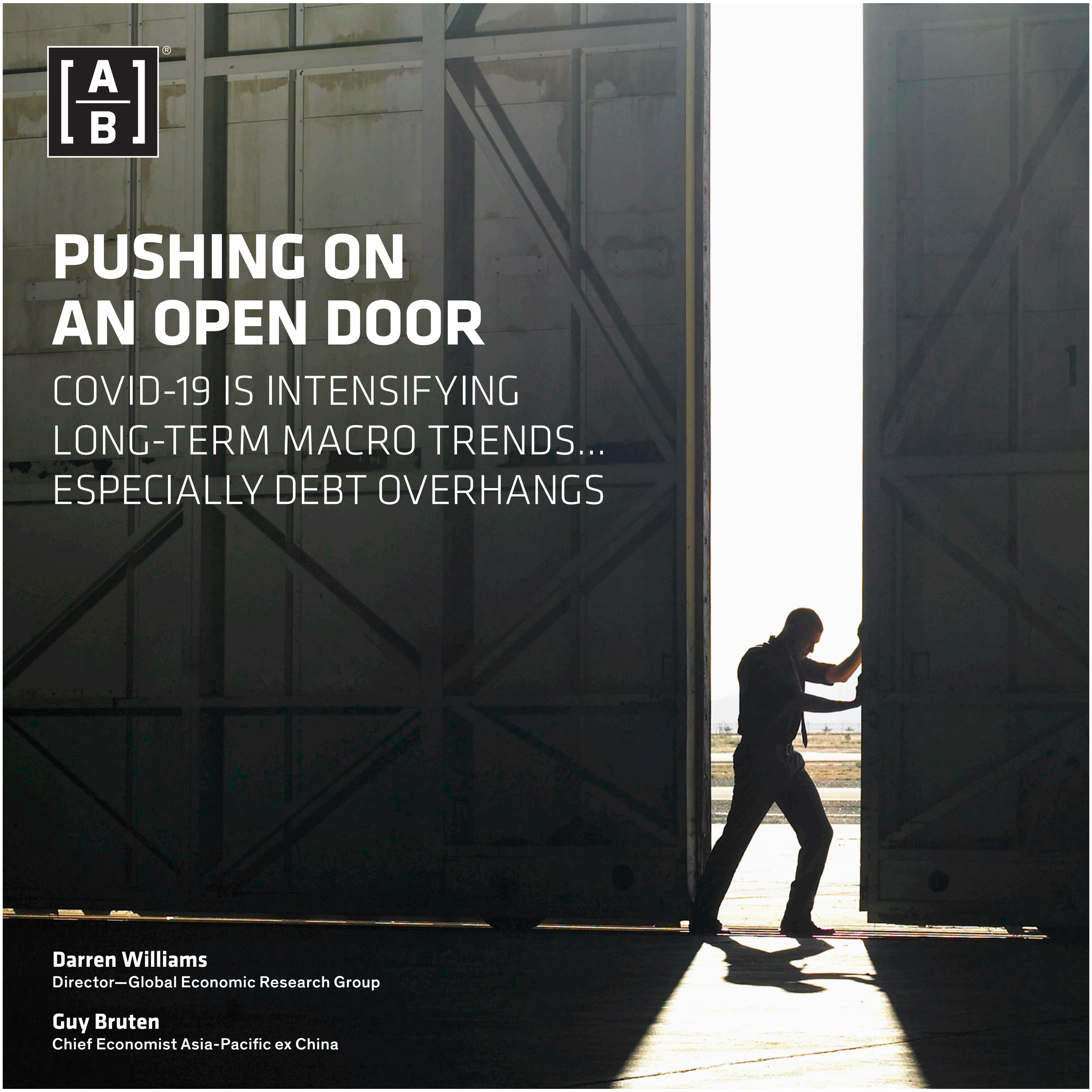
SEPTEMBER 2020



PUSHING ON AN OPEN DOOR

COVID-19 IS INTENSIFYING LONG-TERM MACRO TRENDS… ESPECIALLY DEBT OVERHANGS

Darren Williams
Director—Global Economic Research Group

Guy Bruten
Chief Economist Asia-Pacific ex China

IN THIS PAPER: The COVID-19 pandemic has had historic—and nearly immediate—repercussions for society, the global economy and policy. The aftereffects will last for many years, reinforcing long-term trends, including deglobalization, populism and mounting debt. How will governments tackle the debt overhang—and how do these trends impact our macro views?

