WHO IS PAYING FOR COVID-19?

Wisdomtree EU
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On September 28, 1918, the City of Philadelphia, despite warnings of a deadly virus circulating, held a Liberty Loan parade to encourage citizens to buy war bonds to fund our participation in the First World War. Unfortunately, thousands of Philadelphians died as the virus swept through the crowds who urged citizens to buy bonds to support our troops.

Today we are fighting a “war against Covid-19,” a war that will cost trillions of dollars, many times the cost of our participation in the “Great War”. Yet there are no parades, no bond rallies, no solicitations whatsoever to us to buy “Corona War” bonds to fund the effort to stop this pandemic. No American has been asked to contribute a penny of extra taxes to pay for the trillions of dollars needed to help maintain our economy. In fact, the government is cutting taxes and putting -- not taking -- billions of dollars into the pockets of those impacted by the economic shutdown. How can we possibly afford to give away trillions of dollars without anyone being asked to pay for it?

The answer is that our central bank, the Federal Reserve (Fed) is buying all the bonds the Treasury is selling to finance the war against Covid-19. The central bank is crediting the Treasury’s account, as well as private banks with hundreds of billions of dollars to distribute to the unemployed, shuttered businesses, besieged hospitals, and hard-pressed state and localities. This new money is technically “backed” by Treasury bonds, but these bonds pay virtually no interest, and there is no prospect that any of them will ever be paid off.

Impact of Liquidity Creation

This huge increase in liquidity will not come freely. History shows the increase in the quantity of money created will inevitably spark inflation and have dramatic implications for both our economy and financial markets.

In 1918 the newly-created Fed could not issue money unless it had gold to back it, and the Fed did not nearly have enough gold to buy war bonds. The government did raise taxes but had to finance the remainder of the war effort by borrowing from the US public. The central bank was not allowed to be a source of funds for the government.

Nearly 60 years before World War I, President Lincoln faced the same dilemma. The government did not nearly have enough money to finance the Civil War and the Union was forced to issue “greenbacks,” money that was unbacked by gold and eventually traded at a discount of 50% to true, gold-back money. Inflation rapidly increased to double digit levels. It took another 13 years after the Civil War ended before the government finally redeemed all the greenback in gold.

But there will be no monetary redemption after the War on Covid 19. The gold standard is long gone; first repealed by the Roosevelt Administration at the onset of the Great Depression and finally by President Nixon in 1971. Central banks can now create any amount of liquidity that they want, and with no constraint. Late in March Fed Chairman Powell stated the central bank would buy government bonds in “any size necessary” to stabilize the market.

I can hear critics scoffing at my inflationary prediction by noting that Bernanke engaged in massive bond buying during and subsequent to the 2008-2009 financial crisis, but this hardly caused a ripple of in inflation.

But the bonds the Fed bought during the financial crisis ended up as excess reserves in the banking system, not in the pockets of individuals and businesses. These excess reserves were never lent to the public. The increased reserves were designed to create a buffer for the banks and discourage them from calling in loans which would have hampered our recovery. And the Fed actions did achieve their goal; our banking system is far better capitalized than it was in 2008 and has weathered the current crisis extremely well.

What is happening now is completely different than what happened during the financial crisis. Monetary economists, led by Nobel- Prize-winning Milton Friedman, had pointed out that the central bank’s creation of excess reserves has, by itself, a small impact on spending. But money placed in the pockets or bank accounts of consumers and businesses, which he termed M1 and M2, had a powerful effect. And that is the money that is now being created.

Recent Data Foreboding

A look at the most recent monetary data issued by the Fed is eye-popping. In the last two weeks alone, the M1 money supply has increased by $368 billion, more than the entire increase in the preceding 52 weeks. This is about equal in percentage terms, to the entire increase in M1 in the whole year following the Lehman crisis which included all the Fed emergency lending, quantitative easing, the Federal government’s Troubled Asset Relief Program, as well as other measures.

And the money creation we see now is just the beginning. Current programs call for hundreds of billions more dollars of purchasing power to be transferred to the public. When an effective therapeutic or vaccine is developed and this repressed demand ends, this increased liquidity will indeed spur a strong economic expansion, but also push inflation much higher than we have experienced in recent years.

Are there ways to prevent this inflationary surge? Congress can sharply raise taxes, reducing firm and consumer incomes, and the Fed could sell some of its massive bond holdings back to the public to reduce the money supply. Alternatively, the Fed could spike interest rates to extremely high levels and squeeze both investment and credit-sensitive spending. Or – and this is my bet -- the Fed could let inflation rise, which would lead to far more moderate rise in interest rates and be politically be the path of least resistance. I am not predicting hyperinflation. I am talking about 3 to 4% inflation for several years before prices moderate. There will be many winners from this scenario. Strong economic growth and a robust demand for labor will mean that wages will more than keep up with rising prices. Rising sales will permit firms to raise their prices and borrowers who have locked in lower rates will benefit significantly.

The losers will be those relying on income sources that do not keep up with the rate of inflation and most bondholders would take it on the chin. Rising inflation and interest rates will end the nearly forty-year bull market in bonds, a period that has seen interest rates fall from nearly 20% to zero. Eventually inflation will reduce the real value of the Fed's liquidity creation and restore the economy to a new non-inflationary equilibrium.

In contrast to a century ago, Americans today won't die attending rallies to buy government bonds to fund the current economic bailout. But there is no "free lunch." The "War on Covid-19" will be paid for by those holding monetary assets whose value will be eroded by the upcoming inflation.

The views expressed in this blog are those of Jeremy J. Siegel, any reference to "we" should be considered the view of professor Siegel and not necessarily those of WisdomTree Europe.

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