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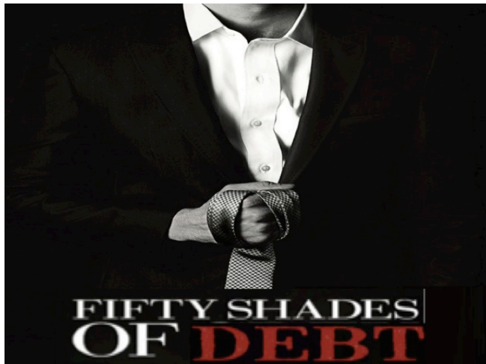

Global Macro Themes – Fiscal Dominance: Fifty Shades of Debt

Last December we published a research note outlining our thoughts as to what would be required for the global economy to overcome the headwinds that have impeded the establishment of a self-sustaining recovery; the crucial element was a radical rethink on monetary policy. The multitude of monetary easings that have occurred since the start of this year, which has seen a number of central banks taking their key interest rates into negative territory, acknowledges the ongoing problem but does not go far enough to rectify it. More will be required from central bankers. In this research note we posit the likely catalyst for change and outline the economic and financial market implications that follow on from the emerging threat of fiscal dominance[1].

Defining Dominance

According to Bundesbank President Weidmann, in a speech given last April[2] at a joint conference with the Banque de France, fiscal dominance is:

"a regime where monetary policy ensures the solvency of the government. The traditional roles are reversed: monetary policy stabilises real government debt while inflation is determined by the needs of fiscal policy."

We can think of no more succinct definition of fiscal dominance than this.

Weidmann's concern about the potential subjugation of monetary policy stems from the fact that government debt has increased sharply, to historically elevated levels, over recent years; a direct result of the deficit-financed fiscal stimulus injected to avoid the depressionary headwinds that impacted the global economy in 2008/9.

While Weidmann's comments were largely directed at the Euro zone region - it was, after all, the geographic focus of the conference - similar public sector debt dynamics are evident in many developed economies. Hence, the concerns raised are more broadly applicable.

[1] The title of this research note is a shameless play on the title of the newly released film Fifty Shades of Grey. For the avoidance of doubt the present author has neither read the book nor has any intention of seeing the film.
[2] Weidmann (2013), "*Who Calls the Shots? The Problem of Fiscal Dominance*" (see: http://www.bundesbank.de/Redaktion/EN/Reden/2013/2013_05_24_weidmann.html)

However, for many investors concerns about the possible subjugation of monetary policy, and consequently a more inflationary future, are easily dismissed given the marked deceleration in headline CPI inflation in many economies; below-target private sector inflation expectations; and, historically low nominal government bond yields. Further encouraging such perceptions, Professor Krugman no less, has been publically denigrating economists for *"wrongly predicting [higher] inflation"* following the introduction of QE based on his earlier analysis of Japan's lost decades[3].

In our view, this is a grave mistake. First and foremost, that the topic was on the central bank conference agenda at all is, of itself, interesting; certainly it should be to investors seeking to understand the issues that policymakers are facing in the post Great Recession environment. Moreover, as we detailed in "*GMT – Fiscal Consolidation: A Sisyphean Task*", 27 August 2014,

"given that such a [policy] shift would represent a sea-change in political and economic thinking, and runs contrary to what the private-sector has been repeatedly encouraged to think and plan for, when the nettle of economic reality is finally grasped, a very nonlinear private sector response should be expected. This implies that when higher inflation does eventually manifest itself it will likely accelerate quickly."

Investors who fail to think in advance and prepare for the possibility of a significant monetary policy regime change, preceding a more inflationary environment, not only risk significant underperformance of their portfolios as and when the shift occurs, but their ability to either hedge or close existing positions at this point will prove extremely costly as financial markets are likely to be very one-sided and liquidity poor.

Finally, we would argue that as a direct result of disinflation/deflation concerns having resurfaced there already exist low-risk investment opportunities to begin positioning for a more inflationary environment.

