DO DEFICIT MATTER?

Public deficits are ballooning after economies were paralysed by COVID-19. Alongside increases in healthcare spending, governments across the world have had to enact substantial new spending measures to protect the economy, while at the same time suffering sharp declines in tax revenue.

Higher deficits everywhere

While final figures will depend on how long shutdowns last and how quickly economies recover, economists are predicting substantial increases in public deficits this year. The federal deficit in the US is forecast to reach 18% of GDP. Italy is forecasting a budget deficit above 10% of GDP and even traditionally austere Germany has introduced economic measures which will cause its deficit to rise above 7% of GDP.

This comes after the suspension of the EU's stability and growth pact designed to limit deficits of member states to 3% of GDP: there is an acknowledgment that countries should spend whatever is necessary to fight the virus.

While fighting the virus and protecting the economy are primary concerns, debates are beginning about how (and if) countries will deal with deficits of this size, and the debts they lead to.

Debt sustainability

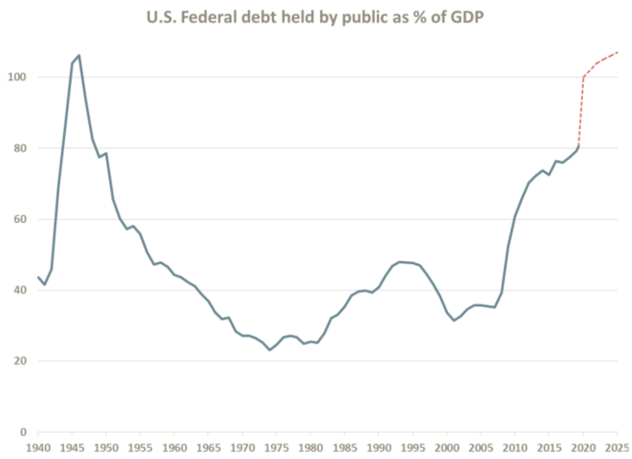
Ultimately, the impact of higher public debts depends on how sustainable they are. Economists have set out models by which to assess this. One notable example comes from Olivier Blanchard, former chief economist at the IMF. He suggests that if growth rates in nominal GDP exceed debt interest payments, higher debt levels (caused by one-off higher deficits) can be fiscally sustainable in the long run.

This gives one option for policymakers: they could attempt to boost nominal GDP growth as soon as the health crisis has passed. This would reduce the burden of debt to GDP and is essentially what the US did after World War II.

In 1943, the US federal deficit and debt to GDP ratio reached 27% and 120% respectively. By 1980 debt to GDP had fallen back to 30%. This is despite the fact the federal government only ran budget surpluses in eight of those years.

Instead, nominal GDP growth averaged over 7%. The US government managed to grow the economy in the years after World War II, making the debt burden more sustainable.

It remains to be seen whether growth rates close to this are possible after COVID-19, however.



Source: Bloomberg, Clarus Capital

Yield Curve Control

Central banks can step in to help governments fund their spending measures. One option is yield curve control. Under Yield Curve Control, a country's central bank would peg the yield on longer term bonds, buying the quantity necessary to achieve their target. This would keep borrowing costs low.

This differs from quantitative easing programmes in that QE only specifies the amount of bonds that will be purchased, not a target yield.

Yield Curve Control has been successful before. The Federal Reserve conducted something akin to Yield Curve Control after World War II. To help the US government manage costs accumulated during the War, the Fed agreed to buy as many bonds as necessary to achieve a 2.5% yield on long term Treasuries.

More recently, the Bank of Japan has enacted Yield Curve Control, pegging the yield on 10 year Japanese Government Bonds at zero. This is one reason why Japan has been able to cheaply service a debt to GDP ratio above 200%.

Monetary finance

Another - more radical - option is monetary finance. This would involve the central bank directly purchasing debt from the government, crediting the government's central bank account. This would allow governments to bypass bond markets to finance deficit spending.

This option is available to countries with 'monetary sovereignty' - countries that can issue their own currency. This means monetary financing is available to countries such as the US, the UK and Japan. Eurozone countries, however, do not have this option. It is also not available to emerging market economies who have to issue foreign denominated debt.

Even assuming a current lack of domestic inflationary pressure, monetary finance would run the risk of fuelling inflation via a weakening exchange rate. However, this can be countered if major central banks around the world enact such a policy simultaneously.

Monetary financing of this type would, however, make it more difficult for central banks to fulfil their inflation targets in the longer term. If inflation rises, the normal response by the central bank is to increase interest rates. This would hurt the government's budget either directly via higher bond yields or indirectly via lower central bank remittances.

Monetary finance does also raise questions about central bank independence. Once central banks begin financing government deficits, it might become difficult for politicians to resist this temptation in the future.

Indeed, QE has already blurred the lines. QE has helped to keep borrowing costs for governments low over the last decade with programmes done on the understanding that central bank balance sheets would eventually be unwound. Only modest attempts have ever been made to unwind QE.

Lasting Consequences

Kristalina Georgieva, director of the IMF, said recently that countries should 'spend what they can' to battle COVID-19. Different options exist to deal with the resulting debt, though each will have lasting economic and political consequences for countries as they recover from COVID-19.

Given a highly uncertain growth outlook, it appears that central banks in advanced economies will continue substantial QE programmes. This will help to hold government borrowing costs low, without central banks explicitly conducting monetary finance.

There is, however, also likely to be a series of sovereign defaults amongst EM economies; over 100 countries have already appealed to the IMF for financial assistance.

In the long term, growth returning will help stabilise debt to GDP ratios. Do not, however, expect the nominal value of debts accumulated during 2020 to ever be repaid.

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