Magic Money Tree Worship

107 – 4 October 2021

Key points

- Looking into "debt ceiling crisis" mitigation, should an accident happen
- The depth of attachment of a large share of the US political class to an "ever accommodative "Fed is concerning
- Shades of central bank independence could determine Emerging Market (EM) response to higher rates in the US

Our baseline is that economic and electoral rationality will prevail and that the various factions within the Democratic Party will ultimately unite to tag an extension of the debt ceiling to a social and environmental fiscal package which, like the bi-partisan deal on investment, will be smaller than advocated by Biden in his platform. Yet, accidents happen, and we explore how hitting the limit at the middle of this month could be mitigated.

Avoiding a default on interest payments would entail cutting some non-financial expenditure. Available simulations of such an approach are consistent with a "mild recession" after one month of such regime, while the loss of standing of the US bond market could have long-lasting effects on the US interest rate premium. But this "first line of defence" would still be predicated on the US Treasury retaining enough market access to "roll over" maturing securities into new issuance. If this fails, the only solution would be for the Fed to "take out" the tainted bonds from the market. Beyond the likely postponement of the tapering this would entail, the political economy ramifications would be profound. This would be a "dream come true" for proponents of "Modern Monetary Theory": The Fed would be faced with extreme fiscal dominance, downgraded to the role of mere auxiliary of the government. A temptation, as a next step, would be to withhold interest payments on the debt held by the Fed, to gain more room for manoeuvre on non-financial payments. A dangerous slippery slope.

Beyond the mitigation of a possible although still unlikely default, we are concerned with the depth of attachment of large segments of the US political class to an "eternally supportive" central bank, which may threaten Powell's chances to be re-appointed for a second mandate. This would be detrimental to perceived central bank independence, while using ultra-loose monetary policy to "offset" constrained fiscal action would be nefarious. The structural problems of the US economy can't be solved by lower interest rates.

Central bank independence also looms large in emerging markets, as we explore whether the "taper tantrum" of 2013 can shed light on how EMs would deal with Fed tapering. A big difference with 2013 is that at the time, the foreign financial position of many EMs had deteriorated for several years. External imbalances forced monetary tightening then. Today, it is inflation which is the main challenge facing central banks there, and we take Brazil and Turkey as polar examples of how political constraints can impact the monetary stance.

Parachuting into the abyss

In the US the circular firing squad continues to assemble. **With 15 days to go before Yellen's "soft deadline" for Armageddon – the treasury hitting its debt ceiling – no political solution has yet been found**. Republicans continue to refuse a bipartisan support to a debt extension/suspension, while factions within the Democratic Party continue to fight on the size of the fiscal package on which a such extension/suspension could be tagged on a single-party reconciliation process. The market is starting to notice, with a premium appearing on treasury bills due to mature around the deadline. At this stage, it **probably makes sense to investigate some of the *technical* solutions which could alleviate the pain if need be.** We might be "staring into the abyss", but there are some parachutes if we fall. It's just that they are not very palatable.

This is not the first time we have to consider this, and we highly recommend our readers to read this transcript of an October 2013 conference call at the Federal Reserve (Fed) – possibly with a stiff drink in hand if you are allergic to market volatility. Ever the forward-looking leader, then-Chairman Bernanke opened the call by stating that *"the minutes of this discussion might be a potentially useful way to communicate some of our thinking to the markets in preparation for another episode, which, unfortunately, seems more likely than not to occur at some point"*. Indeed!

The first line of defence would not involve the Fed. The Treasury could roll-over existing securities by issuing new debt just enough to cover the maturing bills and bonds as they expire, thus keeping the overall quantum of debt unchanged, complying with the debt ceiling regulation. But it would be in breach if it issued debt to cover interest payments too. To avoid a default, the treasury would then have to prioritize interest expenditure over some non-financial spending. In clear, a disproportionate share of federal tax income would go towards serving interests to bond bearers. This would be complex to work out in practice, since tax receipts are concentrated in the year – with a large share coming in April, and a smaller one in September. The treasury would thus have to cut non-financial spending enough to create cash buffers allowing for the immediate interest payments. Moreover, more than 20% of planned federal spending was intended to be covered by debt issuance anyway (the US government runs a large primary deficit).