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[3] See: http://krugman.blogs.nytimes.com/2015/02/26/quantitative-easing-and-monetary-aggregates/?module=BlogPost-Title&version=Blog%20Main&contentCollection=Opinion&action=Click&pgtype=Blogs®ion=Body. In this blog post Krugman quoted from his 1998 paper on the liquidity trap to show that *"theory and experience both predicted exactly the sterility of monetary base expansion that we saw in practice".* We find Krugman's reference to this paper somewhat ironic given that one of the key conclusions he also draws in the paper is:

"whatever the specifics of the situation, a liquidity trap is always the product of a credibility problem: the public believes that current monetary expansion will not be sustained. Structural factors can explain why an economy needs expected inflation; they can ***NEVER*** *(our emphasis) imply that credibly sustained monetary expansion is ineffective."*

So, there you have it, monetary stimulus is both ineffective and effective depending upon which part of Krugman's research paper you refer to. What a wonderful example of a two-handed economist!

"Inevitable" Deflationistas

Such deflation concerns reflect the view of a significant number of financial market participants that debt levels (public and private) are "excessive", in the sense that they cannot hope to be repaid out of higher real economic growth (Ed. note - agreed). As a consequence of fiat money being backed by debt[4], and as witnessed during the Great Recession, eradicating excessive debt generates strong deflationary headwinds. The resultant fall in the aggregate price level further increases the real value of debt, encouraging yet more deflation-generating deleveraging; a highly disorderly and economically destructive process.

Such a pessimistic scenario is, of course, economically plausible. Moreover, it can be argued that this essentially market-based solution to an excessive debt problem is the best for the global economy in the long-run[5] (Ed. note – also agreed.)

However, and this is where we diverge from the "inevitable" deflationist camp, we are not in the business of saying what policymakers should do. Rather, we are in the business of predicting what they will likely do as this is what will influence global asset markets. The question we therefore must ask ourselves is this: Does any investor seriously think that global policymakers, who tried so hard to avoid such a scenario playing out just five years ago, will not use every policy tool at their disposal to avoid a repetition?

We certainly don't.

Moreover, as we will go on to elaborate, policymakers are not as impotent as some investors like to think (or would wish) with regards to overcoming deflationary pressures resulting from prior excessive debt accumulation. There are policy options, admittedly highly unorthodox, still available to them.

Tipping Points

In the aforementioned BSEC research note *"GMT – Exit Strategies: Pandora's Box"*, 22 December 2014 we not only outlined our rationale for why we consider the global monetary policy regime will change, we also outlined what the most likely form of this change would be. To recap, the promised policy of fiscal consolidation once the economic upswing becomes established – as a result of accommodative monetary policy - is simply not credible. Threfore, we predicted that central banks will eventually find themselves forced into adopting explicit caps on government bond yields[6]; a policy that was first employed in the mid-

[4] As opposed to alternative monetary systems that we discussed here: *"GMT – Bitcoin: The World's Hardest Currency?"*, 11 December 2013.
[5] This policy response, or rather lack of a response, is typical of the Austrian school.
[6] This is the greatest problem we have with investors in the opposing inflation-camp who are positioning for a big sell-off in nominal government bonds.

1930s and which remained in place, at least in the US, until the Fed/Treasury Accord of 1951.

We acknowledged at the time that such thinking is a complete anathema to the present crop of central bankers. Due to the fact that there are not enough degrees of operational freedom for central banks to target CPI inflation and nominal government bond yields simultaneously, it would entail a dramatic shift away from the current regime of low inflation-targeting. Furthermore, this change would imply a loss of independence for central banks; something that was hard-won and will, therefore, be robustly defended.

In the face of such strong institutional reluctance to shift away from the current monetary policy framework, a major catalyst will be required for any regime change to occur. In our judgement the best candidate for such a catalyst is the arrival of the next economic downturn.

While we do not consider there to be a specific periodicity to business cycles, it is worth noting that according to the NBER business cycle dating committee[7] that the average duration of US economic expansions in the post-war period is 58 months. Given the recovery from the Great Recession is already 73 months old, the clock would appear to be ticking. For sure, the boost from the fall sharp in crude oil prices, which is analogous to a one-off positive aggregate supply shock, should serve to delay any downturn, but one thing is equally certain an economic downturn will occur in the coming years. Our best guess as to what will cause the downturn is a policy mistake by the Fed.

