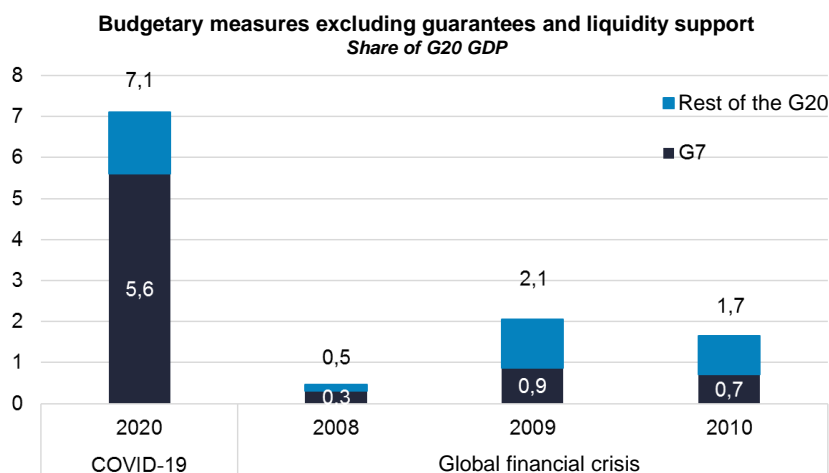


In the wake of the Covid-19 crisis, governments everywhere have been engaging in support programmes on an unprecedented scale. As a result, deficit and debt levels are soaring all over the world. In a bid to underpin these policies, central banks have implemented public debt purchase programmes on an equally unprecedented scale.








Sources : IMF, data as of June 12

These measures were welcomed by financial markets that initially stabilized before rebounding significantly, but they raise several questions. For instance, what can central bank financing realistically expect to achieve? What are the associated risks and is there a possibility of runaway inflation? Should government debt held by the ECB<sup>1</sup> be cancelled? Can debt grow unfettered? And will governments be forced to abruptly tighten fiscal policy?

## Deficit, debt, and quantitative easing: orders of magnitude

The table below shows the sizes of and changes in deficit, debt, and quantitative easing as a share of GDP for the US, eurozone, Japan, UK, and France. As a reminder, quantitative easing (QE) involves central banks buying assets on a massive scale (government bonds, private-sector bonds and even equities). The primary objective of QE is to keep banks awash with liquidity to encourage them to lend to companies and private individuals. Other objectives include assisting governments with financing their economic support packages and lowering risk premiums on risky assets.

	Budget balance in %			Debt / GDP in %			Announced QE / GDP in %
	2019	2020	2021	2019	2020	2021	2020
United States 	-6,3	-23,8	-12,4	108,7	141,4	146,1	no limit
Eurozone 	-0,6	-11,7	-5,3	84,1	105,1	103,0	12,0
Japan 	-3,3	-14,7	-6,1	238,0	268,0	265,4	no limit
United Kingdom 	-2,1	-12,7	-7,0	85,4	101,6	100,5	11,0
France 	-3,0	-9,2	-6,2	98,5	115,4	116,4	12,0

Sources: IMF, Bloomberg

The data highlight the scale of these deficits, which is previously unseen during peacetime. The rise in debt levels between 2019 and 2021 ranges from 15 to 40 percentage points of GDP, and the lower end of the range, the UK, will probably soon be revised upward as a result of Prime Minister Boris Johnson's recent announcement of a massive stimulus plan. Central banks in both the UK and the eurozone have already announced asset purchase programmes of just over 10% of GDP, and these may well be increased if necessary. Neither the US nor Japan has set any asset purchase programme limits.

## What the quantitative easing programmes can achieve

QE increases the volume of demand for government bonds. If supply remains constant, then the interest rate will fall. If supply rises, new issues will have less difficulty finding buyers. The rise in the interest rate will be contained and governments' short-term financing challenges will be lessened, irrespective of the quantity of bonds issued.