COVID-19: A HISTORIC ECONOMIC IMPACT

By the summer of 2020, the world was six months into the COVID-19 pandemic. The first wave alone is more expansive—and global—than other 21st-century outbreaks, including severe acute respiratory syndrome, Middle East respiratory syndrome and even Ebola.

The economic impact of COVID-19 is already historic. To control spread of the virus, governments brought a sudden halt to economic activity with social distancing restrictions and shutdowns, causing massive labor-market dislocations. The scale of the public-health, monetary and fiscal response is simply unprecedented.

If these actions are successful, restrictions will eventually be lifted and economies should recover. But what happens after the initial bounce? Prior to the pandemic's outbreak, we sketched out five long-term trends that we believe will drive an environment of weak growth, a deteriorating growth-inflation mix and, ultimately, a shift to higher inflation itself:

+ A negative supply shock from demographics
+ Weak productivity growth
+ Resurging populist policies
+ Rising geopolitical competition and conflict
+ A mounting debt overhang

Will COVID-19 reinforce these trends, counter them or have no effect? The pandemic has already ushered in major changes. For consumers, movies and airline travel are now off the menu, while for producers, densely packed workspaces are a thing of the past. Failed and bankrupted businesses and financial-sector impairment from collapsing asset prices and bad debt will not be uncommon. And even as restrictions are gradually eased, it may be a long time before people feel safe returning to "normal" behavior.

But the pandemic's easiest path to influence long-term macro outcomes is where it's pushing in the same direction as long-term trends that are already under way. Think of this as pushing on an open door.

COVID-19 WILL LIKELY INTENSIFY DEGLOBALIZATION

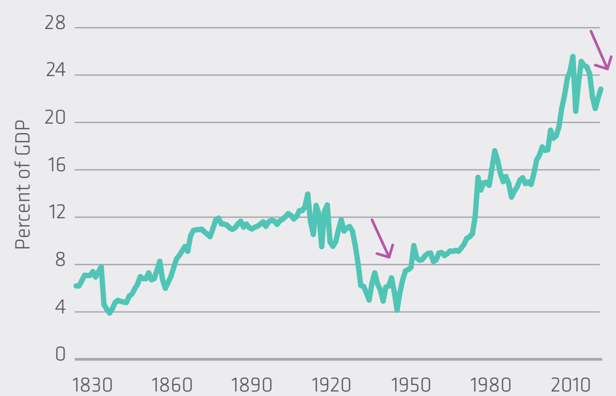
Globalization is one of those open doors, given its apparent peak before the pandemic arrived. A simple way to visualize the globalization trend is by looking at the ratio of exports to gross domestic product (GDP). This ratio rose steadily as globalization made headway in the decades after World War II. More globalization meant more goods and services shipped outside national borders.

Since 2013, though, this trend has started to reverse (*Display 1*), partly because the global financial crisis (GFC) revealed flaws in global supply chains—notably the reliance on trade financing. Technology—automation, in particular—is pushing on the open door, too, by making onshoring production a viable option versus offshoring to low-wage-labor nations. And, of course, the institutional framework for free trade has been shaken by trade wars, due in part to a resurgence in populism.

COVID-19 arguably pushes the open door for deglobalization even further, revealing more supply-chain flaws concentrated around single points of failure. Regions of the world that had been more globally connected or networked have felt a deeper impact. But this isn't just about supply chains; indeed, escalating geopolitical conflict between China and the West in the wake of COVID-19 threatens to push the deglobalization door wide open.

DISPLAY 1: THE EBBING TIDE OF GLOBALIZATION

World Exports as a Percentage of Gross Domestic Product



Historical analysis does not guarantee future results.

Through December 31, 2018

Source: Haver Analytics

POPULISM SHOULD MAKE FURTHER ADVANCES

Populism is another point of intersection between long-term themes and COVID-19. Some argue that populism may have peaked already, given that several populist-led countries have struggled to address the pandemic, including the US, the UK and Brazil. Populist leaders in those nations have faced severe blowback and tumbling approval ratings.