Fed Up

As shown by the latest Fed minutes published on 18 February, the FOMC board members judged the domestic US economic outlook as favourable and while ongoing risks due to external developments were identified[8], the tone of the discussion strongly suggests the Fed will begin to remove monetary policy accommodation later in the year, or in their terminology achieve "liftoff"[9].

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[7] The US economic recovery prior to the current one was the longest ever recorded by the NBER lasting some 120 months (see: http://www.nber.org/cycles.html).

[8] Interestingly, FOMC members considered that the numerous accommodative monetary policy actions that have been announced by central banks in other parts of the world since the start of the year had *"strengthened the outlook abroad"*.

[9] Fed Chair Yellen's comments during the semi-annual testimony to the Senate Banking Committee made it clear that the guidance term "patient" means that liftoff is unlikely for a couple of FOMC meetings, but that once that phrase is removed from the FOMC statement the liftoff decision will be taken *"on a meeting-by-meeting basis"*. While Yellen was careful to indicate the Fed would be "data dependent" (we hate that phrase by the way, it is one of the most vacuous statements a forecaster can make) she made it clear that if, *"as expected, economic conditions continue to improve an increase in the target funds rate would be considered"*. Our take on the testimony is that Yellen and her colleagues on the FOMC are still timetabling the start of monetary policy normalization to begin in late summer/early autumn. We have outlined in previous research what we judge to be the potential economic and financial ramifications from Fed tightening. In addition to the aforementioned *"GMT – Exit Strategies: Pandora's Box"*, 22

Judged from the perspective of what Fed officials are aiming for in removing monetary policy accommodation later this year, namely a self-sustaining economic recovery concomitant with price stability, failure to achieve this outcome will be considered (albeit in hindsight) a mistake.

No Room To Repeat

In the event of an economic downturn – whether Fed induced or not – what is manifestly obvious is that there is no scope for policymakers to respond in the same manner as they did to the Great Recession. Nominal interest rates are very low historically. Hence, the scope for orthodox monetary stimulus is extremely limited. Similarly, with government debt levels even higher than in 2008 the scope for deficit-financed fiscal stimulus is also extremely limited (see footnote 24 below).

While the resumption of unorthodox monetary policy tools, such as QE, is possible, a more radical rethink is likely. This rethink, we consider, will take the form of even greater government bond markets intervention by central banks in the developed world.

Conflicting Mandates

Over the past 50 years financial market participants have become accustomed to the separation of debt management policy and monetary policy. The former is implemented by national debt offices mandated to minimise borrowing costs subject to risk constraints whereas the latter is implemented by operationally independent central banks with the objective of maintaining price stability.

This separation made sense in the seemingly benign macroeconomic conditions witnessed in the decades prior to the Great Recession. Moreover, as pointed out by Allen (2012), QE was theoretically consistent with this ongoing separation:[10]

"Quantitative easing has the attraction, from the central bank's point of view, that it can be conducted without any coordination with the debt management office, and therefore avoids raising the question of independence directly."

However, as testimony to the depth of the problems facing the global economy, QE programmes have lasted much longer and consequently become much larger than originally envisaged. They have resulted in a dramatic increase in the size of central balance sheets (upwards of 80% of GDP in Japan and Switzerland[11]).

December 2014 we discussed this risk here: http://www.blackswaneconomics.com/in-the-news/us-nfp-lotto-day-752.html.

[10] Allen (2012), *"Government debt management and monetary policy in Britain since 1919"*, part of a BIS Paper No. 65 entitled *"Threat of fiscal dominance?"* see: http://www.bis.org/publ/bppdf/bispap65.htm

[11] Obviously in the case of Switzerland it was foreign currency purchases rather than domestic government bond purchases that drove the expansion of the SNB's balance sheet.

