BANQUE
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STIMULATING MONETARY AND BUDGET POLICIES:

NEAR-TERM COMPLACENCY, MEDIUM-TERM DOUBTS

"Do not spoil what you have by coveting what you lack" Epicurius.

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Governments are facing a dilemma, and central bankers are like tightrope walkers who need to keep in mind this Epicurean motto: use, at the risk of abuse, the opportunity to take advantage of low rates either to stimulate growth or to preserve budgetary orthodoxy, and be sure to contain or even reabsorb accumulated public debt. More and more frequently, we get the idea that manipulating rates or injecting liquidity constitutes the ultimate weapon, as the rationality of the financial markets is affected.

Since the Keynesian era, it seemed to be an accepted fact that stimulating fiscal policies was reserved for the bottom of the cycle in order to re-launch growth. Its resulting success was just part of the parcel. Today, in many countries, real rates are lower than GDP growth rates, causing an over-accumulation of capital. Germany, Switzerland and one or two smaller countries appear to be alone in their desire to reduce their debt because the United States, southern Europe, Japan, and China seem to be ignoring this lesson and are tolerating higher public deficits.

History demonstrates that stimulating monetary and fiscal policies is a response to weakened economic growth, resulting from wage stagnation which boosts company profit margins but penalises consumers. It is a response to worsening debt, which for several years has served as a workaround to try to maintain growth. An alternative to this dead-end model may be to resume raising wages and therefore household consumption, but in return there would be reduced company profits, a return of inflation, and therefore a rise in rates and thus defaults, and so on. This scenario is upheld by populists and would be very negative for the markets.

Let’s try to evaluate the opportunities presented by low rates, assess the risks, and try to draw conclusions on the future performance of the financial markets. Continuing debt policies, i.e. combining permissive expansionary fiscal and monetary policies at the peak of the cycle, means offering or justifying new possibilities for appreciating financial markets. This will only last as long as a rise in rates, loss of investor confidence, flight from currency, and the resumption of inflation do not come together to halt the dynamic movements of stock prices we have seen over the past ten years, or even reverse them.

1. **The context: higher saving ratios and aggravated debt.**

- ***Higher savings worldwide***: interest rates have fallen since the early 1980s because worldwide savings have increased. There are two main causes for this trend: first, the integration of China into the international system since they have the highest savings ratio, at nearly 50% of GDP, and secondly, the aging population in several countries since life expectancy has risen to 72.6

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years according to the UN, versus 64.5 years in 1990. Additionally, the number of births/woman of childbearing age has fallen from 3.2 worldwide in 1990 to 2.5 today. Currently, the number of deaths exceeds the number of births in 55 countries, raising fears about pensions and a search for low-risk assets, hence the low rates on the sovereign debt of large economies.

- ***Low growth***: although it has been long, the growth cycle that started in 2009 in the United States, and later in Europe, is of a much smaller magnitude than previous re-growth cycles. To date, American GDP has grown by just 22% since its low point in 2009, while in the decade from 1991-2001, growth exceeded 40%. German GDP has only surpassed its previous high by 14%, Spain by 6%, and in Italy it has not yet done so.
- ***Worsened debt***: for about twenty years, and especially since 2008, public debt and, in some countries, corporate debt, have continually increased. The worsening of public debt to fund public demand has mitigated the slow economic growth caused by stagnating wages. Thus in OECD countries, while household debt has been kept under control, with the exception of a few countries such as South Korea which has debt equal to 96% of its GDP, Switzerland, and Sweden, public debt as a percentage of GDP rose from 70% in 2008 to 110% in 2018.

  Out of all the main economies, ***Japan*** has the worst public debt/GDP ratio at 240%, which is much higher than the 60% recorded in 1990, but savings in the country remain high, currently in excess of 3.5% of GDP, and lender confidence has remained high.

  The ***United States***, driven by the privilege of the dollar as international reserve currency, attracts the world's savings and is funding an all-time high public deficit at the peak of the cycle at nearly 5% of GDP. Every time American rates rise, the dollar becomes scarcer in emerging countries that need to deal with capital flight, depreciation of their currencies, and rising rates.

  Contrary to what doomsayers may claim, the worldwide economy is not threatened by a recession. In the 1st quarter, the American economy grew by 3%, that of the Eurozone by 1.6%, and growth of the main emerging countries remained high. Therefore, we need to think about the opportunity this stimulus presents.

2. The opportunity:

Using expansionary fiscal policies at the peak of the cycle, combining them with apparently perpetually accommodating monetary policies, and maintaining rates at very low levels is a temptation many countries have succumbed to.

