Seed Weekly

2 April 2020

The Massive Monetary and Fiscal Policy Stimulus in Response to Coronavirus Shutdown

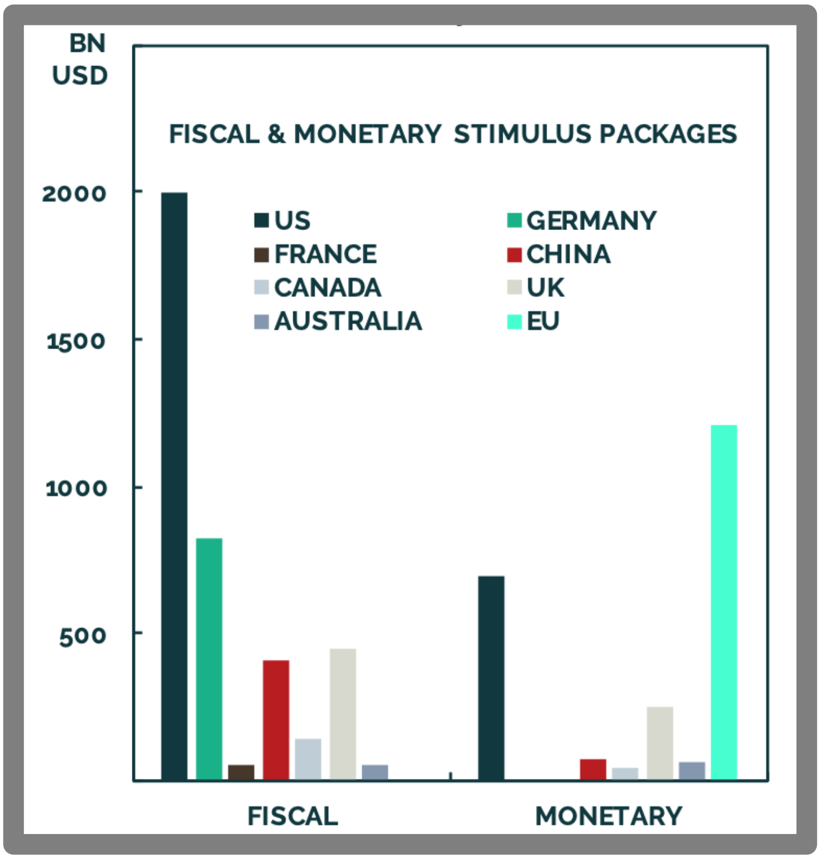
From a financial point of view, governments around the world are tackling the current economic shutdown by doing the one thing that they do know how best to do – print and **print BIG TIME**.

Last week, we discussed the highly leveraged global financial system, from governments, to businesses and consumers. Once again, it appears that the global debt situation will be exacerbated as central banks and governments have opened the flood gate to a massive dose of money printing, which largely makes its appearance via increased debt levels.

Chart 1 (below) indicates the extent of the current stimulus that has now been proposed and passed by various countries. Even quicker than was the case in the 2008 global financial crisis, the US was first off the mark, passing the $2 trillion CARES Act (the Coronavirus Aid, Relief and Economic Security Act) last week. **This is now the largest ever economic stimulus bill in modern history and represents some 9% of the country's $21.5 trillion economy.**

By mid-March the US Federal Reserve had dropped interest rates to almost 0% after two emergency meetings and launched a $700 billion stimulus program. At the same time, they reinstated currency swap lines with a number of other central banks in order to provide much needed US dollars.

Chart 1: Fiscal and Monetary Stimulus



Source: BCA Research

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There are a range of methods that central banks and the governments can and are implementing to ultimately increase the quantum of money into the financial system. These include :

- Set short-term interest rates lower and lower
- Buy longer dated bonds to lower these rates
- Reduce bank's reserve requirements which allows banks to extend more credit
- Buy other assets such as corporate credit and money market instruments
- Extend out tax payment deadlines
- In the US send *"checks"* directly to the public
- Provide low interest rate loans to small and medium sized businesses
- Lending to large business

Ultimately, the monetary authorities and government aim to do three things :

1. Alleviate the global economy cash crunch
2. Aim to support growth directly
3. Boost confidence and ease financial conditions

What Are The Consequences?

Ultimately, both monetary and fiscal measures increase the quantum of debt that governments owe. If debt levels remain in reasonable proportion to the size of the economy, and if the cost of servicing this debt is manageable, then the debt load is sustainable and can ultimately be repaid.

Chart 2 (below) indicates US government debt as a percentage of its economy, which grew to over 100% during WWII, but fell back by the early 1980's as the economy grew. The expansion from that time coincided with one of the biggest bull markets in equities – albeit interrupted in early 2000's, in 2008 and again now.