As we see it, COVID-19 is actually stoking the drivers of populism we've previously identified: stagnation and inequality in income and wealth, rising national identity and social insecurity, and political ineffectiveness. Younger, low-skilled workers have been among those hardest hit by economic shutdowns, and COVID-19 has been more prevalent in low-income areas and those in which minorities form a majority.

Given the link between COVID-19 and populism, we're already seeing advances in the three channels through which populist policies emerge: (1) greater trade protectionism (with clear implications for deglobalization), (2) the erosion of traditional institutions (including the undermining of central bank independence and greater use of fiscal policy) and (3) income redistribution.

UPWARD PRESSURE ON DEBT OVERHANGS

Perhaps the most important area in which COVID-19 is reinforcing an existing long-term trend, though, is rising debt (*Display 2*). Public sector debt in developed economies had already hit record highs before COVID-19, and massive fiscal support measures could lift it by 20% or more of GDP in many countries. How governments choose to deal with the debt overhang will have a huge influence on the secular outlook.

Some observers, such as Nobel laureate Paul Krugman and Martin Wolf of the *Financial Times*, have argued that there's nothing unusual about such elevated debt levels, pointing out that UK government debt has often been above 100% of GDP. But this is disingenuous and ignores the historical role of wars in driving government debt higher, in the UK and elsewhere. Until recently, the norm during peacetime was for government debt to fall, not rise.

This is where the UK does make an excellent case study (*Display 3, page 3*). From the end of the Napoleonic Wars through the start of World War I, national debt fell by a staggering 200 percent of GDP. And the UK repeated this trick, in an even shorter time period, in the three or four decades after World War II.

How did the UK government pull this off? In both periods, it ran very large primary budget surpluses (in other words, excluding interest payments), which helped lower the debt burden. Economic growth also played an important positive role, particularly in the strong growth period following World War II.

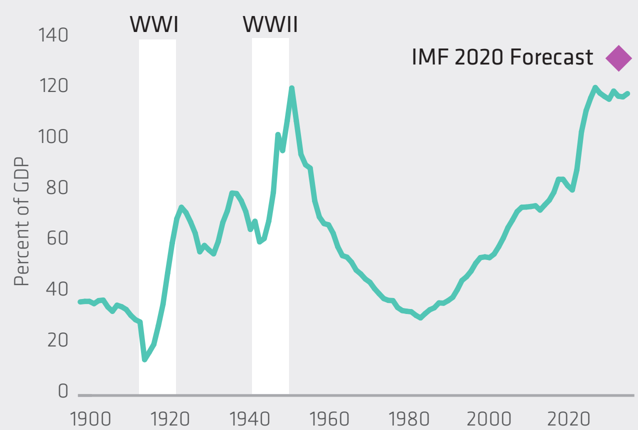
USING LOW (AND NEGATIVE) RATES AS A DEBT-MANAGEMENT TOOL

But there's a key difference between those two eras, with important implications for the scenario the developed world faces today. From 1816 through 1919, real interest rates in the UK were strongly positive, creating a headwind for debt-reduction efforts. After World War II, real rates were negative, which helped reduce debt by about 3% of GDP per year.

The UK wasn't the only country to benefit from negative real interest rates after World War II. Using a technique called "financial repression," many countries (including the US) held nominal interest rates below inflation during this period to help deal with their debt mountains. Over time, this led to a substantial erosion in the real value of government debt (*Display 4, page 3*).

DISPLAY 2: DEVELOPED-MARKET DEBT BURDENS HAVE SOARED

G7 Gross Government Debt as Percent of GDP



Historical analysis does not guarantee future results.

