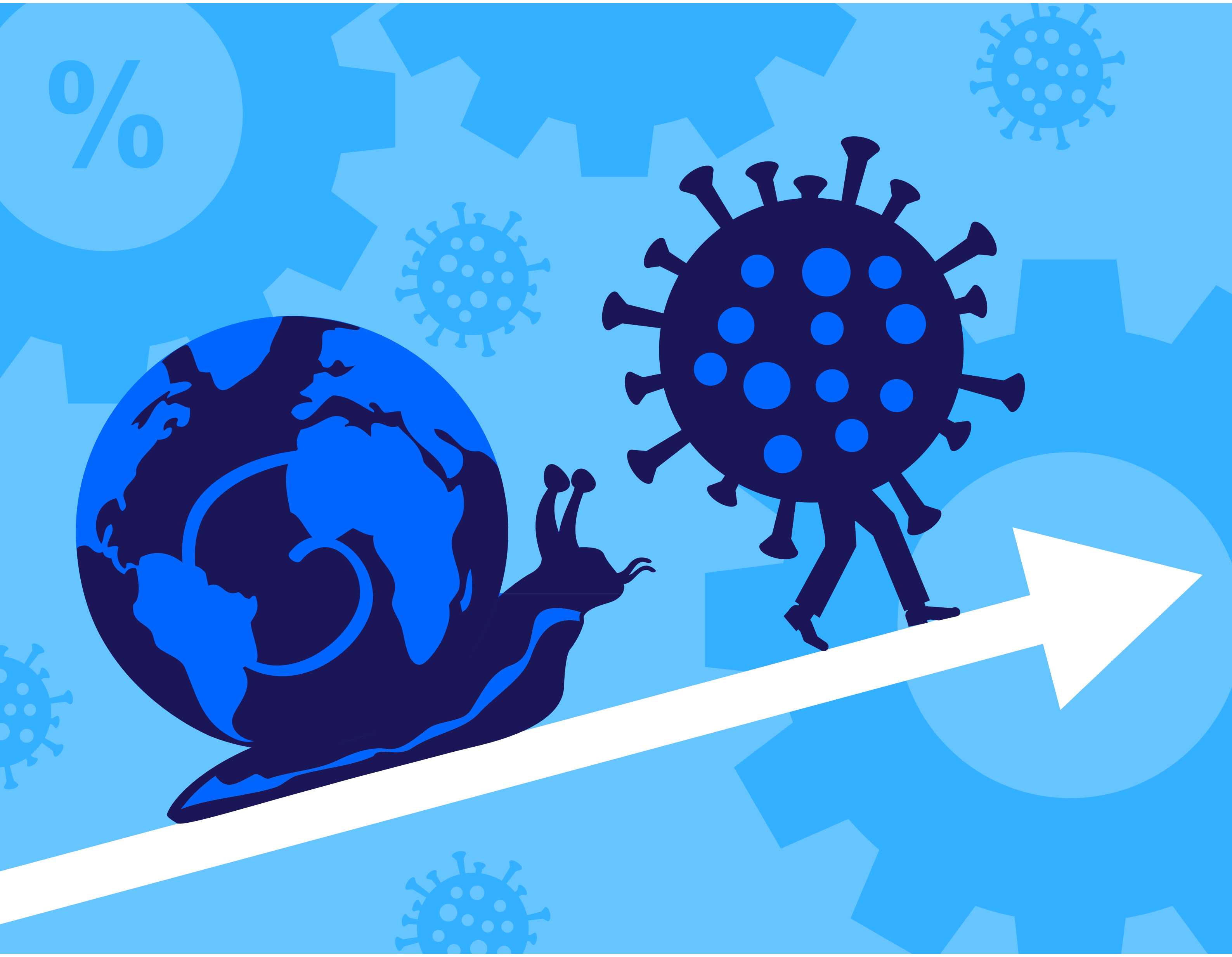
A new era of slow growth, low inflation and high debt

Q4 global forecast 2020

A report by The Economist Intelligence Unit



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A new era of slow growth, low inflation and high debt

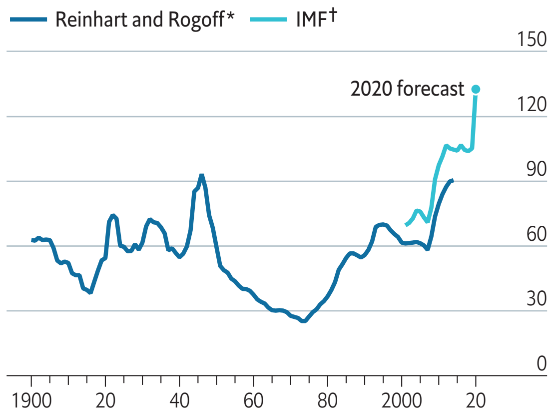
Will the pandemic turn us all Japanese?