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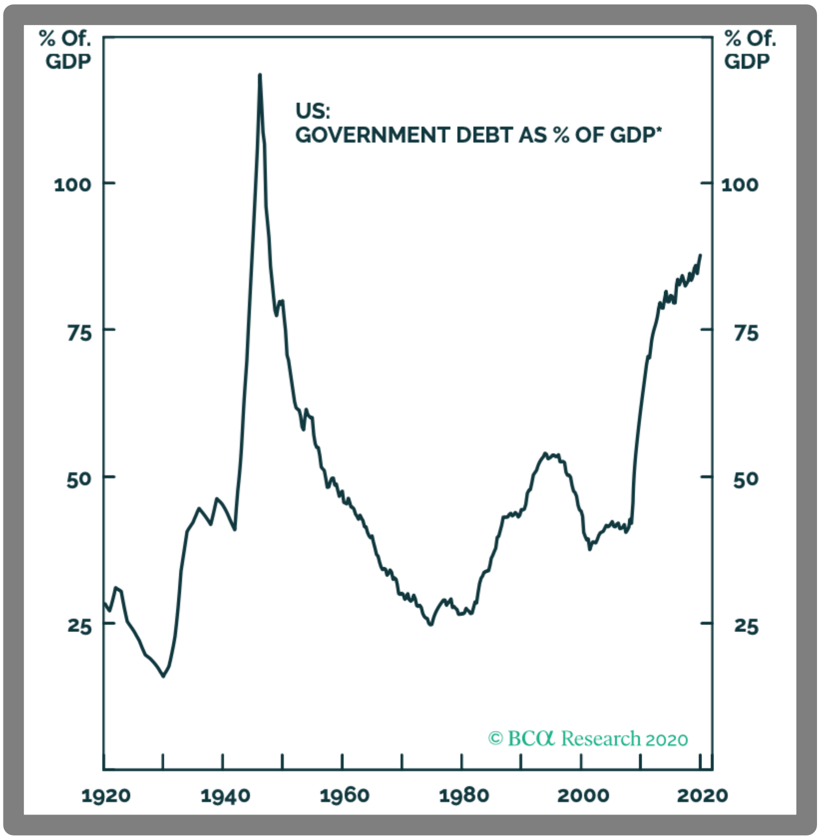
Chart 2: US Government Debt as a Percentage of GDP



Source: BCA Research

At the current proposed rate of debt expansion and fiscal deficits, US government debt will soon be rising to a level above 100% of GDP. Debt levels were expanded enormously in the financial crisis of 2008 and into ensuing years in order to help prop up the banking environment and asset prices.

Developed economies generally have a greater ability to expend debt levels compared to emerging markets such as South Africa. **The US, with the world's Reserve currency, has a greater ability to print and rack up debt levels because there is a substantial global demand for US dollars to settle US denominated debt.**

South Africa has far less ability to increase its fiscal deficit in order to bail out businesses and the public. Indeed, the ever-expanding debt to GDP level, which is now north of 60% and moving towards 90%, in the next few years was cited by Moody's as one of their main concerns in last week's downgrade of government's debt to sub investment grade.

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Central Banks Balance Sheets

Ultimately, central banks are the entities that provide new money into circulation. They also come into their own as lenders of last resort when a financial crisis erupts, such as the one we are currently experiencing.

From the time of the last financial crisis in 2008, the major central banks of US, Europe, Bank of Japan and Peoples Bank of China, expanded their balance sheets dramatically, from a collective $6 trillion at the beginning of 2008 to the current $20 trillion.

The question now being asked is, "Can central banks continue to underpin asset prices through further stimuli or are we heading for a *"Japanese"* type economy?" Japan's central bank has continued to expand and expand, buying a range of assets to the point where its balance sheet is north of $5.2 trillion and higher than its GDP of $5.1 trillion.

By comparison, the ECB's balance sheet is some 30% of the total size of its economy, while the US Federal Reserve balance sheet, at $5.3 trillion, is a quarter of the its GDP ($21.5 trillion). At this stage they are, however, on a similar trajectory to that of Japan.

Conclusion

The speed with which we have seen this virus spread, along with the speed of the global shutdown – estimated now at some 3 billion people in full or partial lockdown – has in many ways been matched by the speed with which governments and central banks are responding with stimulus packages.

At this stage, given the severity of the negative economic impact due to world shutdown, it is unlikely to be sufficient. **We are very likely to see further large doses of stimulus from major central banks.**

Ultimately, an increase in money and debt in the world relative to productive investment has the effect of debasing the purchasing power of currency. However, for many years it may not result in high, or even hyperinflation, because for as long as low interest rates and money creation keeps on propping up sub economic businesses and non-performing loans on banks' balance sheets, there remains too much supply relative to demand in the world.

As always, and especially in these trying times, our team is available to answer any questions that you may have. Please feel welcome to phone us on +27 21 914 4966 or send an email to info@seedinvestments.co.za (general enquiries) or wealthadmin@seedinvestments.co.za (private client assistance).

Kind regards,

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