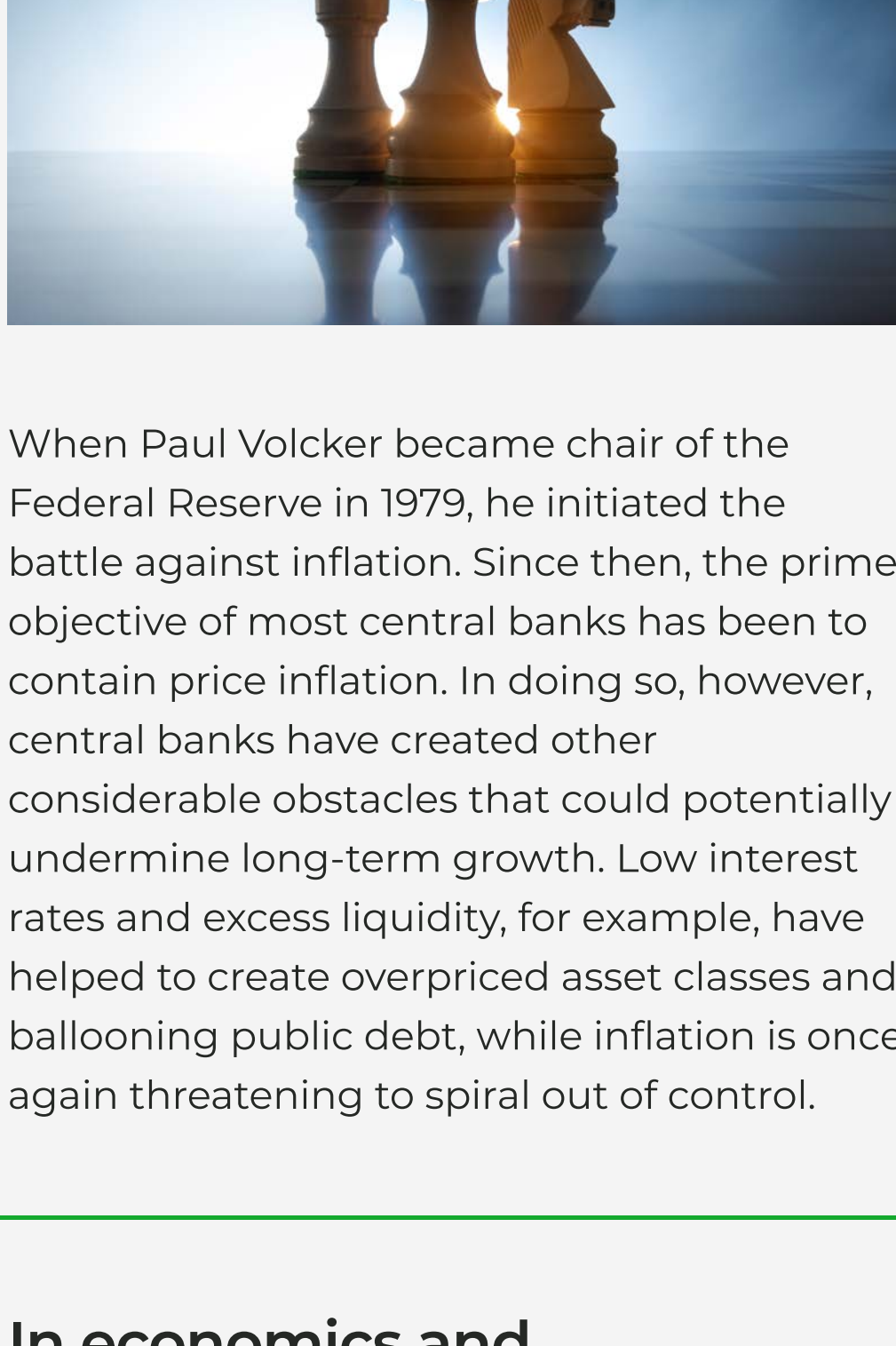


# The battle of the titans

## Part 1



When Paul Volcker became chair of the Federal Reserve in 1979, he initiated the battle against inflation. Since then, the prime objective of most central banks has been to contain price inflation. In doing so, however, central banks have created other considerable obstacles that could potentially undermine long-term growth. Low interest rates and excess liquidity, for example, have helped to create overpriced asset classes and ballooning public debt, while inflation is once again threatening to spiral out of control.