Through June 30, 2020

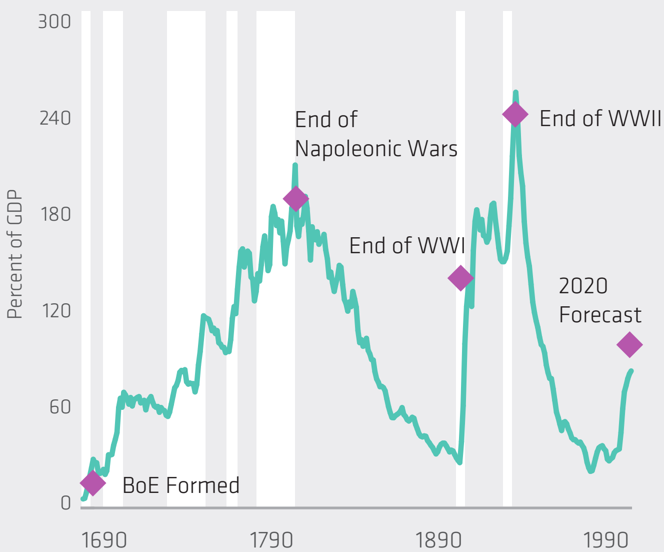
Source: Haver Analytics, International Monetary Fund (IMF), Jordà-Schularick-Taylor Macrohistory Database and AB estimates

SO HOW DO THE VARIOUS DEBT-REDUCTION ALTERNATIVES STACK UP THIS TIME AROUND?

Strong economic growth would, of course, provide the resources to work off government debt. But relying on a sustained period of strong growth in the decades ahead seems like wishful thinking at this point. Austerity has been tried and has failed—and faces even bigger hurdles in today's populist world. Outright default or debt restructuring is also an option. But this is surely the last resort—and, as we'll see, an unnecessary one for countries that have the power of the (monetary) printing press.

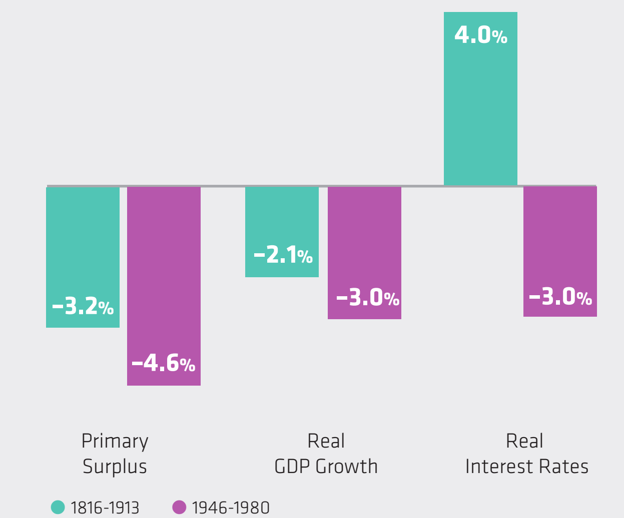
DISPLAY 3: A TALE OF TWO DEBT REDUCTIONS

UK National Debt*



Annual Contributions to Change in Government Debt†

Percent of GDP, Annual Average



Historical analysis does not guarantee future results.

As of June 30, 2020

***** Shaded periods represent wartime. **†** A negative number means that this component helped lower government debt.

Source: Bank of England (BoE), Haver Analytics, IMF, Jordà-Schularick-Taylor Macrohistory Database and AB estimates

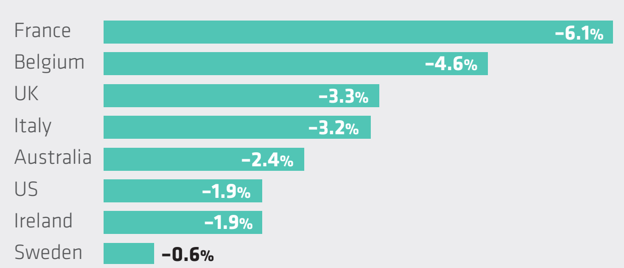
All things considered, history suggests that financial repression is an effective and relatively painless choice, especially when it's accompanied by modestly higher inflation.

Inflation, of course, is largely absent in developed economies today. But an ultralow interest-rate regime is entrenched and is once again reducing the pressure on governments to manage debt levels that have soared since 1970 (*Display 5, page 4, left*). We can see the impact of the low-rate effect in government debt-servicing costs, which have tumbled in recent years despite the remorseless increase in debt (*Display 5, right*).