As a result, many financial market participants believe that some form of monetary policy rubicon has already been crossed. They have a point, as Allen (2012) goes on to note:

"[T]he Bank of England needed an indemnity from the Treasury for any losses incurred in its recent quantitative easing operations. Had the Treasury not agreed with the policy, there would have been no indemnity and no quantitative easing."

So, even though by design central bank QE programmes have allowed for the continued, formal, separation of debt management and monetary policy, in reality there is already overlap.

More recently, an increasing number of central banks have breached the zero bound, taking key deposit rates into negative territory. For pure arbitrage reasons there is, however, a limit as to how negative short-term interest rates can become for the simple reason that investors can always convert bank deposits into cash and store it either under the mattress or more securely in safety deposit boxes[12]. Hence, in the event of another downturn in economic activity central banks will, out of necessity, be forced to operate further out on the government yield curve. A further blurring between the two roles, therefore, seems very likely. While this might appear highly unorthodox, there is not only policy precedent both in the US and the UK (in the aforementioned research note we concentrated on the US experience but the Bank of England also capped long-term interest rates during WWII[13]). Moreover, there is also precedent in economic theory. As Keynes noted in *The General Theory*:

"The monetary authority often tends in practice to concentrate upon short-term debts and to leave the price of long-term debts to be influenced by belated and imperfect reactions from the price of short-term debts – though ... there is no reason why they need do so."

Moreover, Tily (2012)[14] made the following observation:

"Keynes's theory led to the conclusion that a monetary authority could set whatever long-term rate it chose, given the necessary domestic and international arrangements[15]."

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[12] Admittedly a much easier transaction for private individuals than for large financial institutions!
[13] Hat tip JA for indirectly raising another positive for central banks using an explicit yield cap versus QE as a method of controlling longer-term interest rates. Central bank purchases of government bonds remove high-grade collateral from the private sector, which is obviously important for the functioning of financial markets (i.e. the plumbing effect). While this detrimental impact can be mitigated by central banks relending government bonds. Conversely, a yield cap does not necessarily require any (or limited) central bank purchases of government debt, dependent of course on the credibility of the interest rate cap.
[14] Tily (2012) *"Keynes's monetary theory of interest"* also part of BIS Paper No. 65 *"Threat of fiscal dominance?"* referenced in footnote 10 above.

Low, But Low Enough?

As the historic record shows, the decision by central banks to abandon the gold standard and implement interest rate caps in the 1930-50s provided sufficient stimulus to reinvigorate economic growth (rearmament in anticipation of – and during – WWII no doubt also helped). However, some question whether in light of poor demographic trends in many major economies, which can be thought of as effectively exogenous over the time frame we are contemplating, that this might not of itself provide sufficient demand-side stimulus.

Such concerns are not new. In addition to advocating central banks targeting the longer-end of the government curve to generate sufficient monetary policy accommodation, even more famously, Keynes advocated fiscal stimulus as well. Tily (2012) makes the rationale for this very clear:

"Keynes's support for fiscal policy did not follow primarily from any lower bound to this process but from recognition that a low long-term rate of interest might not be sufficient for recovery. A low long-term rate of interest was necessary to prevent recession, but it might not be sufficient to effect recovery from recession, especially given the extent of private indebtedness that was the defining financial characteristic of the 1930s (Fisher, 1933), just as it is today."

As a corollary to the above expression of doubt that a low long-term interest rate "*might not be sufficient to effect recovery from recession*", in a recent client meeting we got some push back on our prediction that central banks will move to adopt explicit government bond yield caps because of the potential for credit spreads to widen for private sector debt, thereby short-circuiting the stimulative effect.

This is a very interesting argument.

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[15] The following paragraphs taken from The General Theory provide some hints as to what domestic and international arrangements might be necessary:

"Freedom of capital movements is an essential part of the old laissez-faire system and assumes that it is right and desirable to have an equalisation of interest rates in all parts of the world."

"In my view the whole management of the domestic economy depends upon being free to have the appropriate rate of interest without reference to the rates prevailing elsewhere in the world. Capital control is a corollary to this."