Central banks have unlimited purchasing power in their own currency. To fully understand this, we must remember that the central bank acts as banker to the commercial banks. Commercial banks are required to maintain reserves in current accounts with the central bank, and this system is the best way for them to carry out interbank transactions. When the central bank buys a security from a bank or from a customer of that bank, it pays for the security by crediting the account of the commercial bank. In contrast with commercial banks, central banks do not have to comply with financial ratios, and they enjoy a monopoly position as the bank of banks. As long as a central bank respects its monetary policy objectives, there is nothing to limit its purchasing power. In reality, QE merely transforms public sector liabilities, as what was privately held debt becomes central bank reserves held, via the banks, by the private sector.

In addition, by bringing interest rates down sharply, QE also temporarily resolves the issue of government financing costs.

Added to this is the fact that as QE is currently being implemented across the globe, countries can avoid being singled out and their currency attacked.

Ostensibly, these extraordinary measures do not seem to have any harmful consequences. Debt levels are certainly increased, but if central banks can indefinitely finance them, then where is the problem?

Furthermore, why stop there? Why not systematize a globally coordinated increase in deficits and repeat tax cuts and spending increases year after year?



## QE side effects

It is tempting to think that QE has no effect on the rest of the economy. The government borrows by issuing bonds and the central bank buys these securities. While the central bank does not purchase securities directly from the government, as a European rule forbids this practice, just because private economic agents fulfil an intermediary role (by purchasing securities in auctions and by selling securities to the central bank), this does not alter the substance of the financial flows.

All this would be true if everything could just stop right there. But governments borrow to finance their excess expenditures relative to their revenue inflows. Their deficits correspond to a net flow of funds to the private sector. To take a simple example: if a government borrows to finance relief cheques for private households, it will be debiting its account and crediting that of the household beneficiaries.

In the end, the cash created by the central bank merely passes through the government, and ends up in household accounts, or other private agent accounts. In accounting terms, equilibrium occurs via commercial banks' balance sheets, which mark central bank reserves as assets and private sector deposits as liabilities.

The process of sending the relief cheques to households, which are financed by a government bond issue that is bought on the market by the central bank, can be summarized as follows:

State			Central bank	
Assets	Liabilities		Assets	Liabilities
	Government bonds +100		Government bonds +100	Reserves CB +100
Bank			Households	
Assets	Liabilities		Assets	Liabilities
Reserves CB +100	Deposits +100		Deposits +100	

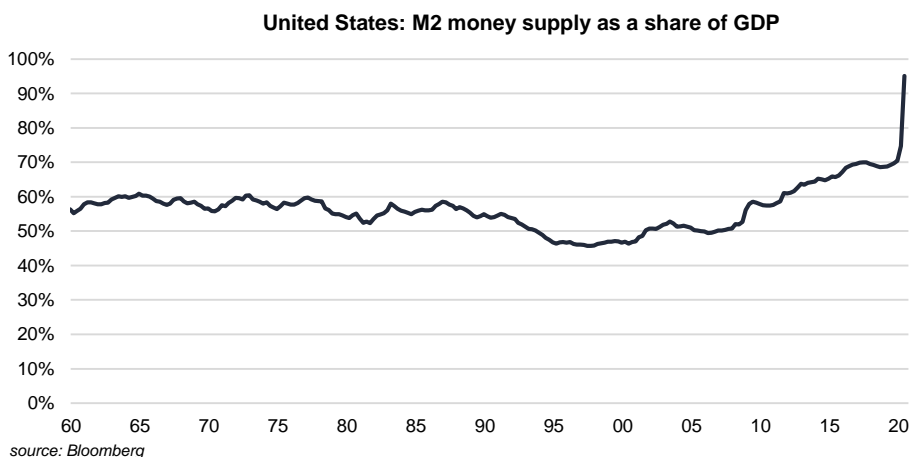
Noteworthy is that in addition to the transfer of liquidity that the central bank provides via the commercial banks, there is also a transfer of wealth from the State to households.

Source: Lazard Frères Gestion, July 2020.

The opinion expressed above is as of the date of this presentation and is subject to change.

