Confluence INVESTMENT MANAGEMENT

Weekly Geopolitical Report

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The Geopolitics of Helicopter Money: Part 3

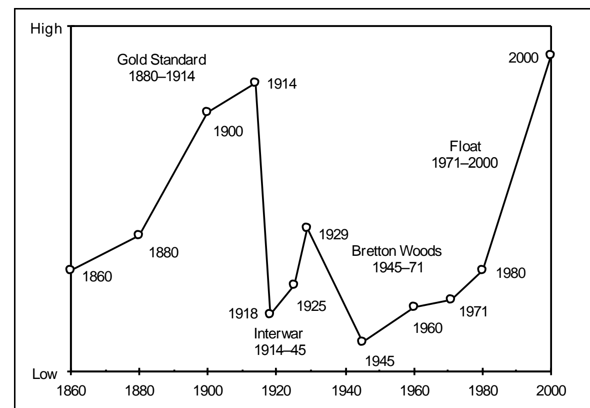
Two weeks ago, we described the process of "monetary funded fiscal spending" (MFFS), including a discussion of why it might be implemented, how it would work and the potential problems that could come with using it. Last week, we examined two historical examples where forms of MFFS were implemented, Japan in the 1930s and the U.S. during WWII. In the final segment of this series, we will make some observations based on the two historical examples discussed last week. We will then discuss the likelihood of MFFS being deployed in today's world, focusing on which nation is most inclined to use it. As always, we will conclude with market ramifications.

Observations

We limited our analysis last week to two historical cases where developed economies successfully used MFFS to lift economic growth during periods of unusual stress.[1] Here are a few observations:

- In both of these cases, MFFS worked because there was ample excess capacity in the domestic economy. Thus, the demand from government spending didn't "crowd out" private sector spending, which was deeply depressed. Using MFFS when there is a lack of excess capacity would almost certainly lead to inflation.

- Japan and the U.S. deployed MFFS during periods of low global financial integration.



(Source: World Bank, Stijn, Claessens)

This chart shows a history of the degree of global financial integration. The previous high point was the onset of WWI. During the interwar period of 1914-45, there was a sharp disintegration of the global financial system that began a slow recovery after WWII. Finally, global financial integration recovered strongly with the Reagan/Thatcher Revolution and the adoption of floating exchange rates. It is arguable that deploying MFFS during periods of low financial integration is probably easier than in periods of high integration simply because the international ramifications of implementing the policy are less pronounced. If a developed nation tried MFFS in today's integrated financial system, the impact would

[1] We excluded the German hyperinflation after WWI because it appears that this event was mostly due to the stresses caused by war reparations. In fact, the German hyperinflation was more a case of pure currency debasement performed by the German banking system and less due to government debt monetization.

rapidly affect other nations as well. The nation implementing MFFS would almost certainly see its exchange rates collapse. Other nations would likely react, although the exact response is not easy to predict. However, the implementation of trade barriers, intervention to offset the depreciation of the MFFS nation's exchange rate, sanctions and other tactics could be deployed. It may lead to other nations being forced to employ the same policies, which might not necessarily be appropriate.

- Although we don't have data on Japan's debt situation, the U.S. experience on the private/public debt swap is important. As the work of Reinhart and Rogoff[2] shows, societies throughout history occasionally face debt overhangs. Their eventual resolution is a task given to the political system because, ultimately, it comes down to a decision about assigning losses. Creditors clearly don't want to suffer losses on the money they lent but if debtors can't pay, denying them debt relief means the economy stagnates. The resolution can include default, inflation or restructuring. One of the outcomes of WWII, although we doubt it was deliberate, effectively created a private sector/public sector debt swap. Military spending supported the recovery of household and business balance sheets and "reset" the U.S. economy for the postwar world.

- The successful use of MFFS probably requires depressed inflation expectations. There are a myriad of examples of debt monetization in the developing world that have ended up with hyperinflation. Printing money to fill fiscal gaps usually leads to a collapse in exchange rates.[3] In many of these nations which have a history of inflation, even a whiff of MFFS will lead households and businesses to quickly prepare for inflation. These preparations usually lead to a self-fulfilling prophecy of higher inflation as households and businesses buy today, worried about higher prices tomorrow. In other words, they quickly move cash off their balance sheets in favor of consumable assets.

- Central banks are required to give up their independence. Given that independence is considered "best practice" in developed world central banks, it seems inconceivable that they would be willing to set policy based upon the government's demands. During WWII, the Federal Reserve was only nominally independent; it did not become fully independent until 1954. Central bankers would need to be convinced that circumstances are so dire that the loss of independence is warranted.

- Some agreement on fiscal policy would be required. Given the degree of political dissonance in many developed nations, even deciding what to spend money on or who would get the benefit from tax cuts or transfer payments would be controversial. Since MFFS requires fiscal action, even if the central bank concluded it was appropriate, getting the

[2] Reinhart, C., & Rogoff, K. (2009). *This Time is Different*. Princeton, NJ: Princeton University Press.

