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Free money will not last – planning for the shift

The fiscal and monetary response to COVID-19 has been quick and massive. The ECB and other central banks have reduced interest rates and purchased assets, including large amounts of government bonds that have been issued by sovereigns to finance the fiscal response. As a result, sovereigns in Europe and other developed markets can borrow at near-zero or even negative interest rates, easily financing deficits that have exploded. Those deficits, which add to the already existing level of debt, further add to the future burden that taxpayers will ultimately bear.

Given the cheap financing costs, is this expansion of fiscal policy really a problem? After all, if governments do not use spending flexibility in a time of pandemics and economic shutdown, then when would such flexibility be used? Indeed, providing necessary stimulus so that the economy minimizes social dislocation and lost production seems justified. That argument has merit.

Alas, the justified short-term response has, so far, not been coupled with a medium-term plan to return to a more normalized fiscal situation. While increased debt levels are frequently criticized for pushing repayment onto future generations, that does not account for risks that could be confronted much sooner. Even if the current cost of issuing new debt is low, or negative, it would be foolish to presume this period of “free money” is permanent.

While numerous risks could disrupt this happy situation, I want to highlight three in particular.

Refinancing risk: The debt issued in 2020 will almost certainly not be repaid at maturity. Instead it will be rolled over into new debt. The cost of that new issuance could increase for any number of reasons, vastly adding to interest costs and forcing a higher level of borrowing.

Rollover risk: When today’s bonds mature in the future, the sovereign may not be able to rollover that debt. A liquidity and potentially solvency crisis may result that could lead to a rescheduling of debts, forced fiscal consolidation, slower growth, and reduced living standards.

Inflation risk: COVID-19 has had a deflationary impact on the global economy. In the medium-term, the impact of reduced trade, de-globalization, interrupted supply chains, and “re-onshoring” are all trends that will push prices higher. If globalization had a depressing impact on prices, then shouldn’t the reversal of that trend nudge prices higher? If that scenario plays out, central banks will take two actions. First, they will increase interest rates. Second, they will stop buying government bonds (and other assets) and, in extremis, sell those bonds. Such a scenario would be the catalyst for both refinancing risk and later rollover risk.

The current period of zero interest rates will not last forever. Central banks will pivot not because they have failed but because they have succeeded! Buying enough time for economies to recover is probably the right decision. But just as central banks stimulated economies during the pandemic, they will reverse course when the recovery is self-sustaining and the output gap has closed.

Governments need to plan for this “positive” scenario. Without a plan to “bend the (fiscal) curve”, debt issuance will be on an unsustainable course and ultimately lead to crisis. Europe has experienced that within the past decade and could again. Who would pay the cost of long-term fiscal profligacy? The average citizen will pay in the form of higher taxes, higher inflation eating into purchasing power, and lower living standards. Governments need to show they can both confront the immediate crisis and plan for the future as well.

Finally, it should be noted that Europe is not alone in this situation. The US budget deficit is forecast to top $3.7 trillion this year – almost 20 percent of GDP. That international backdrop raises the stakes for Europe (and others) to be prepared when the monetary and fiscal tide starts its inevitable reversal. Nobody can know when that will be, but the stakes are too high not to be prepared. ●