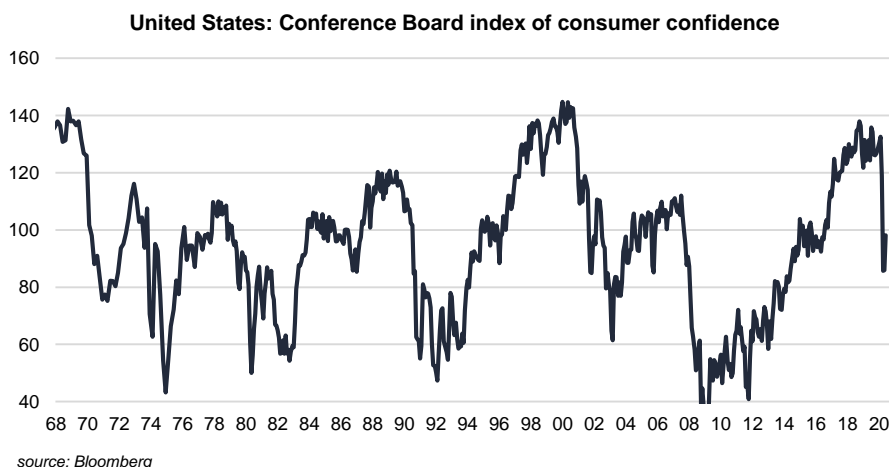
## What is the difference between now and the 2008-09 post-crisis policy?

Following the 2008-09 crisis, we witnessed expansionary public policies that were underpinned by central bank quantitative easing. However, the scale of the current measures goes well beyond what we saw at that time. In 2009, deficits in the United States and the eurozone stood at 'just' 13% and 6% respectively. The effect on monetary aggregates is also without precedent, as can be seen in the graph below showing M2 as a share of US GDP. As a reminder, M2 includes banknotes, demand deposits, term deposits of less than two years, and savings accounts such as French Livret-A equivalents and youth savings accounts.



Private economic agents are finding themselves with levels of liquidity that in principle exceed their expenditure needs. While banks operate within their liquidity constraints, which are generally controlled by the central bank, other economic agents choose their liquidity levels. This level tends to represent the amount that covers expected short-term spending. In the case of households receiving a monthly income, this amount generally covers monthly expenses.

Of course, during periods of heightened uncertainty, private economic agents may prefer to hold greater liquidity levels. However, our 60-year history of M2 data shows that the current increase in liquidity is totally unprecedented. The fall in consumer confidence is significant but the current level is not as depressed as during previous episodes.



## How can private economic agents cover their liquidity to a reasonable level?

One hypothesis is that this process will occur on its own. If growth and inflation accelerate sufficiently, liquidity will at some point and without changing in value, return to reasonable levels. Taking the example of a household that wants to hold one month's spending in cash, all it would take would be for spending to increase sufficiently to meet this new liquidity level. In this case, liquidity does not return to the level of expenditure, instead it is the expenditure levels that adjust. This scenario is only possible if nominal growth accelerates sharply.

Source: Lazard Frères Gestion, July 2020.

The opinion expressed above is as of the date of this presentation and is subject to change.

How else can liquidity be reined in? While the obvious answer might be to spend it, things are not quite that simple, because in 'spending', agents are simply transferring money to other economic agents who receive this liquidity in their accounts. Their respective banks will then exchange central bank reserves and the aggregate amount of liquidity remains the same. The only way to lower the overall liquidity level is to transfer it to an agent sitting outside the perimeter within which liquidity needs to be reduced, and there are three ways in which this can occur:

- Transfer to the State

This may be linked either to improved business conditions, which boosts incomes and reduces government expenditure, or to a discretionary improvement of the deficit.

- Transfer abroad

This commonly occurs when the expansionary policy is carried out in a single country: much of the recovery benefits the partner countries. Private agents' excess liquidity is directed towards imported goods and shows up in the exporting countries' accounts, with a corresponding dilutive effect. Now, stimulative policies are so widespread that it is unlikely that this mechanism will play.

