

Fiscal vs monetary policy: financial repression for the next decade?

It is no secret that we regard Paul Volcker as one of the greatest central bankers of the last century (in many senses: he was 6 feet 7 or 201 cm tall!). He managed to put the central banks on a path towards lower inflation and thereby lower interest rates, ushering in a period of 40 years in which monetary and fiscal policies worked together to achieve stable economic development.

Unfortunately, all good things must come to an end.

Somewhere along the line, monetary and fiscal policymaking went wrong, and eventually central banks had to cut interest rates to zero and even negative levels in order to support the economy, a strategy that persisted into the COVID-19 pandemic before finally running its course.

As such, a combination of low interest rates, quantitative easing and very expansive fiscal policy finally ended what had been a 40-year trend. One positive consequence of this is that EU unemployment has not been as low as it is today for more than 40 years. However, high demand and the war in Ukraine have propelled inflation to a level not seen since Paul Volcker began to reduce it in the United States in the early 1980s.

Impact on the financial markets

With inflation out of control, bond markets have had one of their worst years since 1949, while stock markets have fared little better. Many stock indices, such as the S&P 500, are down by more than 20% so far this year.

The balanced portfolio approach no longer works because monetary policy and fiscal policy have developed divergent objectives, driven by what we consider to be new megatrends

New megatrends

Two events during the last three years have shaken up an already fragile economic policy mix:

- The COVID-19 pandemic

- The war in Ukraine

As mentioned previously, governments and central banks both did everything they could to avoid a dip in the economy, but lost control of economic development and inflation containment in the process.

COVID-19 brought the traditional economic policy framework to the brink of collapse, with the war in Ukraine tipping it over the edge, in turn laying the groundwork for new megatrends.

Impact of COVID 19 – insourcing

During the pandemic, it became abundantly clear that the idea of outsourcing production to reduce manufacturing costs is not viable when supply chains suddenly break down.

When something like a pandemic, or a war for that matter, happens, it is essential that the goods needed to run a modern society can be sourced without problems. While recent events do not call for the reversal of globalisation, they do imply that critical goods cannot continue to be reliably sourced from certain areas.

We strongly believe that, over the coming decade, some production that has been outsourced overseas during the last 20-30 years will have to be insourced again to the US and the EU, not only to ensure supply, but also to reduce transportation requirements.

Insourcing will put pricing pressure on a large number of goods and thereby increase underlying inflationary pressure.

War in Ukraine – security of energy supplies and defence

The most important lesson from the war in Ukraine, especially for Europe, is that we cannot rely on cheap energy from Russia or the Middle East going forward.

Moreover, the megatrend of a shift towards using renewable and reliable non-carbon energy sources has been enhanced in 2022.

Over the coming decades, the most important transformation in the economy will be on the energy side. In order to avoid further climate change caused by our energy consumption, and to ensure the security of our access to it, we simply need to move away from the use of fossil fuels.

This will no doubt require huge investments in the energy sector, and such investments will also drive inflation in the short-to-medium term until

technology and infrastructure enhancements have been achieved, which should lead to cheaper and more reliable energy production in the long run.

Likewise, defence spending will increase. The “peace dividend” from the end of the Cold War will be replaced by a doubling of defence spending in the coming decade. More than 2% of GDP will most likely be spent on defence for the foreseeable future, which is a significant increase in public spending.

Fiscal vs monetary policy

In recent decades, there has been a strong political tendency for politicians to deal with economic problems by increasing spending.

From COVID-19, over high energy bills, via climate investments to the financial crisis, public funds are available to all parts of the economy to compensate for any adverse economic impact.

In essence, there are no decisive economic arguments for or against this, as it is a political choice based on the signals politicians receive from their electorates.

In Europe and North America, politicians serve ageing populations, and therefore have a notional mandate that implies running deficits in the public sector and building up public debt.

Unfortunately, in many developed countries, debt-to-GDP ratios are close to the levels seen in the years immediately after WW2, which puts a number of restrictions on what is economically feasible.

