swamp anything that has come through since WWII.



Source: IMF, National Governments, Media Reports, Evans & Partners

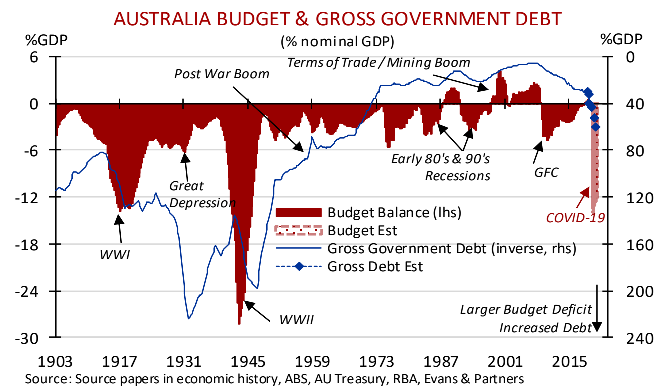
Notably, the IMF's analysis also shows that unlike advanced economies, Emerging Markets (EM) have generally not yet gone down this road. We think it is only a matter of time, given the health and economic risks (see "*Virus trends: curve flattening*", 9 April). But this could also be problematic given EM lacks the capacity to deploy large scale measures. Based on the already substantial amount of debt that needs to be rolled over in 2020, and heightened investor caution, EM nations could face challenges in convincing investors to lend more to them. This reinforces our negative EM stance.



Sources: IMF, World Economic Outlook database

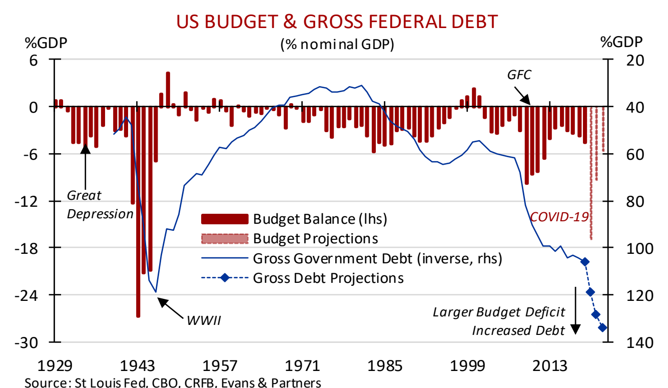
Record peace time budget deficits

US President Trump has taken to calling COVID-19 the "*invisible enemy*". This fits with the general characterization that the current situation is akin to a war time footing. Certainly, from a policy standpoint this is what we are seeing, with fiscal deficits growing rapidly.



Source: Source papers in economic history, ABS, AU Treasury, RBA, Evans & Partners

In addition to the various economic support measures, governments are also increasing health expenditure. At the same time, the 'automatic stabilisers' of lower tax revenue and greater welfare spending are kicking in as economic output drops and unemployment lifts. For Australia, as things stand, we estimate this will see the budget deficit blow out to ~10-12% of GDP over the next year. In the US, the Congressional Budget Office (CBO) predicts the deficit will balloon to ~18% of GDP in 2020 and be ~10% of GDP in 2021. As shown, these are levels only reached during world wars.



Source: St Louis Fed, CBO, CRFB, Evans & Partners

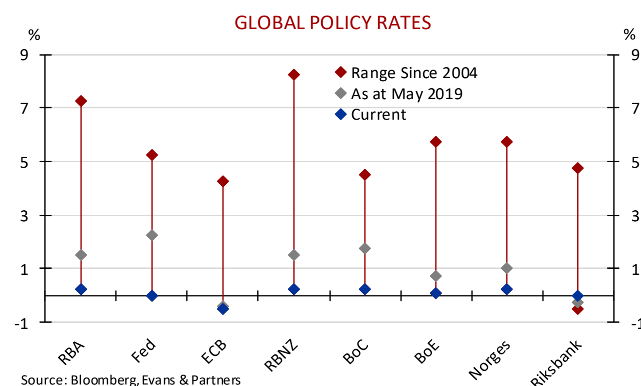
That said, from a relative standpoint, Australia has clearly entered this shock in better fiscal shape than many of its peers. Particularly the US. The US Federal Budget deficit was

already ~5% of GDP when the economy was doing fine. US growth was running around trend and the unemployment rate was near a 50-year low pre COVID-19.

