Sunday Wrap

Happy Sunday,

This past Wednesday, the Fed confirmed that it is indeed pretty relaxed about the higher yields. With that reaffirmed the 10-year US Treasury yield moved another leg up, ending the week above 1.7%. As I discussed last Sunday, while broadly appropriate for the US, this creates a challenge for other central banks. Yet, the challenge is not only imported from the US, but also partly domestically man-made.

In Europe, the ECB has made clear that they'll fight any unwarranted import of higher yields from the US, and so far, it's working. But the real source of stress placed on the ECB remains the insufficiently expansionary fiscal policy.

The central banks in vulnerable EM countries face a more complicated task than the ECB. As I noted last weekend, for now, this is widely seen to apply to particularly Turkey and Brazil. With net foreign reserves in deep negative territory (-USD 47bn, i.e. excluding swaps with local banks and other central banks), it's particularly important for Turkey not to easy the monetary policy stance or to sow doubt about the commitment.

Yet, late on Friday night, Turkish President Erdogan fired respected Central Bank Governor Agbal after just four months in the job, and replaced him with Sahap Kavcioglu, former Halkbank executive and former AK Party MP, who has been arguing against higher interest rates. CNBC anchor Joumanna Bercetche tweeted: "May be the case that the biggest threat to EM isn't the Fed but a fickle Turkish autocrat".

But back to Europe, where the ECB is - again - facing an unreasonably tough task to meet its mandate. While the immediate challenge originates in US markets, and they have handled it successfully so far, I'll return today to the more fundamental culprit, namely the premature reduction in European fiscal stimulus.

As I'm sure you know, ever since it became clear that Europe was planning to reduce the amount of fiscal stimulus this year, causing a sizable "undershooting" of the estimated output gap, I have – along with many other economists - been a vocal proponent of a more ambitious fiscal approach.

If you follow me on twitter (@ErikFossing) you'll know that I have been calling for the past two months for the opponents to spell out the reasons for their disagreement – and to articulate more clearly the scenario they oppose. So far, I can identify two key areas of push-back to the call for a more aggressive fiscal approach, namely a fear of asset bubbles and a concern about public debt.

So, in today's note:

- **I'll first briefly recap, and update, the issue of 2021 fiscal stimulus in the eurozone.**
- **I'll then defuse the fear of asset bubbles. There really aren't any systemically important ones.**
- **I'll then explain why the obsession with public debt is misguided.**

1. The insufficient eurozone 2021 fiscal stimulus: For growth, employment and inflation. A recap.

The insufficient fiscal stimulus this year in the eurozone will lead to a slower recovery from the pandemic than would have been possible, hence higher unemployment, as well as lower income and less inflation - for longer.

This is illustrated by the agreement among all major forecasters that the eurozone GDP will not reach its pre-pandemic level until around mid-2022. The longer-term price for insufficient fiscal stimulus at this juncture is scarring. The longer people and machines stay idle, the deeper the scars in the economy, and the lower the potential growth rate going forward. This is illustrated by the fact that nobody (to my knowledge) expects the eurozone GDP to catch up for many years – if ever - with the extension of the pre-pandemic GDP trend. And nobody, including the ECB, expects inflation back at its target within the forecasting period.

Both stand in sharp contrast to China, where the GDP level already exceeds the pre-pandemic level by a good margin, and to the US, where consensus expects GDP to reach its pre-pandemic level within a quarter or two, and the extension of the pre-pandemic trend line sometime next year. Both were fueled by massive fiscal (and quasi-fiscal) stimulus.

To remind you, on present information, my team estimates the total eurozone cash fiscal stimulus this year (from national budgets and from NGEU) at about 6% of GDP, including automatic stabilizers and assumed extension of all guarantees, compared with an estimated output gap of about 8.5% of GDP.

These past couple of weeks have seen additional talk of fiscal measures around Europe, including this past Friday when the Italian government approved the "Sostegni" decree, detailing the latest supportive measures worth EUR 32bn, which is part of the package authorized by parliament in January. And in Germany, a reported additional EUR 70bn will be added to this year's deficit. We'll get confirmation and more details on Wednesday when finance minister Scholz also presents the first draft of the 2022 budget and the medium-term plan.