The coronavirus (Covid-19) outbreak has prompted advanced economies to unveil extraordinary fiscal measures. So far this year G20 countries have announced stimulus programmes worth around US$11trn (or nearly the size of the Japanese, German and French economies combined). These fiscal measures have helped many companies to stay afloat, kept workers employed, and stabilised financial markets. However, they will also push fiscal deficits to an average level of 17% of GDP across OECD countries. In turn, public-debt-to GDP ratios will rise to around 140% of GDP (or US$13,000 per head) across developed economies.

In the past, such high levels of indebtedness would have alarmed economists and prompted heated discussions about which country would be the first to experience a sovereign debt crisis. However, this no longer appears to be the case. Two factors explain this shift. First, instead of depleting their (already empty) coffers, governments have enlisted central banks to finance their spending spree: over the past few months, the central banks of the US, Japan, the euro zone and the UK have created US$3.7trn in new reserves of money to buy government and corporate bonds.

Central banks now have a new role, which is quite different from their traditional one: instead of focusing on monetary policy, they are tasked with enabling governments to roll out massive stimulus packages. The sums involved are significant: over five weeks in March-April, the US Federal Reserve (Fed, the US central bank) purchased US$1.3trn in US government debt, or the equivalent of the entire federal budget deficit in 2019. In turn, the role of the state in the economy is growing as fiscal stimulus is the new king. Keeping with the US example, the Fed currently holds more than 11% of US corporate debt, giving the institution an unprecedented sway over corporate America.

Public-debt-to-GDP ratios are rising fast
(Gross government debt as % of GDP)
Advanced economies

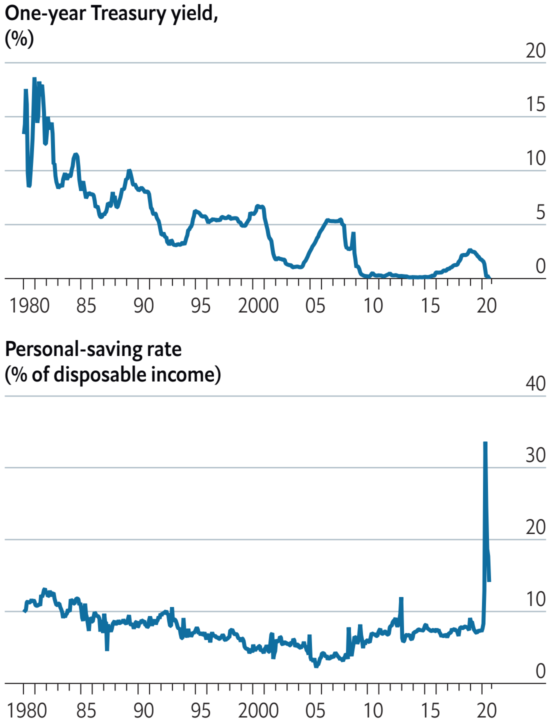


*Simple average, 22 countries. †Weighted average, 39 countries
Sources: Reinhart and Rogoff, 2009 and updates; IMF

Second, low inflation means that sovereign debt will erode over time and, crucially, cost virtually nothing to service. As Olivier Blanchard, a former chief economist for the IMF puts it, at a zero interest rate, it "does not matter whether you finance by money or finance by debt". This was not a given. There were fears at the start of the pandemic that shortages of goods or supply-chain disruptions would prompt price spikes. However, inflation has remained subdued across major economies over the past few months. In retrospect, this is not surprising: in such uncertain times, consumers prefer to save rather than to spend and businesses postpone investments, which keeps inflation in check.

