MONETARY POLICY- THE CURRENT TRAJECTORY IS NOT SUSTAINABLE

BY **ROB VAN LEEUWEN**

In the abbreviation 'ESG' most attention goes to the first letter: the environment and climate change in particular. However, the 'G' stands for 'governance', and should not only apply to business, but especially to government.

During recent years, central banks around the developed world (I focus on the ECB and the FED, but the central bank of Japan has already operated in this mode for at least two decades) have first decreased interest rates to near zero or even into the realm of negative rates, and subsequently engaged in a form of 'money printing' called Quantitative Easing (QE). At the same time, governments have racked up debt levels that are unsustainable at historically prevalent real interest rates (say, between 2% and 4%).

Currently, the ECB has a balance sheet that amounts to around 70% of Eurozone GDP. The FED balance sheet is at a level of 40% of GDP. This would suggest that the monetization of debt has progressed even further in the Eurozone than in the USA. On the other hand, while the USA has a trade deficit that is in the order of magnitude of 3% - 4% of GDP, the Eurozone has a trade surplus of a similar magnitude.

Pure fiat currencies (which the developed world has 'enjoyed' since Nixon decoupled the world's reserve currency from gold in 1971) have historically always faltered, with a lifespan that can be calculated in decades rather than centuries. Since the decoupling from gold, the value of currencies has been guaranteed by independent central banks, with a mandate to ensure price stability (and in the USA: low unemployment).

Currently, this central bank independence is under threat, or has effectively been abolished:

- Central banks have decided that promoting green policies, stimulating gender diversity and offsetting the effects of epidemics in selected countries are also part of their mandate.
- There is a revolving door between central banks and politics: Janet Yellen (ex-chair of the FED) is now Secretary of the Treasury; Mario Draghi

'The actual implementation of Ben Bernanke's previously theoretical concept of 'helicopter money' may provide a trigger for the velocity of money to increase.'

(former chair of the ECB) is now prime minister of Italy, the main beneficiary country of monetary support; Christine Lagarde (former minister of Finance of France) is now heading up the ECB, having come from the IMF.

- In funding budget deficits, the pretence that there is no direct monetary support to certain states has de-facto been abandoned, while de-jure it still exists. As an example: in April and May 2020, the ECB purchased the full bond issuance of Italy during those months.

Thus, it can be said that the rectitude and independence of central banks has been severely compromised. However, it should be mentioned that central banks are taking these actions for good reasons: in their absence a deep depression might take hold and specifically the Eurozone might fall apart in a chaotic fashion. With the benefit of hindsight, the root cause of the problem is that at previous phases the pain of recessions has not been taken (Greenspan and the 'goldilocks' economy; solving the 2008 debt crisis with more debt) and specifically in Europe that knowingly a single currency for rather diverse and diverging economies has been set up, hoping that the resulting crisis will lead to forced political unification.

'This is of course pure fantasy and media spin.'

For asset managers such as pension funds and insurers, this is highly relevant. So let's look forward. How could this situation unravel? The following scenarios can be distinguished:

- The official narrative: after more than a decade of low and negative interest rates and QE, the pretence is still that these are temporary measures, that all debt will be paid back in good faith, that Eurozone economies will ultimately converge and that economic growth will allow economies to outgrow these debts. This is of course pure fantasy and media spin.

- A Japan-type scenario. The world would be stuck forever in low growth and a zero interest rate environment, with the central banks almost exactly offsetting the deflationary tendencies. This scenario is sometimes mentioned in defense of QE and high budget deficits: in a zero interest rate environment, high government debt and budget deficits should be completely sustainable. Of course this scenario can only be temporary and never be an endgame, as the economy will suffer from misallocation of capital, lack of creative destruction and the rise of 'zombie' enterprises. It should also be noted that one country (Japan) having been in this scenario for decades, does not mean the entire world can function this way for decades to come.

- An elevated, but controlled, inflation for a substantial number of years, in combination with 'financial repression'. This is the way the USA and the UK managed to decrease their indebtedness during the post-war years. This will mean a value transfer from mostly the middle classes (bank account holders and participants in pension funds holding bonds) to the population in general. It will mean that pensions will not be indexed, while prices rise. Billionaires and other high net-worth individuals will not be much affected, as they do not tend to hold cash or government bonds, but equities, gold, bitcoin, real estate. However unpalatable, this might still be a relatively benign outcome.

- Hyperinflation. Currently the population responds to the epidemic and other sources of uncertainty by saving in bank accounts. For now only some of the well-off and some of the young (bitcoin!) are feeling something is wrong. If the population at large starts to distrust fiat currencies and the way the financial system is managed, a hyperinflationary scenario cannot be excluded.

'Should I jump left or jump right?'

Of course a fifth scenario is possible: if central banks would backtrack ('taper'), gradually phase out QE and increase interest rates, a deflationary scenario might emerge. It would most likely involve default on many fixed income instruments, including sovereign ones. However, the FED says tapering and rate increases can be contemplated only after substantial inflation will have taken hold and the 2% target will have been overshot, compensating for earlier shortfalls. By that time backtracking might be difficult, as the stakes would have become even higher.

Until recently, each (institutional) investor was in the position of a goalkeeper having to stop a penalty kick: should I jump left (anticipate currency debasement and resulting inflation) or jump right (anticipate the depression that would occur naturally without central bank intervention and the resulting deflation). The narrative in the USA has always taken the Great Depression of the 1930s as something to be avoided at all cost (therefore: jump left, buy everything the government can't print), while in Europe until recently (2014) the experience of the German hyperinflation of 1922-1923 loomed large (therefore: anticipate hard money, jump right, buy government bonds, hold cash). However, at least since 2014 the ECB seems to have abandoned its German roots and Germany does not seem to insist on a return to these roots, as for Germany unity in Europe seems highest priority.

Many say: 'so far no inflation has appeared'. This is because at the same time the velocity of money has decreased. After a short journey through the economy, the money has returned to the central banks, and sits at the liability side of their balance sheets. It is like the pistol that hangs on the wall during the first part of a play: first some events will have to happen in order for it to be used. But it is there, waiting.

'Either we have a depression first and then substantial inflation, or we move to substantial inflation directly.'

Independent pundits nowadays tend to have two views: 1) either we have a depression first (because central banks are initially hesitant to react) and then substantial inflation, or 2) we move to substantial inflation directly. Although the judgment is still out, it seems that the 'bubble' in stock markets, housing, bitcoin etc. is rather persistent and actually might not be a bubble but instead the first wave of an inflationary scenario (a 'melt-up'). Furthermore, the actual implementation of Ben Bernanke's previously theoretical concept of 'helicopter money' (started by Trump and accelerated by the Biden administration) may provide a trigger for the velocity of money to increase.

The above is a very brief introduction to this matter. The main message I offer is that at this point there is no good way out. There will be pain. For investors the task is to anticipate where and how the pain will manifest itself. For those who would like to learn more, some interesting pundits are Willem Middelkoop, Edin Mujagić, Arno Wellens (the Netherlands), Marcus Krall, Max Otte (Germany) and Ray Dalio, Harry Dent, James Rickards and Peter Schiff (USA).

Many say: 'so far no inflation has appeared'