- Transfer to banks/liquidity destruction

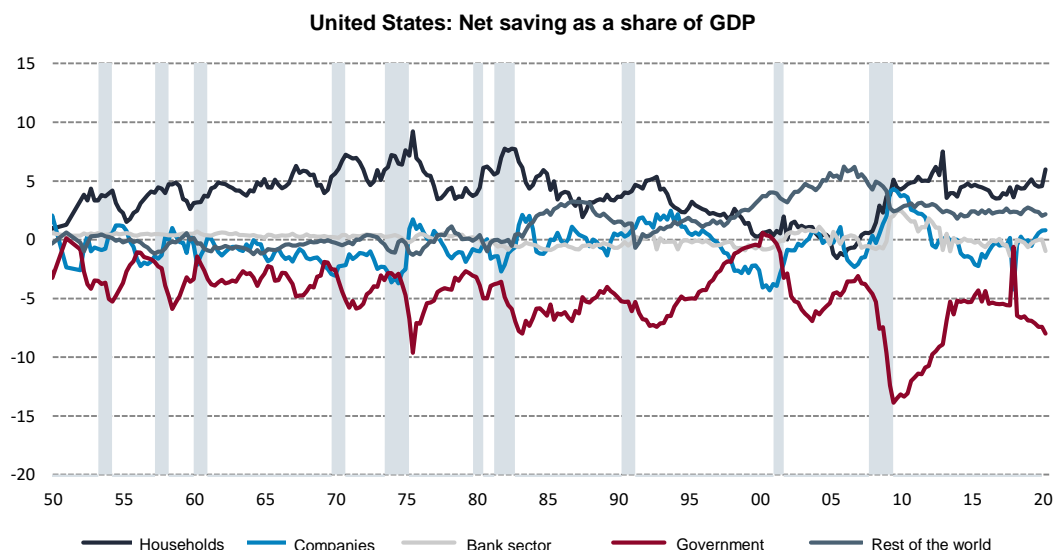
Given their ample cash positions, private economic agents may decide to suspend their otherwise normal borrowing behaviour and may even allocate some cash towards debt repayments. The result is a net cash inflow for banks and a concomitant reduction in the overall amount of liquidity. In particular, companies that have drawn heavily on precautionary credit lines may well reimburse a large part of the quantities. This cash did not correspond to any additional wealth; it came about from a cash management decision. However, can cash that comes from net government transfers reasonably be allocated to savings?

## Net financing positions: changes and outlook

Net financing positions represent a zero-sum game. If an economic agent takes on debt, it is only because of another agent's savings. The government often acts as the variable of adjustment.

Where NS = net saving, this can be expressed more formally as follows:

$$\text{Household NS} + \text{Business NS} + \text{Bank NS} + \text{Government NS} + \text{Rest-of-World NS} = 0.$$

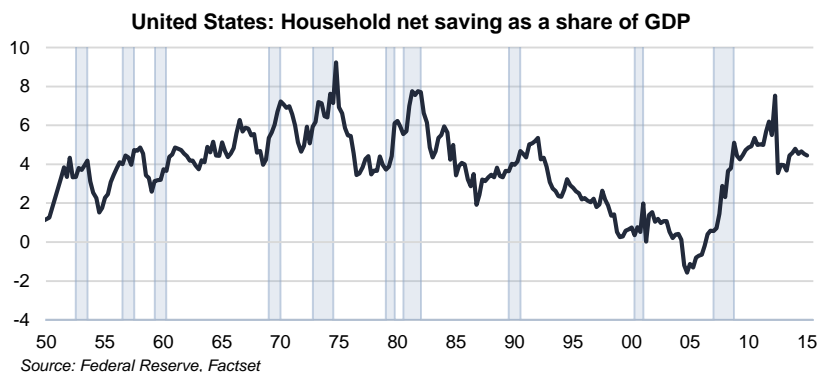


Source: Factset

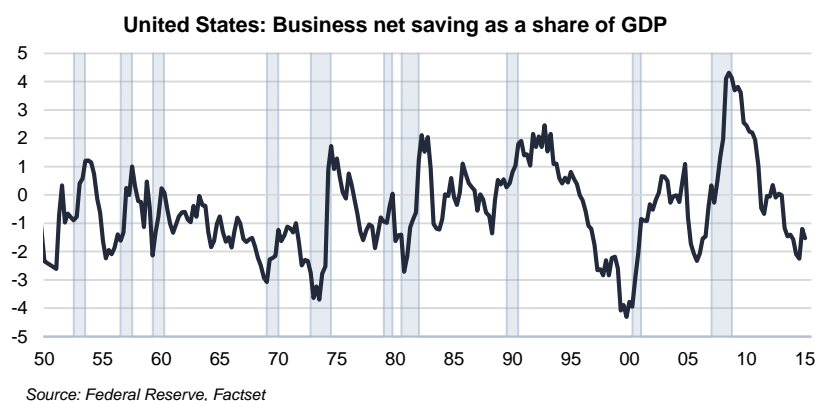
Source: Lazard Frères Gestion, July 2020.