This temptation appears commendable if the idea is to make up for reduced private investment with public investment, such as in infrastructure. A logical temptation, since loan interest rates

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are often lower than GDP growth rates or lower than the rate of inflation. An excusable temptation, because in spite of accumulated public deficits in the past ten years, the financial costs of public debt are lower in most European countries than they were before the 2008 crisis; in France, for instance, they should be falling again, from 1.9% of GDP in 2017 to 1.3% in 2021, according to Banque de France.

We can examine monetary and budget policies:

- ***Monetary policies that are too accommodating***: unconventional monetary policies were put in place in the United States between 2008 and 2014, and in Europe between 2015 and late 2018. Negative rates in Europe undeniably promoted economic recovery, reduced the systemic risk presented by banks, improved budgetary solvency, reduced the debt load of member states, contributed to improving corporate profitability, and encouraged borrowing. However, between choosing to lower rates too soon at the risk of creating bubbles, and lowering them too late at the risk of a recession, the central banks did not hesitate and all chose the former.

  In the ***United States***, the IMF anticipates GDP growth of 2.6% this year. The Fed is counting on 2% in 2020, which after ten years of growth is still favourable and is still higher than the long-term growth trend of around 2%, and does not forebode a recession. Notwithstanding the fact that the economy in the 1st quarter showed growth of 3%, there have been countless calls from economists and politicians to lower Fed interest rates to facilitate the depreciation of the dollar, which has risen in the past year, and thereby to encourage exports. The probability of lower rates this year, which was inconceivable even six months ago, has become more than just a hypothesis since the meeting on July 31, and the American market has grown by more than 5% since June 4 when Powell spoke of the possibility of lower rates, and since members of the Fed such as Bullard have spoken out strongly on this matter.

  In ***Europe***, negative rates for government bonds have grown in Switzerland, Germany, Sweden, and Denmark. Even before the 10-year French debt reached a negative rate, there was $11 trillion of debt with negative rates. The ECB has abandoned the idea of raising rates, and has even mentioned applying the opposite, suggesting a return to buying bonds and confirming the imminent launch of a new LTRO to ensure that banks will be funded at a zero rate. However, the context of the Eurozone is still positive, driven by consumption since wages, which have gone up by 2.5% year-on-year, are increasing faster than inflation and the unemployment rate has continued to fall.

  In ***Japan***, the Central Bank does not intend to reduce its spending, which stands at 640 billion euros per year, with the objective of maintaining the 10-year rate at zero, and is now even accepting BBB company bonds as collateral.

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Australia, a country which has not had to deal with a recession for over 20 years, has just become the first OECD country to decide to lower its rates to 1.25%, even though GDP growth forecasts this year are at 2%.

Finally, only ***Norway*** in the West, although faced with inflation slightly higher than 2%, is pursuing its policy to raise rates, with the third rise in nine months at 1.25%.

Outside of the OECD, central banks have started taking the same path: in ***India***, in spite of GDP growth of over 5%, rates have been lowered for the third time this year, to 5.75%. New Zealand and Malaysia have also lowered their rates. In ***China***, another reduction of the bond reserve rate, meant to facilitate borrowing by SMEs, was voted-in in May, seeing $40 billion of liquidity that will help stimulate business. In ***Russia***, the official rate has just been reduced to 7.5% since public debt is low, the budgetary situation is non-problematic, and foreign exchange reserves are still high.

- What some may call "***Modern Monetary Policy***" shows this in its very essence. Olivier Blanchard, the former Chief Economist of the IMF, is a staunch supporter of resorting to debt when rates are low. For some, the key indicator should not be the public debt/GDP ratio, but rather the evolution of the financial costs/public debt ratio.
- ***Stimulating budget policies***: in order to escape the agony of the 2008 crisis, the United States is not afraid to temporarily increase its public deficit by up to 10% of GDP, while even though in 2012, Eurozone countries agreed on a very expansive monetary policy, they required member states to reduce the public deficit and limit it to 3% of GDP. Today, an agreement has been reached within the Eurozone to create a European budget. No financing has been planned as yet, but in light of an American federal budget reaching 18% of GDP, a European budget equivalent to 2 or 3% of GDP is not at all inconceivable.

Germany, bolstered by a current surplus of over 8% of GDP, by a household savings ratio of over 17% of gross disposable income, by a corporate cash flow rate of over 110%, by a public surplus equivalent to 1.7% of GDP in 2018, and benefiting from a reduction of its public debt ratio to 68% of GDP, could easily allow itself a fiscal stimulus. There are needs in infrastructure and personal care services. Yet Germany is only moderately taking advantage of this opportunity.