Fiscal policy to continue to carry the burden

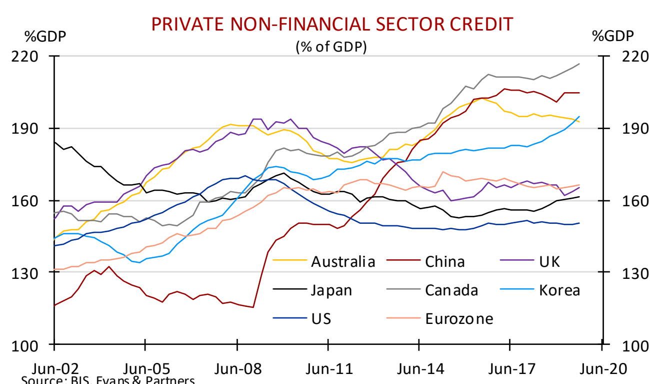
Traditional monetary policy levers are now largely exhausted, with interest rates across the major economies at their respective lower bounds. While unconventional measures will continue to be used by central banks, we think a greater burden, as we roll through the remainder of this crisis and the recovery phase, will fall on the shoulders of fiscal policy.

As articulated by former ECB President Draghi, it is the role of the state to deploy its balance sheet in order to protect its citizens and the economy against shocks that the private sector is not responsible for and cannot absorb.



With this in mind, we think that as the economic costs of the health crisis continue to crystallize, and when the recovery commences, further fiscal action will be necessary. On the former, so far, the multi-pronged monetary and fiscal actions have largely been focused on liquidity, supporting business and household cashflows, and extending credit. But we believe over coming months (and possibly years) there will be greater focus on solvency risks stemming from the unprecedented economic contraction, large rise in unemployment and high private sector debt.

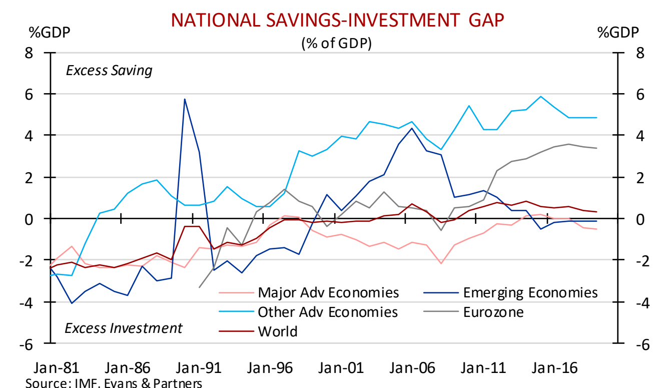
As we have pointed out, the current growth and labour market shocks risk amplifying existing trends and vulnerabilities such as elevated household or corporate debt (see "*Always darkest before the dawn*", 10 April). These risks remain front-of-mind for policymakers as well.



Helping to repair the damage inflicted on private sector balance sheets will require sustained fiscal spending around the world. Without this type of support, the downturn risks becoming deeper and longer than currently envisaged.

Moreover, once the health risks ease and economies start to recover, fiscal policy will also have a key role to play. The global savings glut, and lack of investment has been a headwind to productivity and growth for many years.

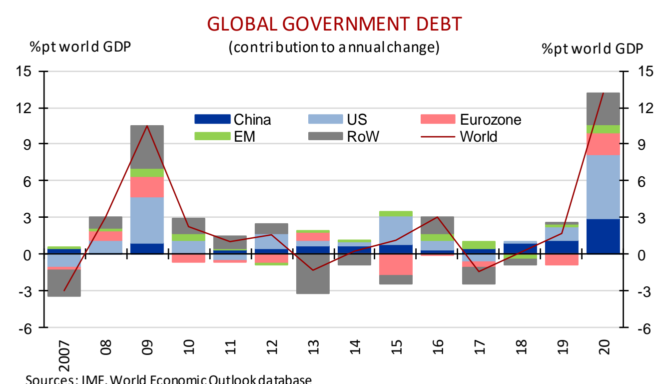
In a nutshell, slower population growth weakens labour supply and in turn potential activity. The more subdued growth outlook reduces the economy-wide investment in capital. While ageing populations also tend to save more.