The US government would have to choose every day, as long as a debt extension is not voted, which non-financial items to cut into. However, two-third of those are so-called "mandatory" programmes (chiefly Social Security, Medicare, Medicaid, the three big federal social programmes) which would probably be prioritized. The Bipartisan Policy Centre, a think tank, has looked into the figures quite precisely. They posited the debt ceiling was hit on 15 October, with a suspension/extension kicking on 15 November. They identified USD401bn of priority expenses coming due during these 30 days, more than half of it coming from the main social programmes, 67bn in interest payment, the rest being made of mostly military and civil payroll expenditure. In their calculations, **the US governments would be forced to suspend more than USD265bn of discretionary payments. This would be equivalent to 5.2% of quarterly GDP.** No small beer, even if there is a subsequent catch-up. A simulation by the Fed in October 2013 – complementing the conference call mentioned above – combining a direct shock from suspended payments with the second-round effects from higher interest rates and restriction in bank lending concluded that a 30 day "debt ceiling crisis" could trigger a "mild recession" over two quarters. Besides, beyond the immediate contraction, the US economy would have to bear the long-term cost of the erosion of its "safe haven" status for international investors, triggering a permanent rise in the country's risk premium, as noted by a recent paper by Brookings.

Yet, we should still see this scenario as "rosy" because it is predicated on the US government retaining market access. Indeed, a key assumption there is that the Treasury could still hold successful auctions to issue enough to pay back the maturing principals. There is of course a risk that investors would shun treasury bonds and bills as long as the debt ceiling issue is not resolved**. In this case, the only workable course of action would be for the Fed to step in and "take out" the defaulted debt from the market**. Quantitative easing (QE) would stop being a monetary policy tool to become a government solvency instrument. This option was openly discussed in the October 2013 conference call.

Let's push the logic of this option to the full. Beyond the obvious fact that it could delay the announcement and implementation of tapering, which timing would become dependent on the resumption of normal treasury issuance and the absorption of the macro shock, the ramifications in terms of political economy could be profound.

The Fed would have a hard time committing to a pre-set quantum of buying. If the market seizes up, they would be forced to buy whatever "tainted" treasury bonds there are, and beyond**. It could then become tempting for the government to stop prioritizing coupon payments over non-financial expenditure**, at least for the (growing) share of federal debt held by the Fed. **The debt ceiling crisis would have created the conditions for what the proponents of Modern Monetary Theory (MMT) have been calling for: full-on debt monetization, in a situation of extreme "fiscal dominance"** where the central bank's role is downgraded to a mere auxiliary of the Treasury. Since this would coincide with the ongoing inflation spike, and even if there would be no causal link, this would understandably cast a doubt on the capacity of the Fed to stay true to the price stability component of its mandate.

We are not there. At his latest Senate hearing on 22 September Powell stated that *"no one should assume the Fed or anyone else can fully protect the markets or the economy in the event of a failure [to solve the debt ceiling crisis]"*. Last week he was even more explicit, answering when probed on the Fed's involvement in a "debt ceiling" mitigation exercise that "*these are things that we really would not like to do*".

Still, **a problem with even the mere possibility of a central banking solution to the debt ceiling is that it can incentivize lawmakers to push their game further** and sit on their current, uncompromising positions. If the Fed's "magic money tree" is seen as eternally giving, otherwise dangerous options can be more easily explored in the fiscal realm. We note that during the November 2013 conference call, Jay Powell – already at the Fed – did not so much push back on the Fed ultimately stepping in, but argued that *tactically it* would be wrong for the Fed to create the assumption of "bailout". Janet Yellen was there as well and argued against being too "talkative" on mitigation plans, but she also concluded one of her remarks with *"never say never"*.

The wrong trade-off

We think the baseline should remain that a crisis of this nature should be averted. Even if the Fed would probably step in in case of technical default, politically, since the Democrats are in power, they would probably take a lot of the blame for such a demonstration of division and general helplessness. Note as well that it is their electoral base which would have the most to lose in case of a suspension in federal payments. Yet, we are concerned with the depth of attachment of large segments of the US political class to the notion of an eternally supportive central bank, which may threaten Powell's chances to be re-appointed for a second mandate (the current one expires in February 2022).