On the other hand, in the ***United States***, Trump did not hesitate to take the public deficit up to nearly 5% this year. A situation like this has never occurred before at the peak of the cycle; it is the "free lunch" mentioned by Olivier Blanchard, who does not condemn this decision because the cost of the debt in 2020 will only represent 2.3% of GDP. This is far removed from the public surpluses of the Clinton era.

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In ***Japan***, the public deficit is chronic at over 6% of GDP, intended to mitigate low household spending since savings are being held back by companies not giving wage increases.

As another illustration of this effect, ***France***, seeking a way out of the “Yellow Vest” crisis, preferred to worsen the public deficit rather than hand out wage increases, which could have affected the competitiveness of many companies exposed to international competition.

Also, the illustration can be drawn in ***Italy*** since the two populist parties in power seem to disagree about exceeding the deficit limits authorized by the Commission in Brussels. In their defence, remember that if the country has a public deficit of over 2% due to the debt burden, it needs to preserve a primary surplus and an external surplus of close to 2.5% of GDP. In other words, local savings will cover the cost of a worsened deficit.

In ***South Korea***, in the run-up to the 2020 election, a fiscal stimulus worth 0.3% of GDP has been announced, but the country is enjoying a public surplus of 2% of GDP and a current account surplus of 4% of GDP.

So we can see that while some may avoid the risk of a recession and anticipate the cycle turnaround in order to prevent it thus holding onto a sort of perpetual euphoria, this does not come without risk and these practices need to be further analysed.

3. The nine risks:

- ***A loss of credibility in monetary policy:*** letting central banks inflate their balance sheets by accumulating public debt and letting them prevent rates from sliding naturally means allowing unprofitable companies to survive, hindering innovation, diminishing productivity gains, maintaining overcapacities in many sectors and letting deflationary pressure take hold.

  Letting central banks reduce rates in order to preserve market stability even though the context does not require it would mean mortgaging the future of monetary policies. Can we imagine a significant positive impact of another reduction of rates by the Fed even though rates are already low and are not hampering growth? In 1995, after four rate increases, the Fed changed its policy because it was concerned about the risk of an economic slump. Yet rates were 6% at the time, while today they are only at 2.25-2.50%. In 2007, they did the same thing, but rates were at 5.25% and it never did avert the recession. The repercussions are most evident in mortgages, but the housing market no longer has the same dynamic nor the same weight on the economy as it did prior to 2008. Let us recall that at the time, new build projects reached 2.2 million annually, while today, despite a larger population, there are only 1.2 million.
- ***Higher rates***: the risk would be higher rates, and the Bank for International Settlements has constantly warned of this. Reducing the liquidity accumulated by central banks and thereby accepting an increase in long rates would force the bankruptcy of highly indebted companies.

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Let us remember that the last financial crisis in 2007/2008 was partially the result of higher rates.

Higher rates may result from concerns in the markets, or, as an example, the appointment of Weidmann from Germany as the head of the ECB could be interpreted as a sign of a stricter monetary policy, in which case, incidentally, the euro would strengthen.

Higher rates are sometimes the result of a loss of confidence in the markets. As testimony of this, concerns in international markets about Italian debt, about the 10-point gap between the 10-year yield in Germany and that in Italy - a recent record since Salvani now intends to defy Brussels, allowed the public deficit to spiral even though it had already reached 132% of GDP, at 2.373 trillion euros. In Europe, only Greece has surpassed this, at 180% of GDP, and in the developed world, only Japan has a worse ratio.

- ***Weakened banks***: a flat growth curve would not be beneficial to the banking sector, which also has to overcome other challenges. It's no surprise that stock market underperformance occurs in the sector every time lower rates are mentioned. In Europe, banks are particularly weak in Germany and Italy. The German government, which has recently reduced its debt to 68% of GDP, should have the financial capacity to help its banks, but this is less the case in Italy.
- ***Depreciated currency***: this is an obvious risk for those who borrow in a third-party currency. Numerous emerging countries have suffered from a depreciation of their currency.
- ***Inflation***: a risk common to all countries would be resumed inflation. In a context of floating rates, there would be a rise in long rates and the debt repayment burden would become insurmountable. However, we are far from such a scenario. In the United States, core inflation in May was 1.6%, and in Europe inflation was 0.8% in May, far from the goal of 2% - which for some was too low. In this context, further discourse recommending a tolerance of inflation higher than 2%, whether temporarily or in the long term, makes little sense.

  There have been many explanations as to why this inflation seems to be structurally weak: an end to indexed wages, weakened trade unions, an increase in temporary work contracts, less bargaining power for employees, who have experienced a decrease in the wage/ value-added ratio virtually everywhere in the past thirty years. Then there is the rise of the "Uberization of the economy," the impact of globalization and competition from low-wage countries, less dependence on commodities markets, and not to forget, the impact of injecting liquidity, which has led to overcapacities and therefore to deflationary pressure taking hold. There remains one cause of inflation that cannot be dismissed: a return to protectionism with closing borders and the production within national borders of goods, which until now, had been purchased for less on international markets. Some populist parties advocate such policies, which would be undeniably disastrous.