With consumers and businesses likely to become even more cautious following recent events, various pro-growth fiscal measures and reforms aimed at promoting investment and employment such as tax cuts, subsidies and/or additional cash handouts/infrastructure investment will be needed to help solidify the eventual rebound. Media reports suggest Australia could be heading down this path.

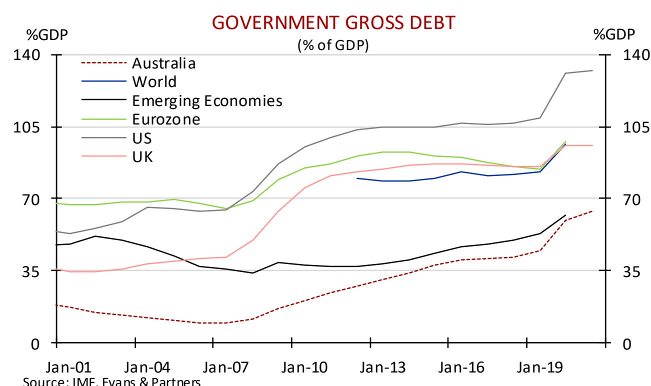
Government debt levels to rise and rise

The large fiscal deficits, and expectations this will remain the norm for some time, will see government debt levels jump up. According to the IMF, the average public debt of advanced economies had plateaued at about 100% of GDP in the 2010s (up from 74% in 2007). By 2021 the average is estimated to rise to ~130% of GDP.



From an Australian perspective, on our estimates, Commonwealth debt could lift from ~33% of GDP to 50% of GDP over the next few years. This would be the highest level since the early-1960s. However, it is nothing to be alarmed

about. While high for Australia, it will be below many other countries (such as the US where the IMF is predicting gross government debt will rise to a record high ~132% of GDP in 2021). And below BIS estimates for when high debt can become a drag on growth (i.e. ~90% of GDP).



Source: IMF, Evans & Partners

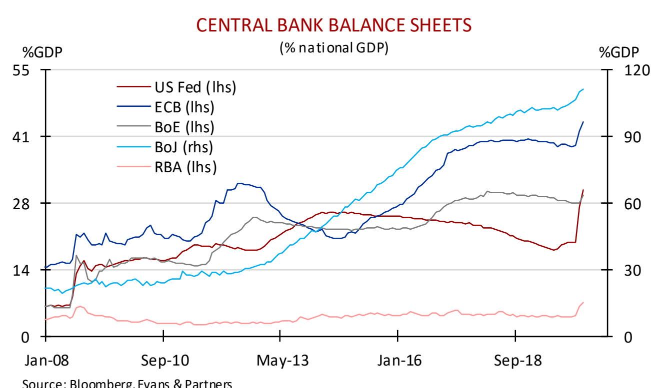
How will the world pay for all of this?

The short answer is we won't. High (and higher) government debt burdens will be with us for the foreseeable future. The speedy decline that occurred following WWII is unlikely to be repeated. During that period there was a sharp and extended post-war economic and population boom.

By contrast, demographic trends are now unfavorable. Populations are ageing, and growth has slowed. These forces only add to burgeoning healthcare and social security costs in various countries. Furthermore, austerity measures typically used to tackle high debt, such as raising taxes or cutting spending, would only act to stifle the future recovery. Focusing on growth, whereby debt-to-gdp ratios are lowered by boosting the denominator appears to be the only viable option. This is something Australian Federal Treasurer Frydenberg has mentioned would be the domestic focus.