The key question is whether low interest rates are part of the solution or part of the problem (by encouraging the taking on of even more debt). To help us understand the answer to this question, and how debt dynamics might play out in the decades ahead, it's important to consider how we got to this point.

DISPLAY 4: NEGATIVE REAL INTEREST RATES AS A DEBT REDUCER

The Liquidation Effect: 1945–1980, Percent of GDP*



Historical analysis does not guarantee future results.

***** Average annual contribution of negative real interest rates to the reduction in government debt.

Source: *The Liquidation of Government Debt*, Carmen M. Reinhart and M. Belen Sbrancia (IMF Working Paper, 2015)

HOW DID WE GET HERE? WAS IT SECULAR STAGNATION...

There are two broad schools of thought on the forces that have led the developed world to the biggest combined public sector debt levels in economic history.

The first school of thought is best framed by the idea that the world has entered a period of secular stagnation. Under this interpretation, an excess of private sector savings over investment weighs down on the equilibrium interest rate. If that rate is unattainable because, for example, it's negative, then the private sector will be forced to run a surplus. In a closed economy (or the world as a whole), the counterpart of this must be a public sector deficit.

To put it plainly, if the private sector isn't spending enough, the government needs to. The alternative would be a depression. Viewed through the lens of secular stagnation, a big increase in government debt is therefore not only unavoidable but also desirable. If anything, COVID-19 is likely to raise private sector savings and depress investment even more, exacerbating the trend toward secular stagnation, bigger deficits and higher debt-to-GDP ratios. And as secular-stagnation proponent Larry Summers recently put it, "That's OK."

...OR BEING STUCK IN A DEBT TRAP?

The alternate school of thought to secular stagnation is that the developed world is effectively caught in a debt trap. The Bank for

DISPLAY 5: LOW RATES KEEP DEBT-SERVICING COSTS MANAGEABLE

G7 Government Debt and Effective Interest Rate

G7 Government Debt-Servicing Costs

Analysis provided for illustrative purposes and is subject to change.
Through January 2019
Source: Haver Analytics

International Settlements is a major proponent of this view, but its roots can be traced back as far as economist Hyman Minsky. Minsky observed that the post–World War II policy imperative of avoiding a second Great Depression involved policies that revolved around higher and higher levels of both private and public debt.

But while that approach might help economies stave off depression, there are unintended consequences. One is greater financial instability, a hypothesis for which Minsky is famed. Another unintended consequence is the support funneled to zombie companies, whose existence weighs on productivity and compounds the problem of low growth. This creates pressure for even lower interest rates, setting off a vicious cycle.

Japan has been the poster child for the debt-trap school of thought (*Display 6*). Since 1990, Japanese nonfinancial-sector debt has risen from about 230% of GDP to 320%; private sector deleveraging was more than offset by surging government borrowing. During that same time frame, the 10-year government bond yield withered from about 7% all the way down to zero—and is now slightly negative, as are yields in a growing proportion of developed economies.

The debt-trap perspective sees rising debt as the cause of the problem, stoking an unwanted cycle of ultralow interest rates and slower economic growth. That's very different from the secular-stagnation view, which regards rising debt as a virtue—or, at worst, a necessary evil.

DISPLAY 6: JAPAN'S DEBT-TRAP EXPERIENCE

Nonfinancial Debt and 10-Year Bond Yield

Analysis provided for illustrative purposes and is subject to change.

Through January 2019

Households, nonfinancial companies and government. Calculated using net government debt.

Source: Haver Analytics and AB

MMT: SECULAR STAGNATION, TURBOCHARGED

If we take secular stagnation to its logical conclusion, we end up at Modern Monetary Theory (MMT)—though proponents of both views would reject this comparison. Under MMT, which has gained considerable traction in recent years, a government that issues its own currency never has to go bankrupt—or levy taxes or issue bonds to spend, for that matter. It can simply print money. Under MMT, the government's goals and priorities, not arbitrary numerical targets for deficits and debts, should guide public sector spending.

In an MMT world, as with secular stagnation, rising government debt isn't part of the problem—it's part of the solution. And given where we are today, it's easy to see MMT's appeal, especially to those who advocate heavy government involvement in the economy. The caveat: policies similar to MMT have in the past been prone to misuse, creating a higher likelihood of inflation.