## In economics and financial markets, everything is connected

When economists talk about inflation, bonds, interest rates, debt, investment and so on, especially with regard to financial institutions, they generally only reflect one side of the story. The whole picture, however, is often much more complex, and if someone owns a debt then there is also someone who owns an asset. If there is demand, there must also be supply.

Bearing this in mind, we will try to illustrate below the complexity of the current economic situation and the tough decisions that lie ahead.

## High inflation – temporary or permanent?

Economists from various schools of thought will doubtless be debating this for a while yet.

Some argue that oil and gas prices will not double every year and that inflation will therefore eventually decline over the coming months. Some foresee a continued rise in commodity and goods prices as well as higher prices for services, while others argue that the deflationary trends that we have seen over the last 40 years or so are still strong and that the current spike in inflation is merely a blip.

Central banks have provided more than adequate liquidity over the last two years and have maintained an ultra-low interest-rate policy for almost a decade. Whether inflation is temporary or not, central banks will now no longer pump liquidity into the system and most have signalled rises in interest rates over the coming 12 months.

One question remains, however: to what lengths are today's central bankers willing to go to fight inflation?

## The forgotten Maastricht criteria

Once upon a time, the Maastricht criteria were, to use a German expression, the “Dreh- und Angelpunkt” of EU economic policy. Today, hardly anyone mentions them. As a reminder, the criteria are:

- Deficit of the general government should not exceed 3% of GDP
- Debt of the general government to GDP should not exceed 60%
- Inflation should not exceed the average inflation rate of the three member states with the lowest inflation rate by more than 1.5%-point.

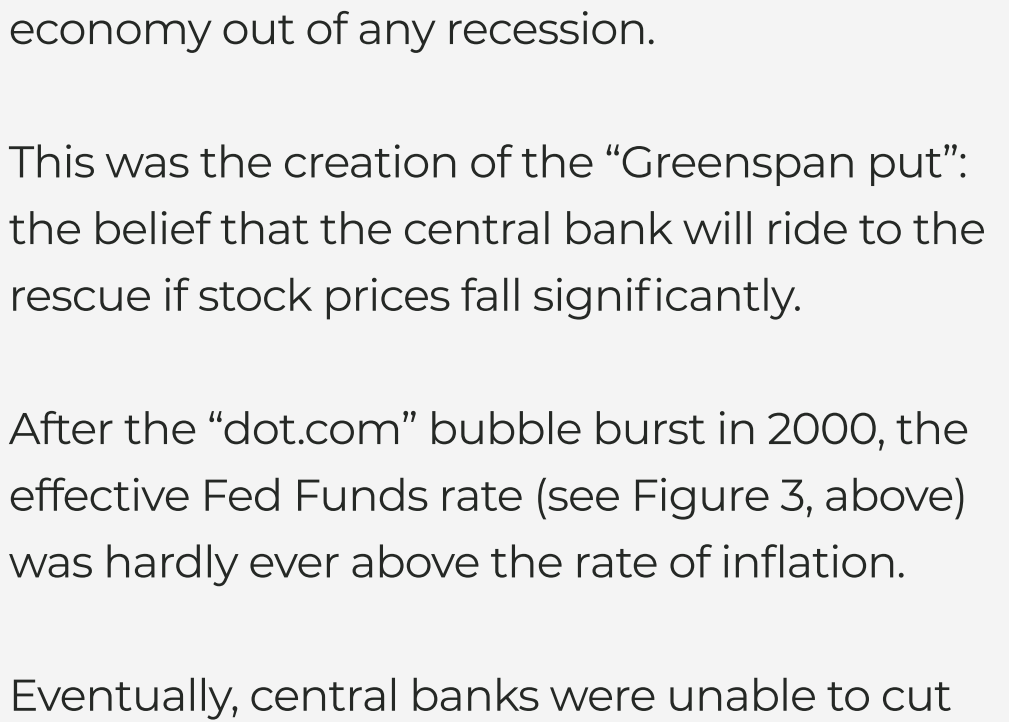
In order to save the economy from COVID-19, these rules were abandoned, and a return to fulfilling them will be a balancing act for the ECB and member states' finance ministers. To illustrate the hurdles for economic policy going forward, a good example to take would be France, which we examine below (although it is important to keep in mind that these problems are not confined to the EU and its member states, but apply equally to countries like the US and UK).