The conclusion about the need for capital controls if, as we have argued, central bank policy mandates change from one of target low inflation to explicitly – or implicitly – capping government bond yields to achieve fiscal sustainability objectives, seems to us correct. Again, we should reiterate we are not advocating such policies, they run contrary to everything we were taught in economics about the supremacy of free markets to efficiently allocate scarce resources. However, we cannot ignore the overwhelming temptation of politicians to interference with this process, especially if the longevity of their careers depends upon it. To ignore this fact seems to us not only churlish but probably extremely detrimental to one's future financial health.

Absent government intervention into private sector credit markets (we think this is a step too far even for our current crop of interventionist politicians as it effectively would mark the return of communist) it inevitably leads one to question what can be done? Especially, given concerns that governments are already close to the fiscal limit – in the case of Japan almost certainly well through it.

Does that mean that the deflationists are right after all and that we have to look forward to a very disorderly deleveraging, with goodness knows what social consequences?

Maybe not.

Deficit ≠ Debt

Over the past several hundred years, we have all become accustomed to governments financing their annual budget deficit shortfalls via the issuance of sovereign bonds. Yet, there is absolutely no need why this should be the case. Governments can, and have historically, financed themselves via the issuance of money[16]. As observed by Warren Mosler (2010)[17]:

"Federal government spending is in no case operationally constrained by revenues, meaning that there is no "solvency" risk. In other words, the federal government can always make any and all payments in its own currency, no matter how large the deficit is, or how few taxes it collects."

Thought about at a deeper level fiat money is, in essence, simply a zero coupon perpetual government bond[18]; a liability that is incredibly attractive to the issuer and hence probably will never be redeemed hence its perpetual characteristic.

So how would this work in practice?

It is actually a relatively simple process. Central banks, in addition to all their other functions, act as the bank to the government. So in the case of Outright

[16] The first government bond issued by a national government was in 1693. It was issued by the newly created Bank of England to help finance William of Orange's war efforts with France. In return for raising the £1.2 million the subscribers were incorporated as the Bank of England (it was a private company until it was nationalized in 1946) and granted privileges, including the not inconsequential ability to issue bank notes!

[17] Mosler (2010),*"Seven Deadly Innocent Frauds Of Economic Policy" (*see: http://moslereconomics.com/wp-content/powerpoints/7DIF.pdf). We first came across Mosler when cutting our macroeconomic research skills as part of the Lehman Global Economics team in the early 1990s when were given a copy of his *"Soft Currency Economics"*. To an economist fresh out of college it was enlightening to come across such heretical reading material.

[18] Yes, dear readers, when writing that sentence we also were struck by thoughts of Greece. The negotiations over how to lower the Greek government debt burden without a nominal write down will, if it works at all, be via interest rate reductions and a lengthening of maturities, or making their bonds more money-like. So much for EMU not allowing monetary financing of governments!

Monetary Financing (OMF) the government gives money to the non-bank private sector, which can be either in the form of notes of coins or increased bank deposits[19]. In order to "fund" these payments to the non-bank private sector and ensure that the central bank remains solvent, the government then sells debt to the central bank, providing it with an asset to counterbalance the liability on its books.

As pointed out in Buiter (2014)[20], it neither matters if the government debt sold to the central bank is interest-bearing or not as central banks repatriate their profits back to the government. What matters is that the central bank holds the debt in perpetuity, and hence it provides a one-off irreversible increase in base money.

The major differences between OMF and QE are:

1) Money flows directly to the non-bank private sector and is directly available for consumption/investment, unlike QE, which goes to commercial banks and is only domestically stimulative via the portfolio balance channel effect.

2) Under QE the central bank buys a government bond from the private sector, which is an asset that can be sold back to them as and when the central bank wishes to reduce the money supply. The irreversibility condition required for OMF to work means that this option is not available to the central bank; a key reason why it constitutes a more effective form of monetary stimulus.

Importantly, OMF does not trigger Ricardian equivalence[21] effects that can short-circuit bond financed government deficits, neither does it put upward pressure on interest rates and hence crowd out private investment. If this all sounds like a win-win, what are the objections to OMF?