Last week, Senator Warren launched a scathing attack against Powell just when Bernie Saunders urged the "progressive caucus" within the President's party to reject the bi-partisan deal on public investment painstakingly negotiated by Biden if the moderate Democrats in the Senate (Manchin and Sinema) refuse to endorse the USD3.5tn social and environmental spending package (it worked: Pelosi gave up on getting the bill through last Thursday). We are tempted to join these two threads since they might signal **a very dangerous trade-off in the US: using hyper-loose monetary policy to try to offset an incapacity to deliver more stimulative fiscal policy.**

Let's first take a bit of distance from the current "debt ceiling drama". The latest US election cycle delivered the presidency to Joe Biden, but with a razor-thin advantage in the Senate and a reduction in the Democrats' majority in the House. This hardly indicates a strong popular mandate for the progressive economic platform of the Democrats. **Larry Summers' concern last winter, that Biden would squander his political capital on a short-term fiscal stimulus mainly directed at supporting consumption, to the detriment of what is the most important underlying issue in the US economy – re-starting investment – is getting everyday more prescient, in our view**. The size of the February package is now being used by the moderates within the Democratic party to justify their opposition to the next round of federal spending. This was made crystal clear in a recent statement by Manchin, who continues to mention USD1.5tn as a maximum. Biden himself is reported as saying that the final deal would be in a 1.9 to 2.3tn ballpark.

On the investment side, the bi-partisan package was already only a fraction of the infrastructure boost Biden was advocating during the campaign (out of the 1.3tn, only 0.55 is really new money)– and also probably a fraction of what the US actually needs after years of neglecting public investment. If it is torpedoed by the left of the Democrats in the House, would this truly incentivize the moderates in the Senate to reconsider and flip to supporting a USD3.5tn plan? We seriously doubt it. Indeed, Manchin's opposition to the programme has at least as much to do with its strong "green flavour" – he hails from a coal state – than with his commitment to fiscal purity. The Democrats – and Biden less than one year into his mandate – would probably lose on both fronts: the already shrunken investment programme would be ditched, for no gain on social and environmental spending. Not much in terms of achievement a year before the half-term elections.

This is where Warren's attack on Powell gets interesting. So far, he has drawn applause from the Democrats for his commitment to an accommodative monetary policy – as well as his acceptance of an inclusion in the Fed's rationale of equality concerns (e.g. considering how progress towards aggregate full employment is distributed across ethnic groups). However, his prudent march towards policy normalization is now drawing criticism. Faced with the prospect of quantitative easing coming to its end under Powell, **the left of the Democrats may be looking to a successor who would continue to keep the taps on**. Even if we don't get to the point where the perspective of a federal default forces the Fed to monetize, **the central bank would be kindly requested to do what fiscal policy could no longer do for lack of a large enough majority in Congress by maintaining an accommodative monetary policy "forever"**. Beyond this economic "rationale", there could be a tactical consideration for Biden: if he can't provide his left flank with enough fiscal giveaways, he could be tempted to placate them by offering them a new, more progressive head at the Fed.

Such approach would be dangerous from at least two angles. First, it would be eerily resemblant to the "abdication" of the Fed to political pressure in the late 1960s/early 1970s, after Johnson's conflict with the central bank upon the monetary accommodation of the "Big Society" programs and the Vietnam war. We are generally sceptical about the chances to rekindle the kind of inflationary drift seen 50 years ago in the near future, but a Fed under political influence would be a key ingredient to get there.

The second is less spectacular but still quite nefarious: **the underlying issues of the US economy can hardly be addressed by monetary policy.** Central banks can do a decent job at smoothing the cycle and from this point of view they help sustain potential growth (by avoiding "hysteresis effects" from a collapse in investment and employment), but they can't lift it. That's the job of structural policy – e.g. promoting technological innovation – or fiscal policy – e.g. public investment improving the quality of infrastructure, public spending on education. An accommodative monetary policy can help fund these efforts, but maintaining an overly loose monetary stance without even the justification of supporting structural action is likely to only exacerbate financial stability concerns, the liquidity poured into the economy by the central bank is likely to end up essentially in higher prices for houses and financial assets. How big is this risk? Some of the names regularly mentioned to replace Biden who would get support from the Democratic left, such as Lael Brainard, would not necessarily end up proving a monetary policy radically different from Powell's… but optics matter.

Meanwhile, the US political process remains obscure. One of the solutions we explored in our previous Macrocast – detaching a continuing resolution avoiding a government shutdown until December from the debt ceiling extension – has materialized last week. But on the latter, if the warring factions within the Democratic Party can't agree on how the investment and the social/green package can be combined, they can't on their own resolve the debt ceiling issue. This puts the Republicans on the spot as well, but for now they are refusing to budge. The Democrats have passed in the House a resolution to lift the debt ceiling last week which they will table to the Senate on Monday 4 October, but the Republican caucus has already made it plain it would refuse to support it. Ultimately, we think that economic and electoral rationality will prevail and Democrats will reluctantly unite around Biden's "ball-park", but it could be two long weeks ahead.