Politically, it is not viable to reduce e.g. spending on health care and care for the elderly and, going forward, there will be the additional cost burden of increased defence spending and investment in climate change.

With inflationary pressure from renewed production insourcing, higher energy prices and no inclination to reduce public spending, central banks will be very much on their own in the fight against inflation.

At the same time, central banks are also fully aware that an even more precarious situation will arise if public debt spirals out of control.

Governments and central banks will therefore have to come to an understanding as to how to solve the public sector debt problem over time, the easiest way being to have inflation slowly erode the real value of that public debt.

This is tantamount to financial repression, which is what happened in the 1950s.

Financial repression

In financial repression, an underlying transfer from creditors to debtors takes place.

Since the public sector is the largest debtor, much of the exercise is to reduce public debt by stealth, transferring it from the private sector (especially pensions) to the public sector.

While 10% inflation causes a huge problem for governments, as voters feel the significant pinch of higher household bills, an inflation rate of 4%-6%, combined with a real growth rate of 2%-3%, would be very helpful in order to achieve financial repression.

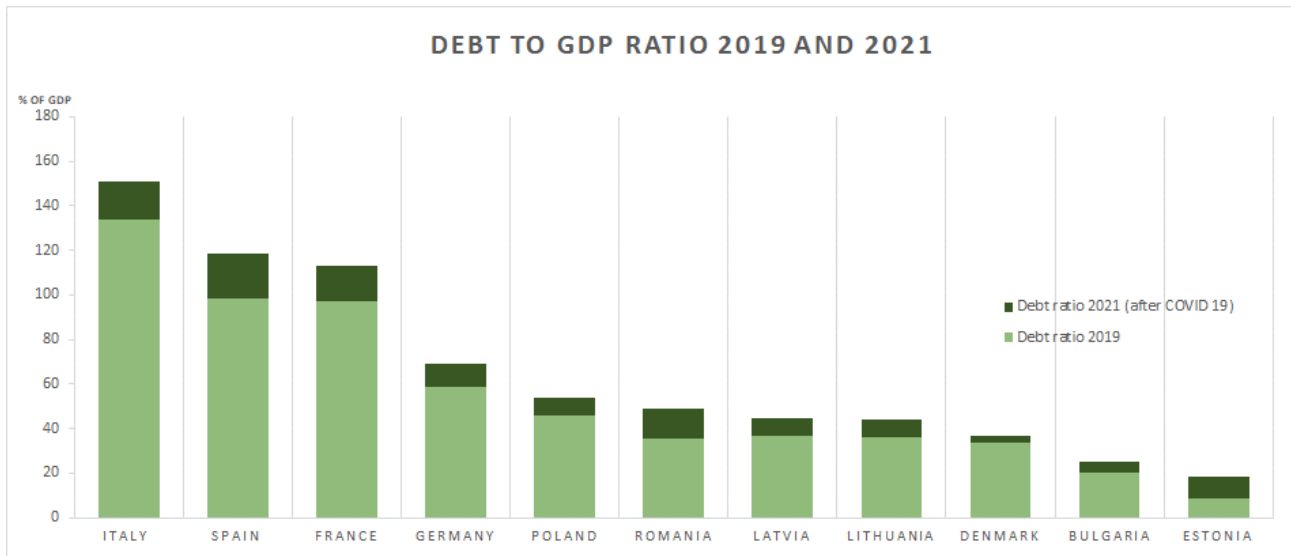
This, however, requires an understanding with the central banks that they can not only reduce inflation to that level, but also simultaneously control the long end of the yield curve by either buying government bonds themselves or getting someone else to do so.

Here, governments can help by regulating the pension and insurance sector to only buy “secure” government or mortgage bonds, in order to match their liabilities with these “secure” assets.