[3] A recent example comes from Venezuela, which finds itself in the positon where it lacks the ability to even pay for printing the money needed to fill the fiscal gap. See: http://www.bloomberg.com/news/articles/2016-04-27/venezuela-faces-its-strangest-shortage-yet-as-inflation-explodes.

fiscal authorities on board is almost impossible in the current environment.

Is MFFS in our future?

Although one can never know for sure, it is not out of the question that it might be deployed. However, the hurdles to its use are high. Central banks will oppose losing some or all of their independence. The high degree of global financial integration will tend to have international repercussions that will make any government and central bank consider hard before taking such a radical step. It is quite likely that the deployment of MFFS would be seen by other countries as a form of "beggar thy neighbor" policy and could trigger currency wars. The general lack of consensus about the proper role of government spending in the economy would make fiscal stimulus alone controversial in most developed nations; complicating that issue with MFFS is even more difficult.

However, if conditions become dire enough, it isn't inconceivable that MFFS might be attempted. If a recession were to develop within the next year that would require additional stimulus in the U.S., Europe or Japan, it isn't outside the realm of possibility that something more radical might be tried. This is especially the case given the current low level of interest rates and the fact that all three of these central banks' balance sheets are expanded and two of the three major industrialized economies are continuing to engage in QE. If a downturn similar to the U.S. experience seen in the 1982-83 or the 2007-09 recessions were to occur under current policy conditions, it is hard to imagine that NIRP or QE would have much effect. The temptation to "do something" would be very strong.

The country most likely to take this action first is Japan. Its economic problems remain despite years of aggressive monetary stimulus. The BOJ is already buying the majority of its government bonds and has branched out into buying equities via exchange traded funds. If Japan were to face a major slump, the only policy tool remaining might be MFFS. However, since the yen would likely depreciate, its actions would be opposed by other nations.

The U.S. is the other potential candidate for MFFS but only if the next recession is a harsh one. Populist sentiment is clearly on the rise as seen by the campaigns of Donald Trump and Bernie Sanders. In the next recession, the idea of "QE for the people," an idea that has been raised by the British Labour Party and its leftist leadership under Jeremy Corbyn, could find root here. Although we doubt a president from the political establishment would support such a radical policy, a populist might be persuaded to do so.

The area least likely to engage in MFFS is the Eurozone. Germany remains staunchly opposed to such measures mostly because of the historical links between German hyperinflation and the rise of Nazism. However, if the Eurozone were to break apart, it would not be surprising at all for one or more European countries to try MFFS. However, once out of the Eurozone, the global impact from a European nation's implementation of MFFS (e.g., Greece) would be significantly less.

Ramifications

The most obvious market ramification from implementing MFFS is currency weakness. The country using this policy would almost certainly see currency depreciation. Other nations, as noted above, would react, but if they don't follow the policy, it will be hard to offset the "beggar thy neighbor" thrust from MFFS.

At some point, MFFS will trigger inflation. The size of the impact will depend on how "anchored" inflation expectations are in that particular economy. In Japan, for example, inflation has been non-existent for so long that it may take some time for prices to increase. On the other hand, in the U.S., where "baby boomers" are a large segment of the population and remember the high inflation period of 1965-80, the reaction to MFFS would likely be faster. The Federal Reserve considers its anchoring of inflation expectations as one of its great success stories. Institutionally, it would be very difficult for the FOMC to participate in MFFS if it might sacrifice inflation anchoring.

The effect on fixed income will be difficult to determine. In our two historical examples, neither Japan nor the U.S. had deregulated their financial markets to the current degree. Thus, in both cases, the BOJ and the Federal Reserve were able to control the level of interest rates even though inflation pressures were rising. However, as seen in the U.S. case, fixing the level of interest rates required the Federal Reserve to expand its balance sheet as much as necessary to maintain that fixed rate.

In our current deregulated environment, we would expect the return of the "bond vigilantes" even if the central bank monetizes the debt issuance. MFFS would signal that the monetary authorities were prioritizing growth and abandoning inflation control. Thus, we would expect that MFFS would likely signal the onset of a bear market in bonds.

The impact on equities would be mixed. Support for economic growth would tend to be supportive for equities but the threat of higher future inflation would likely weigh on P/E multiples. If MFFS is implemented in response to a recession (as would be expected), the anticipated recovery would likely be initially bullish for equities. If the action is seen as resolving secular problems, e.g., the divergences in growth between Eurozone nations, ending deflation in Japan or acting to reduce private sector debt in the U.S. to sustainable levels, it may actually trigger a longer lasting bull market.

Unfortunately, the great unknown about this policy in peacetime is that once the political class realizes it can boost fiscal spending without necessarily boosting the level of debt, the temptation to make such policy permanent will be hard to overcome. This is how hyperinflation occurs. We suspect that any policymaker who engages in MFFS will try to put time limits or economic targets on it but, as we saw with QE, such limits also undermine effectiveness. Engaging in MFFS is dangerous and should be implemented as a last resort. However, political pressure growing from sluggish growth could reach a point where aggressive policies may become impossible to avoid.

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