Monetary and fiscal policy working in tandem

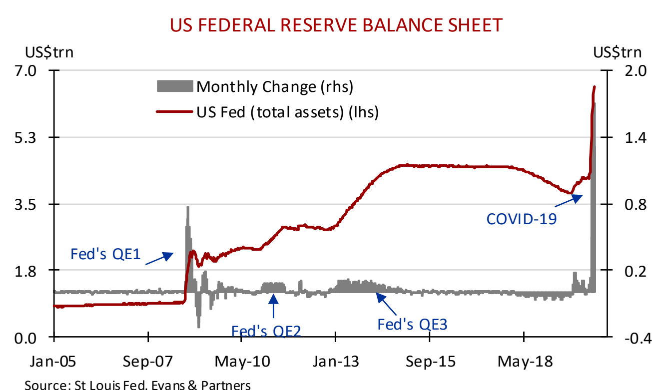
Monetary and fiscal policy has worked in concert over the past month. We think it will continue to do so over the next few years given the long shadow the COVID-19 disruptions will cast over the world economy.



Source: Bloomberg, Evans & Partners

Alongside the large fiscal easing, the major central banks have lowered interest rates, are undertaking large scale asset purchases, and are providing cheap funding to promote the flow of credit to SMEs.

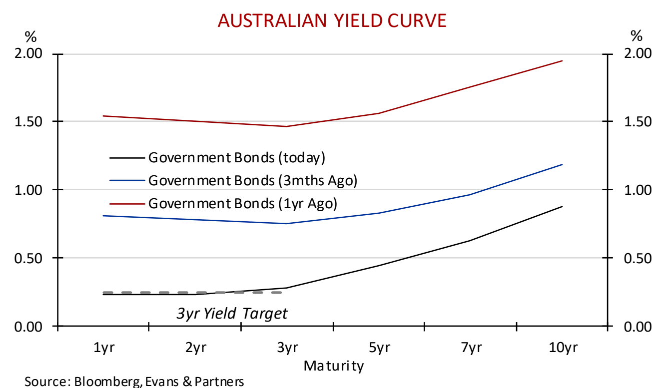
The US Fed has repeatedly surprised by unveiling several assertive measures (such as broadening its asset purchases to include credit, including high yield, and stressing it will buy assets "*in the amounts needed*"). In a sign of its determination, and magnitude of the shock, the Fed's balance sheet has expanded by more over the past month than it did in the year post the Lehman Brothers collapse.



Source: St Louis Fed, Evans & Partners

With the unprecedented fiscal response to COVID-19 set to result in a surge in global sovereign bond issuance, monetary policy settings will need to remain ultra-accommodative to help keep yields, and in turn debt-servicing costs, low. Central bank balance sheets will continue to expand at a decent clip, though policies will no doubt evolve.

In an environment of rising bond supply, we think the RBA's yield curve control policy could be quite effective in helping to keep rates anchored across the term structure. And it could be something other central banks, apart from the Bank of Japan and RBA, look to implement. Any sustained upward pressure on bond yields would tighten financial conditions and undermine growth. In the US, the Fed employed similar polices during WWII, and we see no reason why it wouldn't explore such actions now given how low US bond yields already are. Targeting a bond price rather than a quantity of bonds could be a more sustainable long-term approach.

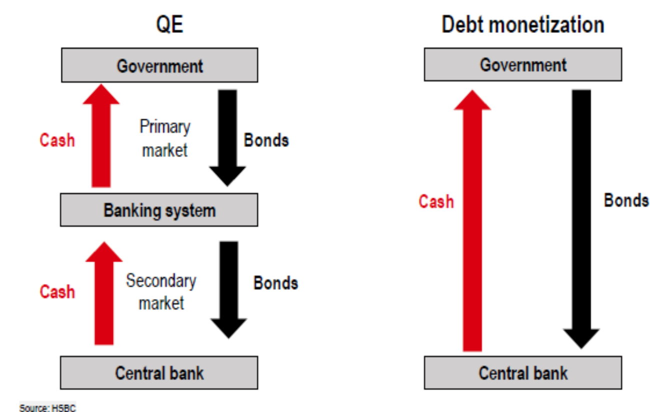


Source: Bloomberg, Evans & Partners

With central banks and governments working hand in glove, and bond issuance ramping up, markets may start to wonder if some could eventually cross the Rubicon into 'debt monetization'. This is where the central bank purchases

government bonds directly in the primary market. Effectively, the central bank prints money and gives it straight to the government. If used in large size, it can undermine central bank independence, and there are also examples of it leading to runaway inflation (e.g. the Weimar Republic in Germany during the inter-war years, and Zimbabwe more recently).