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For example, in 2009, an expansionary fiscal policy was necessary for the US to cushion the return of households to more tenable net financing positions in the aftermath of the housing bubble.



This generally tends to be the role of the State's expansionary policy during a recession, i.e. compensating for the 'withdrawal' of the economic agent that had previously boosted growth during the expansion with unsustainable excesses (euphoric residential investment prior to 2008, and similarly excessive business investment prior to 2000 that respectively led to abnormally low levels of household and business net saving).



This time, however, and although the shock was much more violent, it does not seem that any economic agent in particular was running unsustainable borrowing as to warrant a sharp adjustment in their net financing position. It should be noted that the strong performance of the financial and property markets makes a negative wealth effect unlikely, which could otherwise have led households to increase saving.

If the government's expansionary policy has no private sector withdrawal to compensate, then the knock-on effects for the economy will be all the greater.

The risk then is that the economy is pushed too far and overheats, ultimately leading to higher inflation.

## Why not just cancel the government debt being held by the ECB?

One widely held idea is to cancel the government debt held by the ECB. Does this make sense? What are the pitfalls of such a strategy?

First, we should note that this is just a book-keeping exercise and not a real change. In cancelling the debt, the ECB would make a loss, which would normally have to be made up by the member states, causing a rise in their debt levels. Some argue that the member states should not make up this loss and instead allow the ECB's equity position to turn negative. However, replacing debt with negative equity does not chime with a healthy consolidation of the combined EU member states plus ECB accounts: this situation would have negative consequences for the credibility and independence of the ECB.

In fact, the question implicitly raised is the following: is member state debt really an issue when, via the ECB, we can ensure that it is refinanced at a low rate and for an unlimited amount and duration? Doesn't the example of Japan show that the government can incur almost unlimited debt?

Source: Lazard Frères Gestion, July 2020.

The opinion expressed above is as of the date of this presentation and is subject to change.

## Can public debt grow unfettered with no repercussions?

The simplest way to illustrate the limits of this argument is to apply it in the extreme. Let us imagine that all European states credit all eurozone nationals' bank accounts with €10 million each. Will all households really be richer? No. Not everyone will have a large town-centre upscale apartment, a country home, and a Ferrari parked in the garage. The stock of goods and services to be purchased will not change. The prices of goods and assets will adjust and, in the end, the overall level of real wealth will not have changed. However, the euro will be a persistently weak currency, with all the well-known negative consequences that entails.

Some economists argue that if moderately implemented, the benefits of this policy (i.e. economic recovery) can be reaped without necessarily experiencing the drawbacks (i.e. dilution by inflation). This would imply that the disadvantages are not proportional to the amounts involved. They would not exist below a certain level and only appear beyond that level. Unfortunately, this non-linearity is not proven and lacks substantiating evidence. And even if it were proven, it would not be reassuring as it would mean that the drawbacks of rising government debt levels could materialise all at once, when some unknown threshold is crossed. The risk is no longer that we suffer from the repercussions of the 20% GDP debt that we are currently proposing, but from those of the 80% that we have incurred over the last 40 years. Especially since the risk of an accelerated reaction is real: if, at some point, the central bank has to start raising rates to curb nascent inflation, and the government continues issuing debt to cover ongoing interest payments, then it will be impossible to stop the cycle, unless some countervailing austerity policy is implemented.

These economists argue that not even the slightest hint of a downside can be detected: inflation remains subdued, so we can take more advantage of this non-linearity and take on debt without any contrary effects. The argument is indeed tempting, especially as inflationary pressures currently appear to be non-existent.