Interest rates are ultra low, but savings rates are rising

US



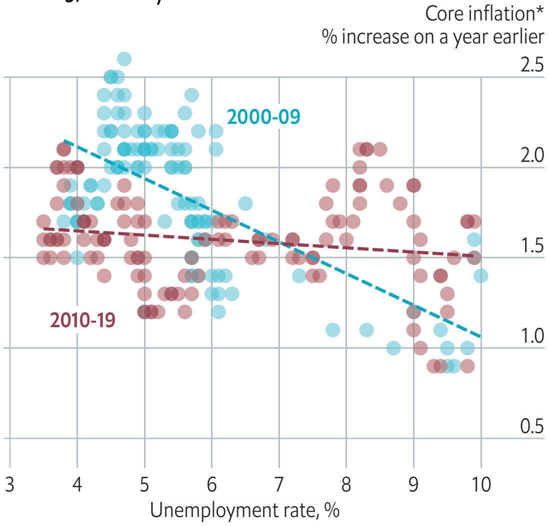
Source: Federal Reserve.

Governments are too busy dealing with the pandemic to worry about fiscal deficits, but the debt pile-up will have to be tackled eventually. Once the pandemic is over, austerity will not be a credible option. Cutting expenses takes up a huge amount of political capital, which will be in short supply once citizens start to scrutinise their governments' response to the outbreak. In addition, the pandemic has shown that years of underinvestment in public services (such as healthcare) have severe consequences. From the revenue side, tax increases are possible, but they will not be sizeable enough to narrow the fiscal shortfall meaningfully. Sovereign defaults do not appear to be a likely option, either. Investors continue to believe that US and Japanese bonds count among the safest assets. The risk of a default appears higher across some weaker southern European economies, such as Italy or Spain. However, in a worst-case scenario, there is little chance that the European Central Bank (ECB) would allow euro zone countries to sink without coming to their rescue.

This means that when it comes to sovereign debt management, advanced economies may find that they need to do precisely nothing. Over time, if nominal growth remains higher than interest rates, the debt pile-ups will simply disappear; with interest rates at zero, and assuming that fiscal stimulus manages to boost growth, this does not look like a far-fetched assumption. The governments of developed countries will hope that investors will continue to be willing to invest in their sovereign bonds: with debt-to-GDP ratios shooting up across all advanced economies, the point at which investors see sovereign debt as too risky could move up from 100% of GDP to, say, 200% of GDP. The situation appears unprecedented, but it is not. In the years that followed the second world war, the US public-debt-to-GDP ratio stood at 112%; that of the UK was more than twice that figure, at 259% of GDP.

As was the case 75 years ago, this situation creates opportunities to finance investment and research in an attempt to fuel the post-pandemic recovery and boost long-term growth prospects. However, this new normal also comes with risks. Generous furlough schemes and support measures will help to keep otherwise unprofitable companies alive, weighing on productivity and innovation and fuelling a rise in the number of "zombie" firms. The companies that benefited from government-sponsored loans will also spend years repaying their debt, instead of investing in research and development. In addition,

Low unemployment does not translate into high inflation anymore
(US, unemployment and inflation)
2000-19, monthly



*Personal consumption expenditures, excludes food and energy.
Source: Datastream from Refinitiv.

if inflation rises unexpectedly (for instance as a result of lockdown-induced shortages), central banks would have no choice but to hike interest rates to curb price growth. In turn, the cost of sovereign borrowing would spiral out of control.

This is a significant risk. In fact, traditional economic doctrine implies that inflation should rise as the recovery takes hold. One commonly accepted view is that there is a relationship between unemployment and inflation: when labour markets boom, inflation rises. If this theory holds true, governments will be in difficulty as soon as the economic picture starts to improve and labour markets recover. However, this economic precept seems to have broken down after the 2009 global financial crisis. Since then, unemployment and inflation have not moved in sync. Instead of fuelling inflation, the excess liquidity created by central banks went to financial markets. With interest rates seemingly set to remain ultra low, there is no reason to think that this will not happen again post-coronavirus.

Until the start of the coronavirus outbreak, Japan was considered an economic oddity. After the country's equity and real estate bubbles burst in 1989, the economy crashed abruptly before going through a "lost decade" of feeble growth between 1991 and 2001. The government tried to boost activity via fiscal stimulus programmes, which increased the debt-to-GDP ratio to around 240%. These measures failed, and subdued demand meant that inflation remained stubbornly low. Coupled with a bleak demographic outlook, these three characteristics—slow growth, low inflation and high debt—will become common features of advanced economies in the coming decades. The impact of such unprecedented conditions will be a game changer for the global economy. The pandemic may not last once a vaccine is found. However, the post-coronavirus zombification of advanced economies appears to be here to stay.

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