GETTING RID OF DEBT OVERHANGS: ASSESSING THE CHOICES

But if extreme government debt levels aren't a desirable outcome—and history comes down heavily on this side of the debate—what can governments do about it?

As already noted, it would be dangerous to assume that we can rely on strong economic growth to bail out developed economies (*Display 7*). The resurgence of populism—likely stoked by COVID-19—means that the appetite for decades-long fiscal austerity programs that clamp down on spending is low. And while we're uncomfortable with some of MMT's more extreme elements, it's certainly true that outright default on domestic currency debt would be a historical anomaly.

That leaves financial repression and inflation as the most likely path. Japan's recent experience illustrates how powerful even a modest financial repression can be. Over the past decade, Japan's policy-makers have managed to stabilize public debt at just below 240% of GDP, despite running persistent sizeable primary deficits, thanks to the combination of lower yields and marginally higher inflation.

THE INFLATION/INTEREST-RATE ENVIRONMENT IS CRITICAL

To illustrate the impact of inflation, consider the outlook for Japanese government debt. Our baseline scenario is that the debt-to-GDP ratio will be broadly stable in coming years, but with interest rates already at their lower bound, inflation will play a big role in the outcome (*Display 8*).

If Japan continues struggling to generate faster price increases—let's say 1% average deflation over the next 30 years—debt growth would be explosive. That's why avoiding deflation is vital in a high-debt world. But what if Japan somehow manages to generate 2% inflation over that time frame? Debt would decline rapidly onto a virtuous path. That's just what happened in the UK, the US and much of the developed world after World War II.

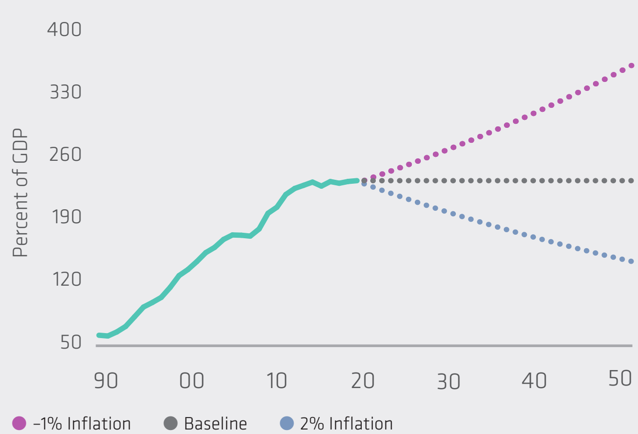
It's worth noting that the improvement in Japan's true debt position is understated here. That's because the Bank of Japan has absorbed a substantial amount of current government debt (equivalent to about 90% of GDP) through open-market purchases. If you believe, as we do, that those bonds will never return to the market (or that the central bank should really be viewed as part of the wider state), this portion of Japan's debt has effectively been canceled. So, the starting point for debt reduction isn't a 200%-plus debt-to-GDP ratio but more like 150%.

DISPLAY 7: A DEBT-REDUCTION TOOL KIT

Economic Growth	✗
Fiscal Adjustment (Austerity)	✗
Financial Repression (Low Interest Rates)	✓
Inflation	✓
Write-Off (Default/Jubilee/Forgiveness)	?

For illustrative purposes only
Source: AB

DISPLAY 8: JAPANESE GOVERNMENT DEBT UNDER DIFFERENT SCENARIOS



Historical analysis and current forecasts do not guarantee future results.
As of June 30, 2020
Projections through 2050
Source: Haver Analytics and AB