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In the longer term, the replacement of aging "baby-boomers," who are concerned about protecting their savings from monetary erosion, by indebted "millennials", may lead to a resumption in inflation, but it is too soon to tell.

- ***Bursting the corporate lending bubble***: this is surely the most pervasive risk. Between reduced rates, reduced collateral required, and an inexorable rise in the number of loans, businesses have been encouraged to take on debt virtually everywhere. In the United States, corporate loans have reached a record of nearly 50% of GDP, yet risk premiums have gone down. At the slightest sign of alarm confidence will be broken, and risk premiums, which are at 400 points in the United States for speculative bonds (versus 550 in December 2018), will stay high and the bubble may burst.
- ***Private equity***: as a consequence of the abundance of liquidity, in 2018 fundraising at $5 trillion (according to Prequin) has never been higher; double what it was ten years ago. It is therefore hard to imagine that the yields offered by these funds can continue.
- ***Student loans in the United States***: reaching $1.5 trillion with 2 million borrowers defaulting in the past six years, this would worsen if rates should rise. This is due to tuition costs increasing four times faster than inflation since 1978, and to the problem of postgraduate job prospects: according to the Fed, in New York 4 graduates out of 10 work in jobs that do not require a degree.
- ***Increased wealth inequality:*** there is scarcely any need to dwell on this subject, which is often brought up.

Conclusion: 5 points.

- ***The euphoria of low rates:*** given the high levels at which central banks are maintaining their balance sheets, we are torn: on the one hand, governments are thrilled with 10-year rates on the Portuguese debt at 0.50% and the Spanish debt at 0.37%, which is a wonderful success for Draghi, but on the other hand, we have hit dizzying heights and there is a feeling that we are forging ahead blindly. We cannot hide from the worsening debt ratios, the burden of which is being shifted to future generations. We cannot ignore the creation of financial bubbles either in housing, bonds, or even in shares. Worse still, we cannot hide from the negative burden of negative rates, in ***Switzerland***, for instance, with a 10-year rate at -0.50%.

- ***The inability of monetary policies to provide an answer to the structural decrease in growth***: permissive monetary policies may create an enticing mirage, the idea of smoothing out the cycles, with the United States experiencing its 120th month of growth - the longest growth cycle in the past fifty years - but they do not provide an answer to such important issues such as weakened growth. They

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contribute to the deflation of industrial prices, and they do not help to raise the potential growth rate. Furthermore, by fostering an appreciation of financial markets and housing bubbles, they aggravate wealth inequalities. It is all the harder to understand why lower rates are being envisioned when in many countries, economic growth is still higher than potential growth, while the positive effects of such a measure on GDP growth as well as on inflation is doubtful. The primary cause of weakened investment is the uncertainty instilled by Trump, whether with tensions underway with China or invective cast against other countries. Lowering rates will have little to no effect on this.

- ***Advantages for the West***: this combination of stimulating monetary and fiscal policies primarily benefits Western world, including Greece, where in spite of public debt at 1.8 times its GDP, the 10-year rate has fallen from 3.4% to 2.6% in one month, giving it a major advantage over emerging countries which, like Turkey, have low savings and have to bear a rate of 24%. With every phase of international tensions, as in 2008 or in 2016, or with every phase of more restrictive monetary policy in the United States, as in 2013 and 2018, capital flight penalises emerging countries because it weakens their currencies, worsens inflation, forces higher rates, and causes a slump or even recession. Here we have another illustration of our doubts over the continuing convergence between emerging and developed countries.

- ***The other contortions of capitalism***: monetary laxness, but also permissiveness in antitrust policies, seems to be creating a climate that is favourable to large corporations. Never has there been so much concentration in the United States, and so few rulings by antitrust authorities. As a search engine, Google holds 90% of the market share in the United States. Amazon holds 50% of the market share of online sales in the United States. Just two companies, Facebook and Google, share 60% of the American digital advertising market. Together, the GAFA companies have a market capitalization of $3.175 trillion plus significant liquidity, allowing them to acquire many promising young companies.

- ***The wide range of alternative currencies***: governments or central banks have such a mass of debt to manage that they cannot tolerate competition from instruments such as Bitcoin, which challenge the predominance of the dollar and the sovereignty of governments. Libra, which was introduced by Facebook, may offer a middle road if reserves are constituted by assets invested in existing currencies. But without further detail, it would be premature to reach any conclusion.

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