Importantly, however, these latest measures are all in response to the emerging third-wave lockdowns in Continental Europe, which themselves are likely to delay the recovery and thus further increase the output gap. I'm not aware of anyone suggesting that we'll get enough additional fiscal stimulus to fill even the presently estimated output gap of 8.5% of GDP, let alone provide the overshoot which would be justified by any reasonable risk-reward analysis.

Why this lack of sufficient fiscal ambition? I'm not sure, but the two key push-backs I have heard focus on claimed asset bubbles and a suggestion that further stimulus will therefore simply end in tears, and a concern about (perceived excessive) public debt.

I disagree with both. I'll take them in turn:

2. Asset bubbles. Are they there? – And if they are, do they matter?

The first objection to more fiscal stimulus, I hear, is a claim that it would fuel already dangerous asset price bubbles and hence – at best – be a short-term gain, before it all ends in tears. I disagree, and here's why:

To be sure we start on the same page, let's agree that for an asset price bubble to be a concern for policy making, it needs to be for a group of systemically important assets. For example, I would argue that Bitcoin is an extreme case of a bubble because it's priced completely without reference to its intrinsic value, but it doesn't matter to society (apart from the enormous waste of energy and hence climate change it causes, but that's a different discussion). Bitcoin could go to zero tomorrow and not a single country's economy would even notice. Likewise, a host of individual stocks could be characterized as bubbles, not least among companies which have never made a profit. But individual stock prices can correct without concern for the economy as a whole.

The two systemically important asset classes that the worriers worry about are equities and real estate:

My conclusion is three-fold: First, it's a stretch to argue either of these two asset classes represents a bubble, and definitely not the one with the potential to cause more severe havoc, namely real estate. Second, for a bubble to be dangerous it'll need to have been credit fueled (you might even wonder if an asset class can get to bubble territory without being credit driven). None of these two asset classes fits that bill. Third, excessively easy monetary policy may cause bubbles, fiscal policy is highly unlikely to do so. Indeed, in an economy with an independent central bank with an inflation target, insufficient fiscal policy should normally trigger more monetary easing to hit that target, and hence add to the risk of bubbles); more fiscal easing does the opposite.

First equities: The S&P 500 trades at a P/E ratio of about 22, lifted from the high teens on the prospect of fiscally stimulated growth, and not that far off its 1992 and 2017 highs of about 25. But as my colleague, Christian Stocker, notes, earnings growth is expected (by consensus) to increase this year by about 25% and by 15% next year - after a decline of 15% last year.

Clearly, an increase in interest rates unrelated to stronger growth or higher inflation would undermine these valuations. For example, a 2pp shock to the 10-year UST yields (note: I define a "shock" as an increase in global yields unrelated to better economics or inflation) would – in a mechanical sense – lead to a 20%-25% decline in the S&P 500.

Would this pose a measurable problem for the US or global economy? Quite likely, but remember that we are here testing the system with a 2pp real interest rate shock out of the blue with no reaction by the Fed. In a stylized FCI-based analysis, this would reduce GDP for a year by close to 2pp, but if it's a permanent shock, the loss in GDP will accumulate to some 7pp over three years. Importantly, however, I am not talking about higher yields as a result of a stronger outlook for GDP and/or inflation, which is what has been driving US yields higher in recent weeks, but a massive permanent yield shock with no reaction (ever) from the Fed; an unrealistic assumption in my view.

The "FANGs" of the big technology companies trade at P/E above 30, which I would be more concerned about in terms of vulnerability and the risk of a correction, but – not least in light of the experience from the 2000 dot-com bubble burst – I very much doubt this would be a systemic event.

Second, real estate prices, and particularly in the cities: By most estimates that I am aware of, European urban real estate is seen as being up to 25% overvalued, although I have my doubts about this because of the boost to prices stemming from the population growth, and hence basic demand.

More importantly, while real estate certainly is systemic, I'm less sure that urban real estate is. In spite of the migration to the cities, Europe remains the part of the world in which the smallest share of the population lives in major cities. Less than 10% of Europeans lives in cities with more than 5 million people (more than 20% in North America and Asia), while some 25% of Europeans live in cities with more than 1 million (50%-60% in North America and Asia). Coincidentally, there was a great illustration of this in Friday's FT.