Tapering and EM

For some time, we have been focusing exclusively on developed countries and we want to turn our gaze to emerging markets as potential victims of the current US situation. Either – our baseline – a solution is found to solve the debt ceiling, and then short of a massive deterioration in the data flow by the next Fed meeting on 3 November tapering starts, which is potentially bad news for capital flows to EM, or the uncertainty triggered by a sovereign "technical default" in the US generates a general "flight to safety" – we would expect German yields to plunge – detrimental to EM.

Historical precedents may not be good guides this time though. Indeed**, in 2013, the taper tantrum and the associated "sudden stop" in capital flows to EM occurred while the external indicators of the key emerging markets were deteriorating** (Exhibits 1 and 2). With domestic saving unable to take up the slack left by departing foreign money, market interest rates shot up. Most EM central banks engaged in a growth-arresting monetary policy tightening to i) dampen domestic demand to rebalance saving and investment quickly and ii) re-create incentives for external capital to flow back. This time, the rise in US yields is not happening in a generalized context of deteriorating current accounts in EMs. Any "sudden stop" in capital flows could be more easily absorbed by domestic saving. **The problem however is in 2021 inflation is on the rise, while it was generally not an issue in 2013.** This is ultimately what is forcing many central banks in emerging markets to hike. Not hiking in a context of rising interest rates in the US would be akin to accepting a depreciation in the currency which would further boost inflationary pressure. EMs are faced with a "traditional" monetary policy problem, rather than the external adjustments of old.

Exhibit 1 – CA deterioration in the run-up to 2013

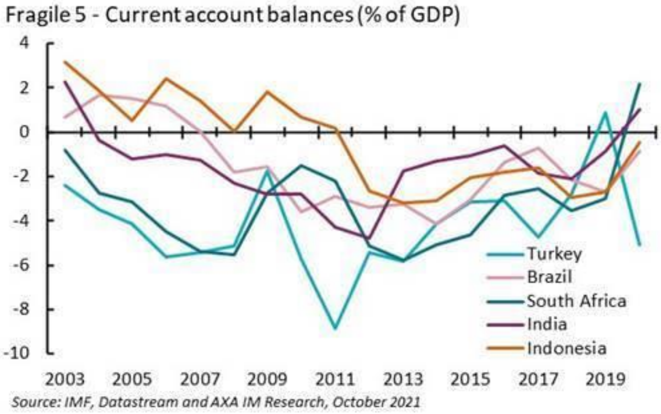
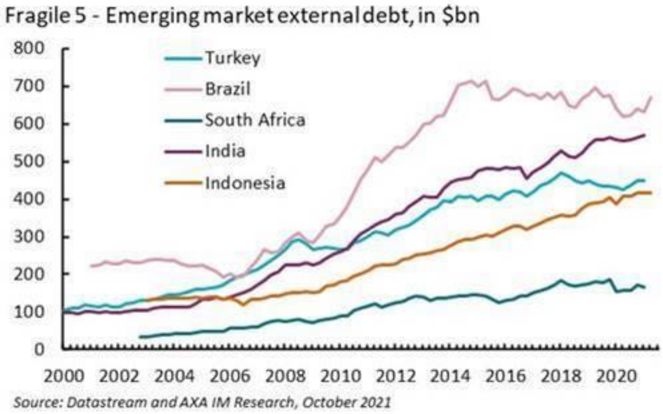


Exhibit 2 – Slower foreign debt buildup in some key EMs



But that state of affairs leaves us with the institutional/political constraints in some of the key countries. We are taking here two "polar" examples: Brazil and Turkey.

Brazilian monetary policy touched peak accommodation with a policy rate at 2% in August 2020, three months after inflation rates as well hit their lowest point in history at a mere 1.9%. Since then however inflation has returned to hit double digits in September 2021 for the first time in 5 years, with more signs of material second-round effects from the food and energy shock to services and industrial goods. The *Banco Central do Brasil* (BCB) started hiking interest rates in March 2021, to a cumulative 425bps to 6.25%, and appears set to keep on hiking rates by 100bps in each of the next couple of meetings, and likely to reach 8.25% by year-end and to its peak at 9.25% by Spring 2022 after clearly stating that a tightening to a significantly restrictive level was the most appropriate strategy.