Public debt and GDP

In our May 2020 Newsletter, we estimated the potential impact of COVID-19 on the public debt as a percentage of GDP. With the most severe impact of COVID-19 now presumably behind us, it is possible to look at the de facto development (see Figure 1, below)

Figure 1 Debt to GDP ratio before and after COVID-19 (Source :Eurostat)

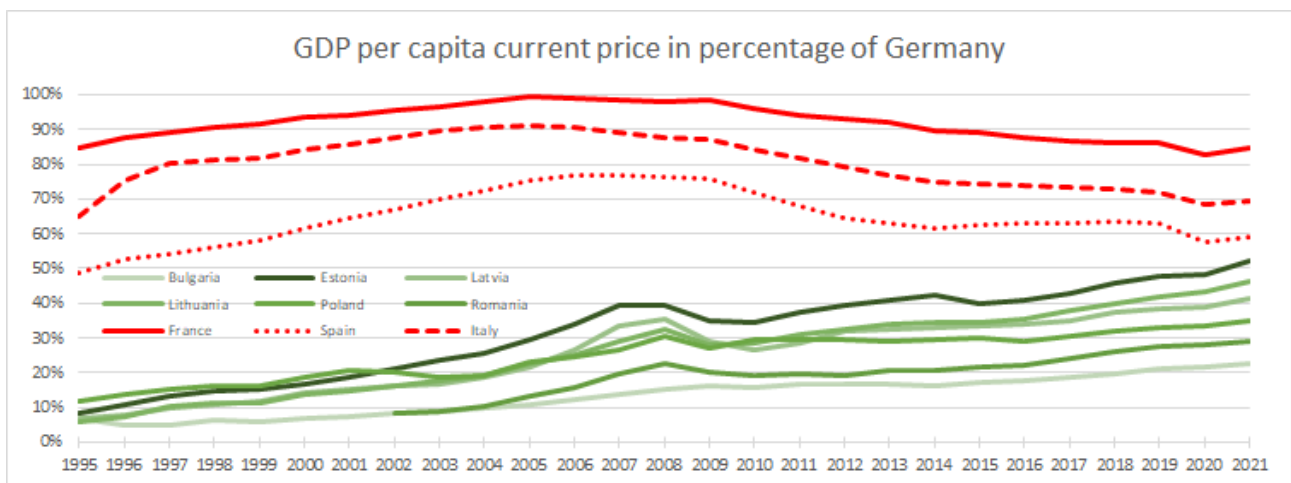


The impact of COVID-19 is quite clear from Figure 1, as the level of debt to GDP rose significantly during the 2020 lockdown. However, it is important to recognize that nothing changed regarding the ranking of the EU countries shown in the chart.

Southern EU countries continue to have the highest debt-to-GDP ratios, and these worsened by more than 15%-points during 2020 and 2021. The countries with the worst starting point were also the countries that had the worst outcome. A vicious circle indeed!

The fundamental problem of these countries is illustrated in Figure 2.

Figure 2 Nominal GDP in comparison with German (Source :Eurostat)



Highly indebted countries, such as Italy, Spain and France, not only have a high debt problem; but more importantly, they have, since the financial crisis, not been able to keep up with the development in nominal GDP per capita in Germany, the economic benchmark in EU.

Not even extremely stimulative monetary policies have been able to change this development, which suggests a number of structural problems in those economies.

Contrary to that, the new Eastern European members of the EU are catching up fast and closing the gap in GDP per capita to Germany.

Most likely, Estonia will overtake Spain in terms of nominal GDP per capita in the coming years. This is a clear indication of the dynamic development in Eastern EU countries.

Macro case – unchanged

The countries with the best macro fundamentals will emerge from any difficult period with the best outcome.

As we are probably going to enter a period of financial repression with controlled higher inflation, those countries with low debt and higher growth rates will very soon be “out of the woods”.

This clearly points in the direction of Northern and Eastern European EU countries like the Baltic states. In general, insourcing would also benefit Eastern EU countries, as they still have lower production costs than their southern EU counterparts.

Investing in a financial repression

As a long-term investor, it is always important to look at the fundamentals and make sure that macroeconomic conditions favour your investments, especially under a new regime of financial repression.

Investing in areas with low debt and high growth is always a good idea, especially if this can be combined with an investment that both generates strong cash flow and offers diversification from the main asset classes.