Furthermore, when considering real estate prices, the (partial) information available suggests that households' interest payments on their debt has not moved materially up relative to their disposable income. For Germany, for example, the Bundesbank shows in its latest real estate indicator publication ("Indikatorensystem zum deutschen Wohnimmobilienmarkt") that this critical ratio is presently 25pp below the pre-financial crisis peak, and 10pp below 2010.

And while not immune, households' vulnerability to higher interest rates has declined these past years. While 15 years ago, some 50% of eurozone households took variable interest rate mortgages and only 15% took loans with rates fixed for at least 10 years, now less than 20% of new mortgages are variable rate loans, while almost 60% has rates fixed for 10 years or more.

That said, residential real estate prices have become an important social problem in many cities. However, that's an issue that should be addressed with macro-prudential (e.g. loan limits), regulatory (e.g. treatment of investment property) and/or micro fiscal policy tools (e.g. taxation and deductibility of interest expenses), rather than with monetary policy tools, let alone overall fiscal policies.

Hence the first part of my conclusion: Perhaps borderline bubble territory for equities, but not for real estate.

But even if we can identify what looks like a systemically important asset bubble, the importance of it in terms of its vulnerability and – specifically - the severity of the impact on the overall economy if/when it bursts critically depends on whether it was built up by a credit boom, or not. And none of them are!

In a big 2015 study of equity and housing market bubbles over the past 140 years across 17 countries, Oscar Jorda, Moritz Schularick and Alan Taylor showed the importance of the root of the bubble and showed that it's the credit-boom fueled bubbles that generate risk of financial crisis, particularly the housing bubbles. When credit-fueled housing bubbles implode, they are typically followed by deeper recessions and slower recoveries. Their highly recommended paper is here: LEVERAGED BUBBLES

In the present environment, neither real estate nor equity prices – bubbles or no bubbles – have been fueled by excessive credit expansion. European households' mortgage credit growth has been running at around 5% a year for the past ten years (6% in Germany), far below the critical level that you can extract from Jorda et al's paper. Meanwhile, European non-financial firms have been deleveraging between 2014 and the onset of the pandemic, bringing their net debt down to about 160% of gross value added, where it was during the years following the great financial crisis. This even includes the roughly 10pp pandemic induced jump last year.

Finally, and critically important: During the ten years leading up to 2020, it was precisely because of the tight fiscal policy stance that monetary policy became stretched too far, as the central banks chased their inflation target or fought off the risk of deflation. This drove asset prices higher, but via reallocation of funds rather than by excessive credit growth. In the process, income distribution became increasingly skewed in favor of capital owners.

What I – and many other economists – am/are now calling for is a correction of this overly skewed policy mix via more fiscal stimulus, targeting particularly those who have been hit hard by the pandemic and the effects of the lockdown. In the process, this will also help alleviate the income distribution issue at hand and (probably) push core inflation a bit higher. If such fiscal expansion still were to drive asset prices higher it will be because of the expectation of stronger growth and a heathier economy - which is precisely the opposite of bubbles.

3. Can we afford more fiscal stimulus, given the existing public debt?

The second objection to more fiscal stimulus, I hear, is a claim that we "can't afford it" because of the existing high public debt levels.

My short reply to this is: Wrong, both because the alternative would be worse, but also because, after ten years of hardly maintaining the public sector capital stock, the vast majority of investments, financed at zero or even negative interest rates, will surely prove profitable for society as a whole.

I'll make two observations:

First, with insufficient fiscal stimulus (by which I mean a smaller fiscal cash injection plus automatic stabilizers than the estimated output gap, unprecise as it is to estimate) GDP will surely grow less strongly than if the fiscal authorities fill, or even overfill, the entire gap. This means that there'll be less fiscal revenue (unless you raise taxes) with which to service the existing debt. If you care about debt/GDP, then your denominator will be smaller and your ratio higher.

The fiscal response to the great financial crisis in 2007 in both Europe and the US is illustrative. Following the immediate stimulus, the fiscal stance turned broadly neutral after a couple of years, and then "austerity" became the mantra, delivering a fiscal drag on both sides of the Atlantic of 1%-2% of GDP from around 2014. By any research I am aware of, this contributed significantly to the fact that it took the OECD some seven years to restore per capita GDP to the pre-crisis levels.