As illustrated, it differs from quantitative easing (QE), which sees the central bank buy bonds in the secondary market. The central bank buying bonds in the secondary market retains a separation of monetary and fiscal policy. This is something RBA Governor Lowe remains heavily in favour of.



However, other central bankers appear to be starting to test the waters. RBNZ Governor Orr said that "*we have to remain open-minded*" with "*just as many risks as opportunities*" coming from direct debt monetization. And while it has been "*taboo for a long time*", nothing should be off the table. Looking back, the RBNZ pioneered other things such as inflation targeting and publishing an interest rate forecast path to help guide market expectations. This suggests its actions on this front should be monitored closely.

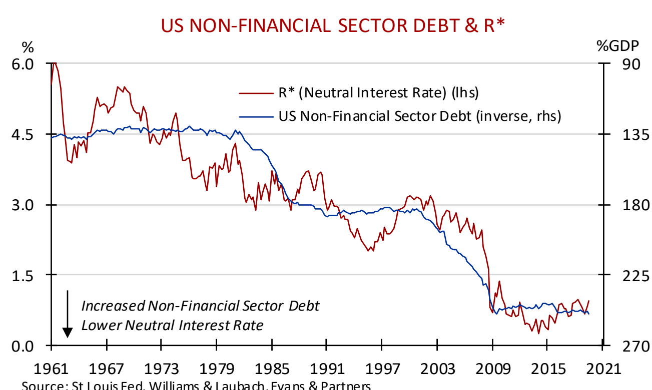
Higher debt burdens mean…

In addition to trying to fill the economic void left by the shutdowns, and support the rebound once health risks recede, below are other implications of high budget deficits and rising government debt levels we are thinking about.

- **Lower equilibrium interest rates**

Interest rates across the term structure of all the major economies are now exceptionally low. This reflects the ultra-accommodative monetary measures being used, the extent of the economic contraction, and outlook for low inflation (see below). But taking a step back, the more recent moves have only added to the structural downtrend in global interest rates that has been in place for the past few decades.

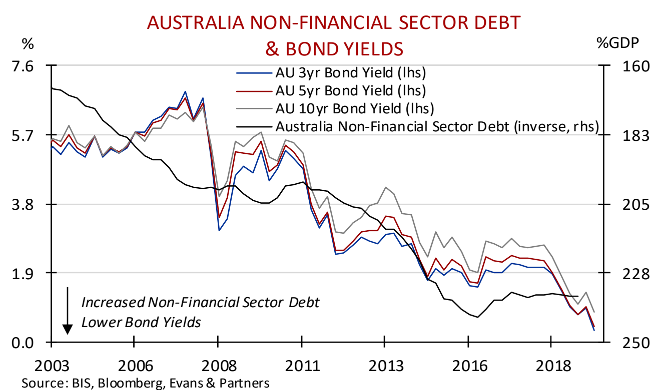
US NON-FINANCIAL SECTOR DEBT & R*



Source: St Louis Fed, Williams & Laubach, Evans & Partners

Factors such as greater savings/less investment, demographics and high debt levels have been drivers of the downward interest rate trends. The saving/investment imbalance and demographics are touched upon above. Rising debt levels (private and public sector) compound these dynamics. Remember, borrowing essentially brings forward future consumption to today. However, the legacy of high levels of borrowing in the past is that there is a greater desire to save in the future. This can act as a headwind for investment and longer-term growth prospects.