The main issue with OMF is that it takes price stability out of the hands of independent central banks and opens up the prospect of politicians manipulating inflation for short-term political gain. *In extremis*, some investors worry that this will necessarily end in hyperinflation. We disagree with this pessimistic assessment. As shown by the experiences in the 1950s, once government debt loads are reduced (via increasing the denominator, nominal GDP) the predominant focus of macro policy returns to price stability.

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[19] Note: the initiator of OMF has to be the government and not the central bank as no central bank has the mandate to act as a fiscal principal.

[20] Buiter (2014) *"The Simple Analytics of Helicopter Money: Why It Works – Always"* (see: http://willembuiter.com/helifinal.pdf). Mental health warning the research paper contains a lot of equations, which many will no doubt find less than simple!

[21] Ricardian equivalence hypotheses that as consumers are forward looking they understand that the government must raise taxes or cut spending in the future to redeem the debt. As a result, consumers increase saving rates to meet this future fiscal liability. This hypothesis was formalized in the famous economic paper by Barro (1974), *"Are Government Bonds Net Worth?"*, (see:http://dash.harvard.edu/bitstream/handle/1/3451399/Barro_AreGovernment.pdf?sequence=4)

Concluding Remarks

In our view, the abject failure of the combination of debt-financed fiscal stimulus and QE to deliver the long anticipated self-sustaining economic recovery, presents a serious dilemma for global policymakers: continue trying the same old approach in the hope it starts to work or consider something more radical.

A combination of OMF to reflate nominal GDP[22], combined with an interest rate cap on existing government bond yields (to avoid a spike in interest rates that would jeopardise the recovery) seems to us the logic next step[23].

Whether we agree with this extremely interventionist approach or not, we must consider that politicians are essentially faced with two choices: deflationary deleveraging, which history shows quickly become disorderly, or inflation the debt away via the printing press: a process that is relatively more controllable and hence intrinsically a more attractive option for global policymakers.

Central bank independence is nothing more than a myth and ultimately the government is in charge what really determines price stability namely, fiscal solvency[24]. The post Great Recession period is bringing these two realities to the fore and investors ignore them at their financial peril.

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[22] Reflating nominal GDP in this manner should ease solvency concerns about private sector debts and help to limit the upward bias to credit spreads.

[23] In many ways we consider the policy mix as being suboptimal and simply a way to deal with the economic crisis; an economic reset button as it were. Once the reflationary process is underway and government debt burdens are returned to historic norms, fiscal authorities must ensure they do not repeat the asymmetric fiscal policy mistakes that precipitated the crisis: counter-cyclical during downturns and either pro-cyclical or, at best, neutral during the booms. This is not to say that there is no role for governments in investing in long-run projects, such as infrastructure upgrades, but these projects must be self-liquidating. The only viable solution appears to be the establishment of a constitutionally imposed upper limit on government debt. For governments approaching this limit during boom times, it would warn investors that absent fiscal consolidation, there is little scope for fiscal response in the event of a downturn (and hence the risk of debt deflation would be correspondingly higher) or, alternatively, inflation-generating OMF will occur: a much more transparent process for electorates.

[24] This point is made clear in the fiscal theory of the price level. As outlined in Cochrane (2001) *"Long-term Debt And Optimal Policy In the Fiscal Theory Of The Price Level",* (see: www.nber.org/papers/w6771) the aggregate price level is determined by the ratio of nominal public debt to the present value of future real primary surpluses in the following manner:

nominal debt / aggregate price level = present value of real primary surpluses

From the above equation it is easy to see that when the nominal level of debt exceeds the present value of future real primary surpluses (ie the government finds itself in an unsustainable fiscal position) the only way the equation can be balanced if is the aggregate price level rises, ie inflation is generated. *A priori* there is no way to identify what level of nominal government debt defines the fiscal limit. In reality it represents a probability distribution based on the collective beliefs of all economic agents. Only when a large enough number of these agents conclude the fiscal limit has been exceeded, leading a change in behaviour, will the fiscal limit be identifiable *ex post*.

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