## France – a stylized case study

As with many other countries, France has been severely hit by COVID-19, making an already difficult economic situation worse. Currently (2020), the debt-to-GDP ratio in France is 115% and the deficit of the general government close to 9% of GDP. Given this, what might the road back to fulfilling the Maastricht criteria look like?

As France has not had a very strict spending policy, we will, in the following, assume that it matches the deficit criteria of 3% for the long term and has a growth rate of 2.5% in real terms. For forecasting purposes, it would be necessary for the ECB to determine what the appropriate level of inflation should be.

**Figure 1 - France: development in debt-to-GDP ratio under different inflation scenarios**



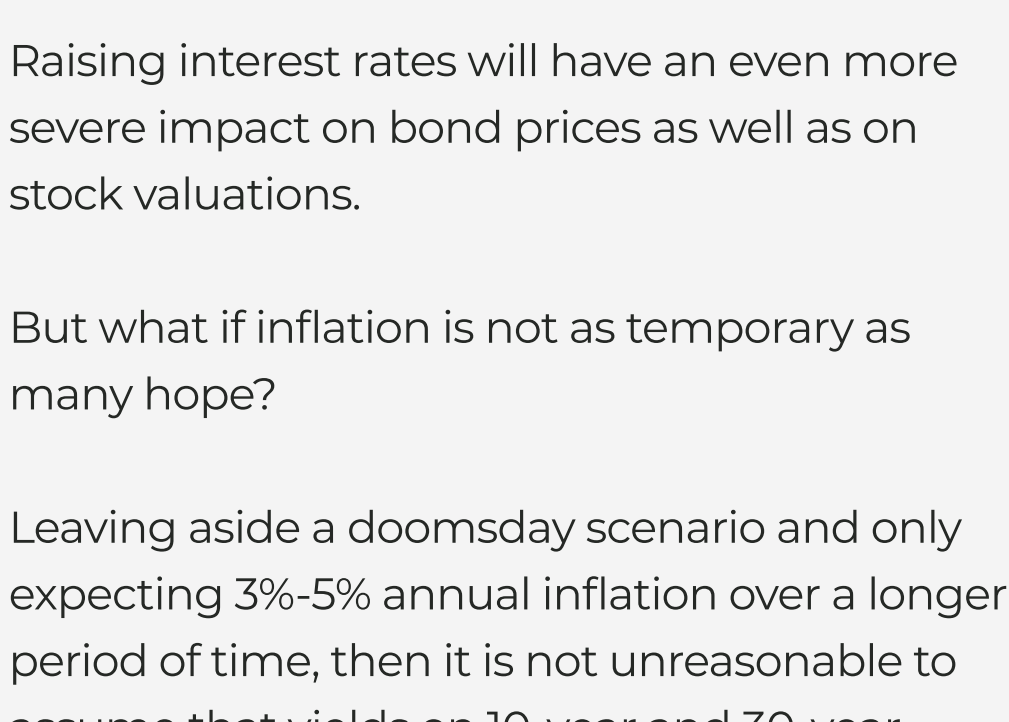
Under three different scenarios (inflation of 1%, 2%, and 4%), there are significant variations in outcome as to when France would fulfil the 60% debt-to-GDP Maastricht criterion.

With 4% inflation, the criterion would be achieved in approximately 16 years' time, while 1% inflation would put the time to achievement almost 40 years into the future.

A little inflation will help bring public finances in order quickly, so what is the harm?

Unfortunately, since there is public debt, some investors will have to own that debt, which, for them, is an asset. Given the different inflation scenarios, how would the real value of this asset develop?