AUSTRALIA NON-FINANCIAL SECTOR DEBT & BOND YIELDS

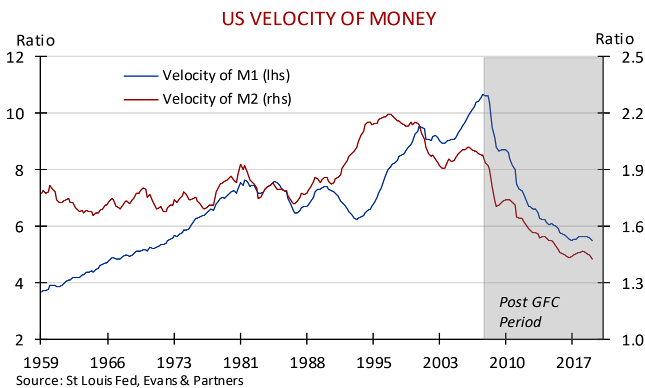


Source: BIS, Bloomberg, Evans & Partners

Higher debt burdens also increase an economies sensitive to monetary policy, particularly interest rate rises, its vulnerability to income shocks, and amplifies the degree of caution during bouts of uncertainty. The financial stability implications of higher debt have seen central banks become more vigilant to downside risks and cautious about removing policy accommodation over the past decade.

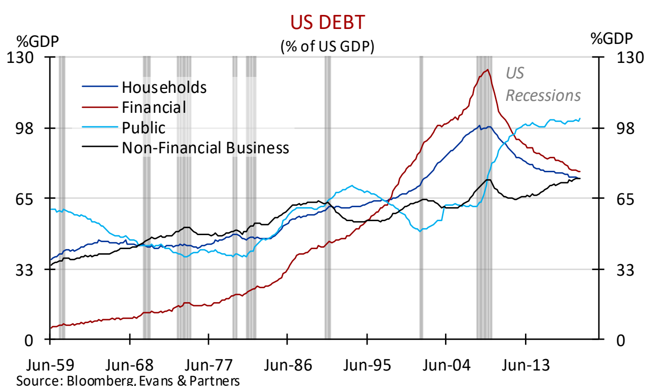
- **What about inflation?**

Fears that the monetary policy measures, such as QE, unleashed since the GFC would generate rampant inflation have been unfounded. If anything, policymakers have struggled to meet their inflation targets. This stems from the inability of economies to sustainably grow above trend, as well as globalization and technological changes.

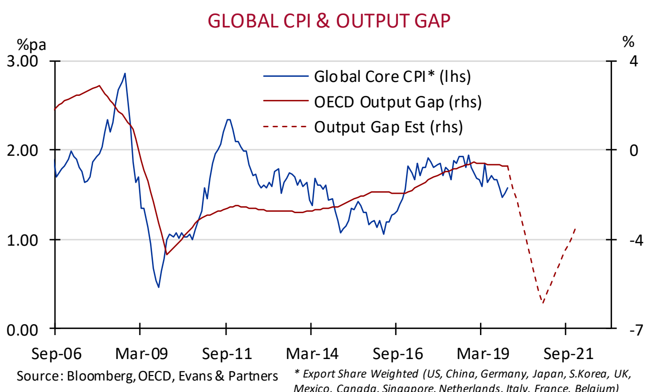


While policies which expand central bank balance sheets boost the money supply in an economy, the '*Quantity Theory of Money*' highlights that it is the 'velocity of money' (i.e. the speed and number of times money circulates through the economy) that is more important for inflation. Noticeably, the US' 'velocity of money' has slowed since the GFC.

Despite the Fed's actions over the past decade the spare capacity in the economy, balance sheet repair undertaken by US households, and lingering uncertainty has meant that the number of transactions occurring has moderated and the degree of precautionary demand for money has picked up.