However, for this to work, two assumptions must hold true. The first is that when the initial signs of inflationary pressure appear, it will be easy to return to a more orthodox policy. The second is that it will not be too late to act once these initial inflationary signs are detected: inertia makes controlling inflation difficult even when a more orthodox fiscal policy is implemented.

For the first assumption, it is doubtful that any return to a more orthodox macroeconomic policy would be easy to implement because in this case it would imply drastic fiscal tightening that would be even more difficult to accept as it would be new. As for the second assumption, while it is impossible to give a definite answer, given the current environment that sees reversing globalization becoming the cornerstone of several forthcoming economic policies, it may be dangerous to hope that the disinflationary pressures produced by globalization over the last 30 years will continue.

We could draw a parallel with the whisky lover who drinks a bottle a day, has a liver scan every six months and promises to stop drinking as soon as a problem is detected.

If we reject the idea that debt levels can increase indefinitely and therefore accept that they need to be reduced in order to regain some headroom to be in a position to manage any future crisis, how can this be achieved?

## How can public debt be reduced?

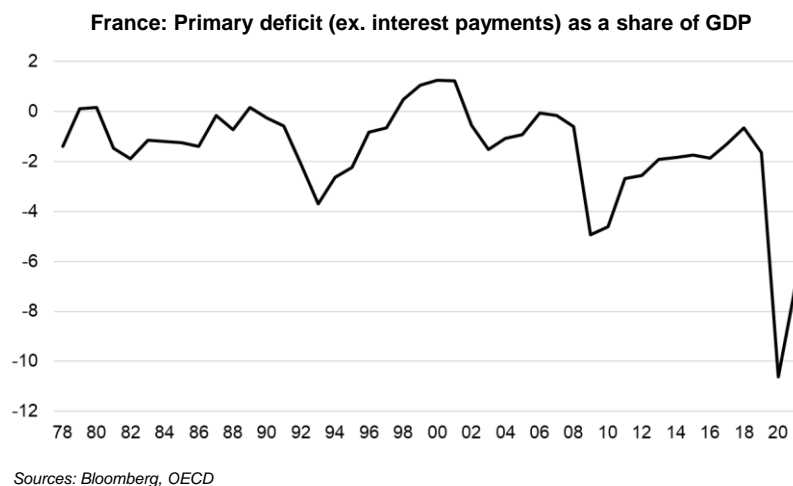
The first step, of course, is to return to a more moderate deficit to halt ballooning debt. This should not be difficult to achieve because the support measures being undertaken are only very rarely permanent. Whether it is short-time working measures, or the sending of relief cheques to households, those costs will disappear once the economy picks up again.

How can debt be further reduced? In theory, there are three solutions:

- Fiscal tightening. We see this scenario as unlikely in the very short term, as governments probably want to first ensure that the economic recovery is sustainable. This is more likely to be a question from the end of 2021 onwards.
- A spontaneous improvement due to a very positive economic climate. Extraordinary stimulus measures launched across the globe could trigger a strong pick-up in the economy, especially if the health backdrop develops more favourably than expected.
- Dilution via a rapid increase in nominal GDP, itself linked to extremely accommodating fiscal and monetary policy.

## What can we expect in concrete terms? Is drastic fiscal tightening a possibility?

As we have said, the return to reasonable deficits—say a primary deficit below 2% of GDP—should come naturally once the economy recovers and the one-off stimulus measures are behind us.



We see only a very small risk of governments being forced to implement tough austerity policies. Indeed, in our view, there are two main scenarios:

- Nominal growth remains contained despite the current surge in money supply.

The ECB then has no reason to withdraw its support and the member states are not under pressure to hasten their debt-reduction measures.





- Nominal growth settles over time at a rate of more than 6% per year for an extended period (2–3 years perhaps).