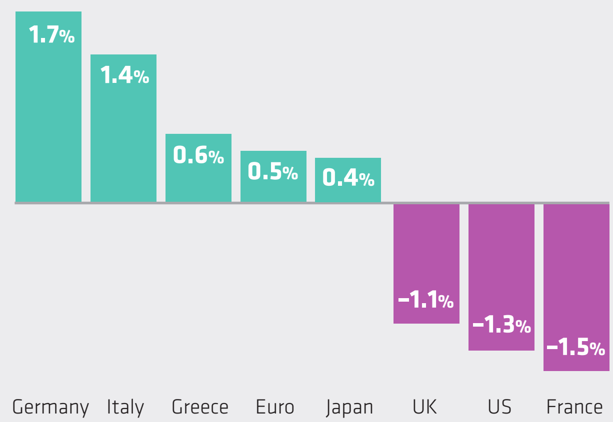
It's clear from this example that, together, low interest rates and positive inflation can be very powerful tools in shrinking debt burdens. And if part of that debt can be permanently absorbed through central bank balance sheets, even better. Few central banks would admit to this approach, but equivalent policies have happened time and again throughout history. And stripping away the orthodox veneer of quantitative easing, it's happening again today.

The bit that's missing in this equation is, of course, higher inflation. Until we see inflation pick up, which could still be some time, interest rates will be forced to shoulder the lion's share of the burden. This means rates are likely to remain at ultralow levels for some time to come. But just how low?

We can get some idea of the interest rates currently required to keep debt levels from rising by examining the debt-stabilizing interest rate (*Display 9*). This is the nominal interest rate needed to maintain government debt at 2021 levels, given International Monetary Fund fiscal projections and our GDP forecasts. For countries, including the US and the UK, that nominal interest rate is negative. Until we get higher inflation, this is likely to be the new normal.

DISPLAY 9: CENTRAL BANKS TO KEEP RATES CLOSE TO OR BELOW ZERO

Debt-Stabilizing Interest Rate*



Analysis provided for illustrative purposes and subject to change.

As of June 30, 2020

* Effective nominal interest rate required to keep the government debt/GDP ratio stable at 2021 levels, given IMF forecasts for the primary budget position and outstanding debt in 2021 and AB forecasts for trend nominal GDP growth.

Source: Haver Analytics and IMF

THE END GAME: HISTORICAL DEBT-REDUCTION TEMPLATES

To sum it up, government debt levels are high and rising. Some would argue that this is a natural response to deeply embedded secular stagnation. Others, with whom we have more sympathy, think the debt-driven economic model of the last few decades has reached the end of the road and the world is now stuck in a debt trap. Importantly, both paths lead to very low interest rates for now.

But what about the end game and inflation? To help us dimension the different paths developed economies might follow, we can lay out four historical templates: the UK experience after the Napoleonic Wars; Germany's Weimar Republic after World War I; the path followed by the US, the UK and other developed markets after World War II; and Japan post-1990.

As we've mentioned, there's little appetite for an extended period of fiscal adjustment right now, so we can safely set aside the earlier UK period. The path Germany followed in the years after World War I, and the hyperinflation that ensued, is a useful reminder of the dangers of debt monetization. This scenario could unfold if an extreme version of MMT were unleashed and misused. But we doubt any country is likely to follow that path in the near future.

That means the tension, for now, is between the two remaining templates. One is the post–World War II decades, but without the strong growth enjoyed during that period—essentially a mixture of financial repression and inflation. Down the other path lies Japan's post-1990 experience: weak growth, unfavorable demographics, rising debt, ultralow rates and—ultimately—deflation.

> This progressive deterioration in the value of money through history is not an accident, and has had behind it two great driving forces—the impecuniosity of governments and the superior political influence of the debtor class."
>
> *Economist John Maynard Keynes*

Trying to gauge which route the world will follow is probably the single biggest controversy facing financial markets today. We favor some version of the post–World War II period—not the Japan-post-1990 template. That's partly because Japan is an outlier in economic history, as recognized by John Maynard Keynes a century ago (*quoted above*), partly because rising populism points in this direction and partly because we're starting to see concrete signs of the policy regime shift needed to underpin higher inflation.

WHAT WILL IT TAKE TO PUSH INFLATION HIGHER?

We've argued for a while that long-term momentum toward higher inflation has been building. COVID-19 represents a challenge to this view. With developed economies operating well below potential, huge output gaps have opened up and near-term inflation is much more likely to be downward rather than upward.

But our expectation for higher long-term inflation has been based more on a changing monetary and fiscal policy regime. This regime change has a number of key drivers, including populism, deglobalization and high debt levels. COVID-19 is likely to accelerate the impact of each of these—so much so that the pandemic has already led to the widespread acceptance of two factors needed for a higher inflation regime.