After three decades, Brazil's constitutional plan for an independent, credible, and accountable central bank is finally complete. A bill took effect early this year, granting "technical, operational, administrative, and financial autonomy" to BCB. Arguably the central bank has been operating rather independently for decades, but it is now enshrined in a federal statute. **BCB is probably keen to make full use of this newly gained autonomy to establish itself ahead of the general elections in October of next year**, which are likely to oppose to spendthrift candidates (the incumbent and Lula da Silva). Note that the central bank highlights fiscal risk as an upside risk for its projected inflation path.

Conversely, the Turkish central bank (TCMB) unexpectedly decided to cut its policy rate by 100bps in September, to 18%. Markets had already integrated the direction of travel, meaning that the next TCMB move was expected to be a cut, but only towards the very end of the year when important base effects would bring down annual inflation rate. True, the absolute level of rates was high – albeit not in real terms – **but this early start to an easing phase is making another visible dent in central bank's independenc**e. The latest inflation print was not far from four-fold the central bank's official target of 5%. The current bank's governor, M. Kavcioglu, is the fourth appointee to the role since 2019. He had kept interest rates at 19% since taking office in March, and finally cut after President Erdogan explicitly called for a cut last month. To justify its stance, the Turkish central bank borrowed from the language of the big global central banks, claiming that inflation tensions are transitory. That is technically true, but it still feels awkward given the specific situation of Turkey: inflation has been on a rising trend since its recent low in October 2019 when inflation was already 7.3%, above the TCMB's target.

Exhibit 3 – Back to (too) familiar territory

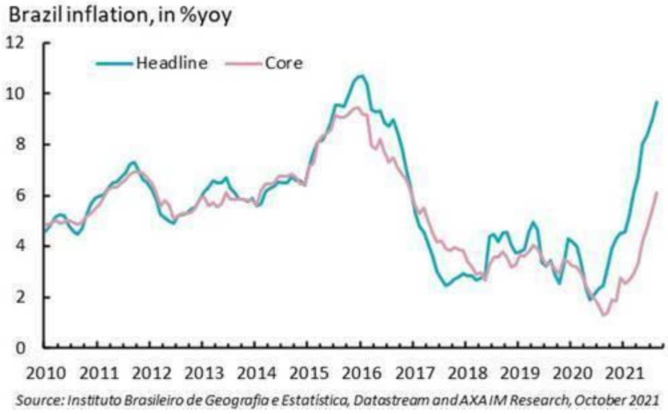
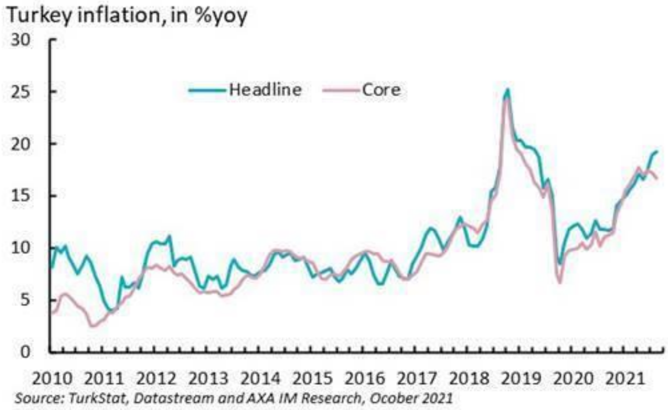


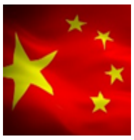
Exhibit 4 – Well above target



Monetary policy is used again by the administration to reignite economic activity at a delicate time for the government. The President's popularity has been falling almost uninterruptedly since the start of the pandemic. Elections are set for 2023, though an earlier poll could be called by the government, facing criticism over its handling of the pandemic and the state of the economy. Opposition is gaining ground and in the latest polls, the incumbent president would already lose in front of either Istanbul or Ankara mayors.

Exhibit 5 – Headwinds from China

So, in a nutshell, concerns over EMs have less to do with any direct impact from rising rates in the US and more with the inflationary challenge, whether or not it is addressed head-on by their central banks. To complicate matters further, over the last 15 years, the economic cycle in EMs has often been driven by the gyrations in Chinese demand (Exhibit 5). The current slowdown is not going to help.

