

## The W&P-Perspective

# The risk of a bond market collapse

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**The world is rightly focussed on halting the spread of the coronavirus. But meanwhile the explosion in sovereign debt as countries scramble to counter the pandemic's grave economic consequences threatens a meltdown long talked about and whose consequences would be so massive they are almost unthinkable. // Adriel Jost**

Governments and central banks around the world are currently outdoing themselves with aid programs in response to the coronavirus crisis. “The more the better” is the rule. “It’s the only way to keep the economy going” is the reason. This shows us just how fragile our economies are. An economic standstill of a few weeks has had a rapid and massive impact. Few companies have the reserves to withstand such a timeout. And the question of how to pay their bills looms over many households, too.

So far, the measures undertaken by governments can alleviate much of the economic distress. Central banks provide liquidity and thus strengthen banks. The banks, in turn, create money by granting additional loans, and governments distribute money coming from loans they themselves have taken out. These responses constitute normal practice in past crises. Only a few governments, companies and households used the good times of the past decade to build up their reserves. Thus, support measures to meet a crisis have to be ever more extreme to spur growth. There is a breaking point in the system and we argue that it may be fast approaching.

### US pushing the limits

The US in particular recently pulled out all the stops to protect its economy from collapse. Although it was already living well beyond its means when the economy was humming, the US is now implementing a truly massive fiscal stimulus package. New debt equalling more than 20 percent of America’s total economic output can be expected for the current year. As a result, US government debt will surpass levels seen during World War Two (see Fig. 1).

No matter what its fundamentals look like, the US can afford a high level of debt because the dollar remains in demand as the global reserve currency. The

story is different for emerging countries. They will be doubly punished by the coronavirus, both in terms of public health and economically. Emerging countries will suffer from capital flight as confidence wanes and investors seek safer havens. This will lead to a steep devaluation of their currencies and sharp domestic price increases. Under these circumstances, support measures for some emerging economies, such as interest rate cuts or fiscal packages, will only be possible with the help of the International Monetary Fund.

But the US is also currently testing the limits of the system. The demand for US dollars is solid, but US government bonds are being shunned. The Treasury department has faced great difficulty placing their bonds on the market. As the Bank for International Settlements recently observed, an increasing proportion of buyers for US government bonds consists of debt-financed, short-term oriented investors. And this cohort fled the market as soon as volatility increased.

The Federal Reserve had to intervene heavily to save the financial system from collapse. To calm the markets, the Fed has promised to purchase an unlimited amount of government bonds. At the same time, it is also deeply involved in the corporate bond market, securitized mortgages and other credit instruments. Not only has the Fed become completely dependent on fiscal policy, the whole economy now relies on the printing presses.

### Missing: an exit strategy

The US is not an exception. In many economies the authorities are behaving similarly. Yawning deficits are being papered over with newly created money and unsecured loans are being extended. Hoping for the best seems to be the operative principle here. “Everything will be fine as soon as the crisis has passed,” runs the mantra. However, we are compelled to point out, we

think it is most unlikely that the economy will “grow out of debt.” Trend growth rates are simply too low.

Throughout history, debt relief has been seen as a way to maintain social stability in difficult times. Specifically, it has often been argued that indebted farmers forced to sell their land and even enslave themselves should be released from their obligations. But, in fact, the record shows that general debt relief has rarely been implemented. We think a blanket debt forgiveness is also unrealistic today. Who stands ready to sacrifice their wealth to save the system? Instead, we think there is a considerable risk that an involuntary, disorderly economic restart is the more likely scenario.

### Countries play a dangerous game

Historically, the interplay of fiscal and monetary policies – the state spends the money, and the central bank prints it – has always led investors and the public to lose trust in both institutions. We worry the same will happen in today’s situation. For example, disruptions in global supply chains could trigger higher inflation. But central banks would have their hands tied, unable to combat rising inflation stalling economic growth. This could lead confidence to decline all the more given the seemingly limitless back-and-forth of fiscal and monetary policy. In the process, we fear, this could transform the huge increase in the money supply built

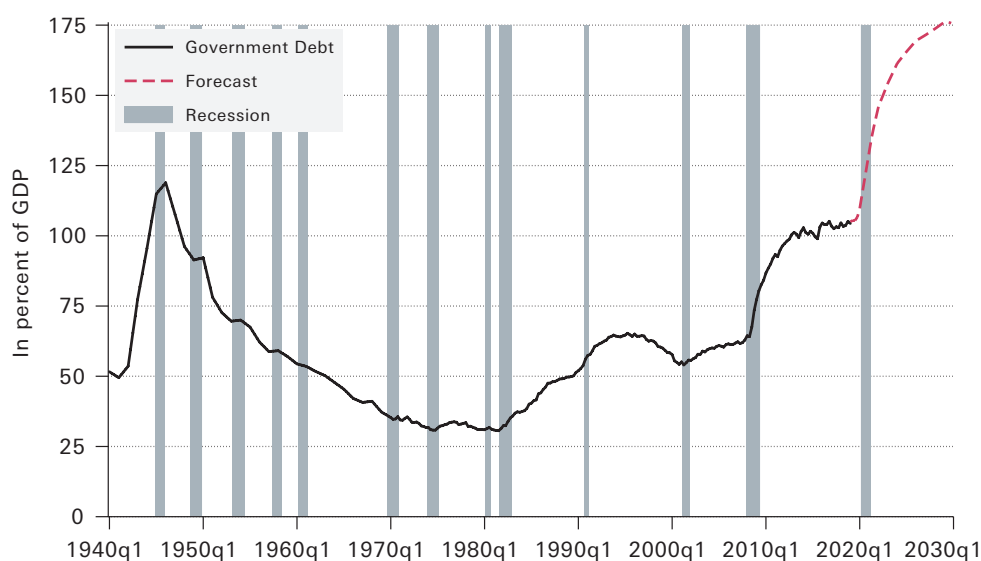
up in recent years into significantly higher inflation. Debt, and thus the bond markets, would soon be on the verge of collapse.

### Thinking ahead

When such a tipping point might occur is unclear. Those who have been calling for it since the 2008 global financial crisis have hopefully learned a few lessons. Even if the latest rescue measures are more extreme, it does not necessarily mean that a meltdown scenario is inevitable. The Japanese example – high levels of debt financed by a central bank for years – should also teach us not to make rash predictions. In the short term, in any case, we think a more deflationary environment can still be expected.

However, given its force and scale, we are convinced that the corona crisis and the economic responses it triggers have the potential to unleash previously unthinkable systemic risks. Imagine what would happen if governments and central banks, even in developed economies, were incapable of meaningful action. This is how dramatic the consequences can be if the trust of markets and the public is tested too often. And it shows what a dangerous game that countries, especially the US, are currently playing. At the least, we think preparation for this scenario must increasingly be part of responsible mid-term planning.

Fig. 1: US Government Debt



US public debt was at a historically high level even before the corona crisis. With the fight against the economic consequences of the pandemic, debt will increase again, massively. The graph shows a scenario based on the existing budget deficit, a significant economic downturn and the economic support package thus far adopted.

Source: SNB, Wellershoff & Partners

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