The first factor is recognizing that fiscal stimulus financed by monetary policy—with the two policies "joined at the hip"—is needed. The second factor is the idea that money should not be channeled into banks but into the real economy. This approach is much more likely to generate consumer price inflation. As the post-GFC experience has shown us, the chief beneficiary of funneling money into banks is likely to be asset-price inflation.

But we're not quite there yet (*Display 10*). The final piece of the puzzle is in the hands of central banks, and it requires a further step into unconventional territory. To generate sustained higher inflation, central banks need to reset inflation expectations higher, and this will require a credible commitment—just as it did (in reverse) in the early 1980s. In this case, such a commitment is likely to involve abandoning or downgrading inflation targets, which, helped by demographics and globalization, have underpinned the low-inflation era of the last three or four decades.

DISPLAY 10: WHERE ARE WE ON THE PATH TOWARD HIGHER INFLATION?

UNCONVENTIONAL FISCAL POLICY

+ Fiscal dominance
+ Monetization
+ Helicopter money
+ MMT

NEO-KEYNESIAN FISCAL POLICY

+ Monetary policy overburdened
+ Fiscal policy takes over as main demand-management tool

INFLATION TARGETING

+ Monetary policy is main demand-management tool
+ Fiscal policy aimed at sound government finances

Current analysis does not guarantee future results.
As of June 30, 2020
Source: AB

So far, there has been little evidence of a real change in central bank thinking in this area.

Many central bankers are happy to pay lip service to the idea of running economies hotter, with talk about average inflation targeting and the like. But when they've had the chance to drive the message home—as during the 2015–16 recovery—they've quickly retreated to the safety of central bank orthodoxy and started "normalizing" monetary policy. If central banks really want to break the back of low inflation, it's essential that they don't duck the next chance they get.

THE COVID-19 IMPACT: REVISITING OUR CORE MACRO VIEWS

So, let's bring this discussion home, assessing the impact of COVID-19 and policy responses to our core macro views (*Display 11*). As we see it, the biggest impact will be a reinforcement of long-term trends that have already been in play. We're not alone in making this claim, and we're not alone in our view that interest rates are likely to remain low for the foreseeable future.

DISPLAY 11: COVID-19 AND THE SECULAR OUTLOOK: CORE MACRO VIEWS

Core Macro Views	Conviction 1–2 Years	Conviction 2–5 Years
Weak Trend Growth	High	High
Deteriorating Growth/Inflation Mix	High	High
Higher Inflation	Low	Medium
Ultralow Interest Rates	High	High

Current analysis does not guarantee future results.
As of June 30, 2020
Source: AB

Where we do differ, though, is in our view that COVID-19 is likely to reinforce a secular shift toward a policy regime that's more conducive to higher inflation. Even if the timing of that shift is still uncertain, it's clear that the pieces of the inflation puzzle are falling into place and that we're closer now than we were a few months ago. With financial markets pricing in a Japanese outcome, that's important.

NEW YORK
1345 Avenue of the Americas
New York, NY 10105
(212) 969 1000

TOKYO
Hibiya Parkfront 14F
2-1-6 Uchisaiwaicho, Chiyoda-ku
Tokyo, 100-0011, Japan
+81 3 5962 9000

SYDNEY
Level 32, Aurora Place
88 Phillip Street
Sydney NSW 2000, Australia
+61 02 9255 1200

NASHVILLE
One Nashville Place
150 4th Avenue North
Nashville, TN 37219
(212) 969 1000

TORONTO
Brookfield Place
161 Bay Street, 27th Floor
Toronto, Ontario M5J 2S1, Canada
(416) 572 2534

SINGAPORE
One Raffles Quay
#27-11 South Tower
Singapore 048583
+65 6230 4600

LONDON
50 Berkeley Street
London W1J 8HA
United Kingdom
+44 20 7470 0100

HONG KONG
39th Floor, One Island East, Taikoo Place
18 Westlands Road
Quarry Bay, Hong Kong
+852 2918 7888

IC2020965
ECO–7989–0920
www.AllianceBernstein.com