The ECB will then be pushed to adopt a less accommodating policy and to reduce its government debt purchases. A rise in interest rates will be inevitable, but only gradually impact the stock of debt, only affect new issues (around 12% of the stock per year), and probably occur more slowly than the acceleration in nominal growth. The debt-to-GDP ratio will automatically decline. Indeed, in this strong nominal growth scenario, the primary deficit will probably fall back to 1% of GDP, without requiring any particular effort to be made: the bulk of government debt is issued at a fixed rate of close to 1% on average. For France, the debt would increase in nominal terms by around 2%. With nominal GDP growth of 6%, the debt-to-GDP ratio would then fall by 4% per year, limiting the need to sharply tighten fiscal policy.

Under both scenarios, governments do not appear to be under pressure to abruptly tighten fiscal policy. The real risk for private economic agents is not so much the risk of fiscal tightening as the risk of seeing their investments being eroded by inflation. The private sector is effectively structurally a creditor and therefore the big loser if inflation accelerates. That is why central banks are independent of governments as the latter, which are structurally in debt, are not the most credible for keeping inflation in check.

## Is a new crisis in the so-called peripheral countries to be feared?

The countries at the heart of the 2011–12 eurozone crisis are among those most affected by the Covid-19 pandemic, with Spain and Italy both particularly hard hit. Even before the current crisis, Italy was struggling to restore its public finances and having to negotiate annually with the European Commission to avoid an excessive deficit procedure being triggered.

		Budget balance in %			Debt / GDP in %		
		2019	2020	2021	2019	2020	2021
<b>Espagne</b>		-2,6	-9,5	-6,7	95,5	113,4	114,6
<b>Grèce</b>		0,4	-9,0	-7,9	179,2	200,8	194,8
<b>Italie</b>		-1,6	-8,3	-3,5	134,8	155,5	150,4
<b>Portugal</b>		0,2	-7,1	-1,9	117,6	135,0	128,5

Source: IMF

As IMF<sup>1</sup> estimates show, the already high level of debt in these countries will increase significantly. The prospect of ECB support will be important to avoid any fresh crisis. Indeed, the eurozone is now equipped to avoid the soaring spreads that weighed so heavily in 2011–12, whether through the European Stability Mechanism, or through the ECB and its outright monetary transactions<sup>2</sup>. ECB purchases under the PEPP<sup>3</sup> (pandemic-related programme) could also be extended for the time it takes to return to normal.

Another positive factor for these countries is the creation of the European Commission's<sup>4</sup> recovery fund, which may amount to EUR 750 billion and from which recipient countries should be allocated funds as necessary. Negotiations over the fund are underway, but opposition from the frugal four remains limited. Germany has adopted a much more constructive stance, which should facilitate finding an agreement.

We can therefore argue that the risk of a new crisis in the peripheral countries is limited in the short term because, unlike in 2011–12, there is no desire to 'punish' countries for mismanaging their public finances. However, in the longer term, unless an acceleration in nominal growth makes it possible to reduce the debt burden, this issue will probably remain one to be watched.

## Conclusion

The Covid-19 crisis represents a major shock to the economy, as well as to public deficits and debt levels. The quantitative easing measures established by central banks are providing a short-term panacea. While the cocktail of public deficit and quantitative easing is powerful in the short term, and its limitations are quite far off, it nonetheless raises questions, and especially that of the possible impact on inflation. An acceleration would create a problem of central bank credibility but would partly solve the problem of increasing public debt. However, this would not be good news for investors in government bonds, who would see the purchasing power of their investments eroded by rising prices. We believe that this risk is greater than that of taxes rising sharply, but it has the advantage of being easier to manage: nothing forces investors to invest in government bonds at a rate close to 0%.

Source: Lazard Frères Gestion, July 2020.

<sup>1</sup> IMF: the function of the International Monetary Fund is to ensure the stability of the international monetary system and the management of monetary and financial crises.

<sup>2</sup> OMT: Outright Monetary Transactions is a program of the European Central Bank under which the bank makes purchases ("outright transactions") in secondary, sovereign bond markets, under certain conditions, of bonds issued by Eurozone member-states.

<sup>3</sup> PEPP: Pandemic Emergency Purchase Programme, temporary asset purchase programme of private and public sector securities.

<sup>4</sup> European Commission: executive branch of the European Union, responsible for proposing legislation, implementing decisions, upholding the EU treaties and managing the day-to-day business of the EU.

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