**Figure 2 - Real value of investment in French 30-year government bonds with 0.5% coupon**



In Figure 2 (above), we assume an investment in French 30-year government bonds with a coupon of 0.5% in 2020.

With 1% inflation, the real value of such an investment in thirty years' time would be reduced by more than 10%. With 4% inflation, the loss in purchasing power would be more than 60% compared with the value at the time of investment.

Inflation may be good for minimizing public debt, but it will be very bad for those who have invested in that debt. The central banks (in this case the ECB) have a true balancing act in front of them.

## The end of Volckeresque inflation-fighting

When Paul Volcker was selected as chair for the Federal Reserve in 1979, his main focus was to bring US inflation under control. Since then, the mantra for central bankers has been to keep inflation down to, or below, a 2% annual rate.

Volcker created an inflation-fighting legacy both in and beyond the United States.

**Figure 3 - US Fed Funds effective rate and inflation since 1960**



His aggressive stance on hiking interest rates to bring inflation to heel worked, cutting the double-digit inflation rates prevailing at the end of the 1970s all the way down to low single-digit figures and creating a long bull market in bonds that lasted between 1980 and 2020.

**Figure 4 - Development in French inflation and 10-year government bond yields since 1960**



The situation is the same for all G7 countries as it is with France. Real interest rates (yield minus inflation) for 10-year bonds fell steadily, especially after the late 1990s, as seen from Figure 4, above.

Under Alan Greenspan, the Federal Reserve changed its philosophy of what a central bank should be doing. The well-being of the stock market became a key factor in the Fed's decision-making, based on the belief that the wealth effect of the capital market would increase demand sufficiently to pull the economy out of any recession.

This was the creation of the “Greenspan put”: the belief that the central bank will ride to the rescue if stock prices fall significantly.

After the “dot.com” bubble burst in 2000, the effective Fed Funds rate (see Figure 3, above) was hardly ever above the rate of inflation.

Eventually, central banks were unable to cut interest rates further, and so quantitative easing was introduced to deal with the financial crises of 2008 and 2009.

Huge quantities of liquidity have been subsequently pumped into the economy, and this has been driving yields on all types of listed bonds down to such levels that almost the entire yield curves for countries like Germany and France are now negative (see Figure 4, above).

For more than 10 years, this monetary policy worked quite well and did not create any inflation except in asset prices. However, a number of exogenous shocks such as COVID-19 have brought inflation back with a vengeance, and central banks now have to find a new monetary regime to deal with this new inflation threat.

It has been a beautiful run for fighting inflation via interest-rate adjustment, lasting more than 40 years.

Is inflation temporary, or should central banks attempt to combat it as Volcker did? Now, central bankers have a choice to make as to what to do next. It will not be an easy choice.

## If this is not temporary

Price inflation may not be as high as in the late '70s but asset pricing is. Draining liquidity from the system, or at least ending the purchase of financial assets, will have a huge impact on the financial markets.

Raising interest rates will have an even more severe impact on bond prices as well as on stock valuations.

But what if inflation is not as temporary as many hope?

Leaving aside a doomsday scenario and only expecting 3%-5% annual inflation over a longer period of time, then it is not unreasonable to assume that yields on 10-year and 30-year bonds could increase from the current levels of around 1% to 3%-5% (which would only return real yields back to zero).

How would this affect bond prices? Quite significantly, as can be seen in Figure 5, below illustrated with two fictive 10 and 30-year bonds with a coupon of 0.5% bought at 100.

**Figure 5 - Loss in bond price on 0.5% bond bought at 100 with an immediate increase in yield to maturity**



Many investors, institutional as well as private, have been buying bonds at such levels due to a lack of alternatives.

A fast increase in yield-to-maturity can lead to significant short-term capital losses. If yields would increase to just 3%, then the capital loss would be around 20 points on a 10-year bond, while a 30-year bond would have a loss of almost 50 points.

Of course, an investor could hold on to such a position for 10 or 30 years, but this would then result in a loss of real purchasing power (as illustrated in Figure 2, above) of maybe 20%-40%. Neither result is very appealing.

*To be continued*