Second, while GDP will do better with sufficient fiscal stimulus what about the increase in debt? My contention is that while it's obviously nicer to have little debt than a lot of debt, the only thing that matters is the debt service obligations, and specifically the interest payments, it generates. (Amortizations don't really matter much because, like corporates but unlike households, sovereigns don't have a finite life-span so the debt only needs to be rollover and not repaid).

I'll make two points again; first on debt sustainability, second on the impact of debt on growth:

For debt sustainability, you should care primarily about interest payments as a share of fiscal revenue or as a share of GDP. I like the ratio to revenue better because that's "the bird in hand", while GDP is more like "the ten birds in the bush". Put differently, if interest payments start to generate stress on the budget, is that the time you'd like to go out and increase the tax take relative to GDP to remain current on your debt obligations?

To remind you, in the 1980-90s, most major OECD countries typically allocated 7%-15% of their fiscal revenue to interest payments on their debt – and I don't recall a lot of questions about debt sustainability in the OECD in those days. In 2019, most of them needed less than 5% of their revenue for interest obligations. In Italy, it was 7.2%.

And if you worry about a future of higher interest rates again, consider my 2pp interest rate "shock" again, now applied to the Italian economy. With a 2pp increase in its cost of funding along the entire curve (and remember that by "shock" I mean an increase in interest rates beyond any improvement in the real economy or inflation, so a massive straight-forward tightening of monetary conditions), this would raise the share of interest payment to revenue in the Italian budget to about 8% by 2023, from the 7.2% two years ago. This is still only about half the ratio Italy paid during the decade prior to the euro.

Then there is the question when – or whether – higher levels of public debt become a drag on growth. The answer depends on who holds the debt and hence who the interest payments are made to.

Roughly told, if the debt is held by the central bank, there is no cost as interest payments are returned to the treasury as central bank profits (typically excluding a small reserve build-up). Debt held by the central bank will obviously stay on the central bank's balance sheet until the economy has recovered and threatens to overheat, hence needing monetary tightening. In other words, the securities held on the central bank's balance sheets will only arrive in private hands once nominal GDP (and tax revenue therefore) is a lot higher than now. Importantly, a reduction of a central bank's balance sheet will always be "economic conditions determined" and never arbitrarily "time-determined". Occasionally, I hear this argument expanded to include a concern about a perceived risk to central bank independence stemming from their big balance sheets. To be sure, central bank independence is important, but I truly struggle to appreciate it if it comes with a need for suboptimal policies.

If the debt is held by domestic private creditors, it has some limited impact on growth via the redistribution from the overall taxation of the economy to the payment to the creditors, e.g. pension funds. Such distributional effects can be neutralized via a host of readily available fiscal tools. If the debt is held by foreign creditors, the interest payments will work as a drag on the domestic economy because taxation is collected domestically and transferred to creditors abroad.

Hence, and very importantly, the eurozone's 2%-3% of GDP current account surplus equals the amount with which the private sector's savings surplus exceeds the public sector's deficit (the dis-savings). Therefore, on a net basis, the public sector deficit is all financed by the domestic sector and has therefore little effect on growth. Indeed, economics 101 teaches you that when the private sector is hit by a shock and cuts its consumption and investment (boosting savings), that's precisely the "hole" the public sector should step in and fill.

But we are still 2%-3% of GDP short of that in the eurozone, and if our political leaders wanted to show bold leadership, then they would – immediately – do 4%-5% of GDP extra. If they were to read this before their European summit this coming week, and feel short of ideas how to do it, here's one: Send a sizable check to every healthcare worker, every scientist and every teacher in Europe as a thank you from society.

The clapping is good, but I think cash would be better – and yes, some of it would end up as additional savings, but I'll happily make a major bet that a very big part of it will be spent and put to good use before the year is over.

And while we wait for that, let's end on an uplifting note: The just released World Happiness Report, based on surveys around the world in the middle of the pandemic, concludes that we Europeans remain a happy bunch. Nine out of the Top-10 happiest countries in the world are in Europe. The amusing – and at times thought-provoking – report is here: World Happiness Report

Best

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MR 20/2

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