Country/Region	What we focused on last week	What we will focus on in next weeks
	• Govt shutdown avoided, funding until 3 Dec • Debt ceiling still issue, Tsy Sec Yellen pointed to 18 Oct as potential critical date • House vote on bipartisan package was delayed into next week as progress in talks continues • Q2 GDP revised slightly to 6.7% (from 6.6%) • PCE inflation (Aug) edged higher to 4.3% (peak), with core remaining at 3.6% • Consumer spend (Aug) up 0.7% on month • Fed hawks Kaplan and Rosengren step down	• Relentless march to 18 Oct debt ceiling deadline – expect no progress this week • Democrats to marshal spending plans • Payrolls (Sept) expected to make modest rebound, but COVID and Hurricane Ida to dampen, clouding outlook for Fed taper • Weekly consumer confidence watched after 4 successive declines reflecting elevated inflation • ISM serv's index (Sept) – drop to Aug leaves index around previous series high at 61.7
	• German election results broadly in line, with SPD largest votes. Coalition negotiations begin • Lagarde speech from ECB's Sintra forum warns against overreaction to short-term events • EZ CPI inflation reaches 3.4% – 13yr high • European gas futures hit record €100/MWh	• ECB account of Sept meeting, gauge balance of PEPP adj based on fin conditions or inflation • Industrial output (Aug) for Ge, Fr & Sp, looking at scale of supply constraints • Services PMIs (Sep, f) with first est's for It & Sp EZ PPI inflation (Aug) – any moderation
	• Q2 GDP was unexpectedly revised upwards to 5.5% (from 4.8%), HH spend largely unchanged, but investment and net exports revised sharply. • Panic buying leads to fuel shortages. Expect this to weigh on Sept GDP • BoE's Mann highlights transitory inflation	• Resolution of fuel shortages • Services PMIs (Sep, f) dipped to 54.6 on prelim reading – softening from post-lockdown high • RICS housing data releases to point to ongoing housing strength post Stamp Duty holiday • New car registrations – supply-chain constraints
	• LDP elects Kishida as new leader, party reshuffle including replacing Fin Min Aso, election expected 7 Nov • Tankan survey (Q3) up above exp +18 (14) • Ind prod (Aug) -3.2%, (-1.5% Jul), risks Q3 GDP	• Confirmation of November election date • Tokyo CPI inflation (Sep) to confirm rise after drop in Aug • Leading indicator (Aug), remain elevated • Current account/trade (Aug), expect drop
	• Spreading power shortages causing electricity rationing adds another risk to the economy Markets take a breath amidst ongoing Evergrande saga, but situation remains fluid	Manufacturing activity should weaken due to power shortage, while the services PMI may improve as COVID impact fades
	• CB: Angola, Ghana, Kenya and Thailand stood on hold; Mexico +25bp to 4.75%, Colombia +25bp to 2.0%; Czech Rep. +75bp to 1.50% • Sep inflation picked up pace in Poland (5.8%yoy) and Indonesia (1.60%yoy) • IP (Aug) fell in Taiwan (13.7%) and Singapore (11.2%); it expanded in Korea (9.6%)	• CPI figures for September across EM countries • CB: India (on hold at 4.0%); Romania (on hold at 1.25%); Israel (on hold at 0.10%) • IP (Aug): Argentina, Brazil

Upcoming events	US:	Mon: Factory orders (Aug); Tue: Trade balance (Aug), Services PMI & ISM non-manu (Sep); Wed: ADP survey (Sep); Thu: Weekly jobless claims (2 Oct); Fri: Non-farm payrolls (Sep
	Euro Area:	Tue: EZ Services PMI (Sep,f), EU19 PPI (Aug), Fr ind prod (Aug); Wed: EZ retail sales (Aug), Ge new manu orders (Aug), Sp ind prod (Aug); Thu: ECB minutes, Ge ind prod (Aug); Fri: Ge current account (Aug), Ge trade balance (Aug)
	UK:	Tue: New car registrations (Sep), Services PMI (Sep,f); Wed: Construction PMI (Sep); Thu: RICS housing survey (Sep), Halifax house price indx (Sep)
	Japan:	Fri: Current account balance (Aug), Trade balance (Aug)
	China:	Tue: Industrial profits (Aug); Thu: Official manu & non-manu PMIs (Sep), Caixin manu PMI (Sep)Thu: Foreign exchange reserves (Sep); Fri: Caixin Services PMI (Sep)

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