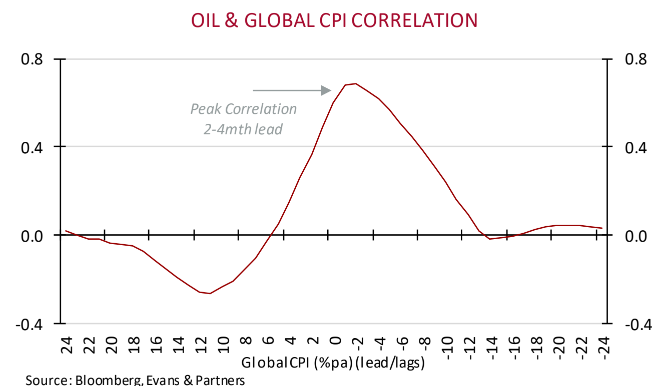


Excess demand is the key driver of inflation. Robust activity generates a reduction in labour market slack. Higher wages and price pressures should follow. While supply disruptions could generate some pockets of inflation near-term, the broader trend is for stronger deflationary impulses to win out over the next few years. The size of the global demand shock will see output gaps widen markedly.



The large amount of excess slack points to weaker underlying inflation pressures over 2020/21. As discussed above, even under a rosy scenario it could be years before economies return to pre-shock levels.

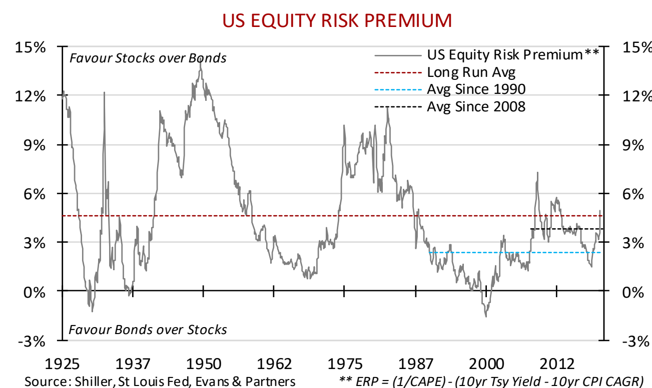
Added to this is the large fall in oil prices. Our correlation analysis shows that this will start to show up in the global inflation data over the next few months. So rather than inflation risks, the backdrop points to central banks needing to be more worried about, and willing to guard against, the potential de-anchoring of inflation expectations.



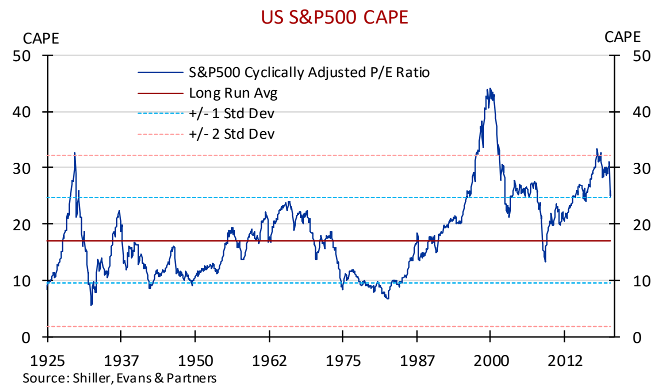
Equity risk premium

Lowering interest rates and large-scale asset purchases are designed to impact the real economy via the financial system. An easing of financial conditions is expected to support activity, and there is also an intended transmission through the 'portfolio rebalancing channel'. The idea here is that as central banks lower rates and purchase assets, participants rebalance their portfolios towards investments with higher expected returns, which pushes up asset prices.

In our view, with interest rates set to remain suppressed for the foreseeable future, as policymakers try to foster a post-COVID-19 recovery, the 'equity risk premium' (ERP) looks set to remain above more recent averages over coming years. The ERP is the rate by which stocks are expected to outperform fixed-income assets such as government bonds. An illustration of our estimate for the US ERP is below. From a medium-term asset allocation perspective, a higher ERP means investors should favour holding stocks over bonds as they should offer more attractive returns.



Although in the short-term, we still think investors should remain cautious. The rebound in markets over recent weeks has eroded a lot of the underlying valuation support. In our opinion, at current levels, there does not seem to be adequate compensation for the macro risks that are still ahead of us as the full impacts of COVID-19 present themselves over the next couple of months (see "*Only the end of the beginning*", 6 April and "*Was that it?*", 20 April).



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