

Chapter 1

The debate on the “magic money tree” is open

The Covid crisis undermined the global economy, yet the unprecedented actions of governments and central banks averted the worst. This episode marked central banks’ *modus operandi*, once again in the spotlight. This is what we seek to decode with this series of papers entitled “*How the Covid crisis has shaken up monetary policy*”.

In this first issue, we tackle the topic of the “magic money tree”.

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During the Covid crisis, public deficits increased very sharply in all countries of the world but this did not lead to a public finance crisis because central banks bought at the same time very large quantities of sovereign bonds. This has led some commentators to say that there is a “magic money tree” and that it needs to be used overwhelmingly again for other uses. In reality, things are a bit more complex.

Most developed countries experienced their highest budget deficit since World War II in 2020, due to a collapse in activity and to the implementation of exceptional aid programs for households and businesses. The fiscal deficit, for example, approached 16% of GDP in the United States in 2020 (the highest figure since 1945). In the euro zone, it amounted to 7.6% of GDP, the highest level since the creation of the monetary zone.

See Appendices – Graphs 1 & 2

Such an increase in public debt was cause for fear of a sovereign debt crisis but it did not happen because central banks bought very large quantities of government bonds:

- the ECB has launched an exceptional securities purchase program, the *Pandemic Emergency Purchase Program*, with an envelope of € 1,850 bn, that can be used until March 2022,

- the Fed bought Treasury securities at a spectacular pace in March / April 2020 (with a peak of \$ 75 bn in Treasury securities purchases per day), before switching to a monthly purchase pace of \$ 80 bn,
- the BoE and the Riksbank reactivated their government bond buying programs and the BoJ continued its program,
- and unlike the 2008 financial crisis, the central banks of Australia (RBA), Canada (BoC) and New Zealand (RBNZ) embarked on large-scale government bond purchase programs.

Here, it is important to underline that the purchases of sovereign bonds by central banks were different in their objectives from the “Quantitative Easing” operations of the 2010 decade: the objective in 2020/2021 was much less to weigh on long-term interest rates (with the aim of stimulating growth) than to avoid a collapse of the economy, which would have been for example caused by troubles to fund the exceptional policies of support for companies and households. This is particularly clear in the case of the ECB with a very clear difference between the purchases of securities made under the mandate of Mario Draghi and those made under the mandate of Christine Lagarde: in the first case, there was no coordination between monetary policy and fiscal policy while coordination was total in the second case. **While the**

QE operations of the 2010s had only a moderate impact on the evolution of the money supply, the 2020/2021 securities purchases had a much more direct and immediate effect on the money supply.

See Appendices – Graph 3

It is this coincidence of monetary and fiscal policies that has fueled the "magic money tree" debates. It also happens that the amounts of government bonds bought by the Fed and the ECB during the Covid crisis (we consider here the whole of 2020 and the first half of 2021) are extremely close to the increases in the amount of outstanding long-term sovereign bonds over the same period. **Given that the exceptional policies to support businesses and households have been almost entirely financed by central banks**, many commentators have questioned whether there is "magic money tree", which could be used to finance new social or environmental policies, for example.

See Appendices – Graph 4

The subject of monetary financing of government spending has been the subject of much inkling among economists over the past century. **Milton Friedman, one of the foremost scholars of monetary history, wrote as far back as 1980¹ about the magic money tree when government spending is funded by money creation:**

"Financing government spending by increasing the quantity of money looks like magic, like getting something for nothing. To take a simple example, government builds a road, paying for the expenses incurred with newly printed Federal Reserve Notes. It looks as if everybody is better off. The workers who build the road get their pay and can buy food, clothing, and housing with it. Nobody has paid higher taxes. Yet there is now a road where there was none before. Who has paid for it?"

The answer is that all holders of money have paid for the road. The extra money raises prices when it is used to induce the workers to build the road instead of engage in some other productive activity. Those higher prices are maintained as the extra money circulates in the spending stream from the workers to the sellers of what they buy, from these

sellers to others, and so on. The higher prices mean that the money people have in their pockets or on deposits at banks will now buy less than it would have before."

Thus, in the light of Friedman's thoughts, we can only note that the very strong increase in the money supply in developed countries in 2020/2021 (it was particularly impressive in the United States, with a peak of + 27% year-on-year in February 2021) coincided with a sharp rise in commodity prices and an acceleration in inflation. In the United States, core inflation reached in June 2021 its highest level since 1991. In addition, the price of a certain number of commodities (agricultural or metals) increased very sharply in 2020/2021, reaching all-time highs for some metals (copper for instance). It is obviously very difficult to determine the exact causes of the acceleration of inflation. Part of the price increase can be explained by supply chain difficulties caused by the covid crisis and part by the reorientation of investments as part of the energy transition (demand for certain commodities is increasing sharply against this backdrop). But we absolutely cannot dismiss out of hand the hypothesis that the financing of government spending by money creation has also pushed up inflation. It is thus probable that the "magic money tree" partially contributed to a fall in the purchasing power and to a further rise in the real value of real estate, which excludes a significant part of the population from access to housing. In addition, in a globalized framework, the least developed countries may find themselves relatively more penalized because of the rise in the price of raw materials.

See Appendices – Graphs 5 & 6

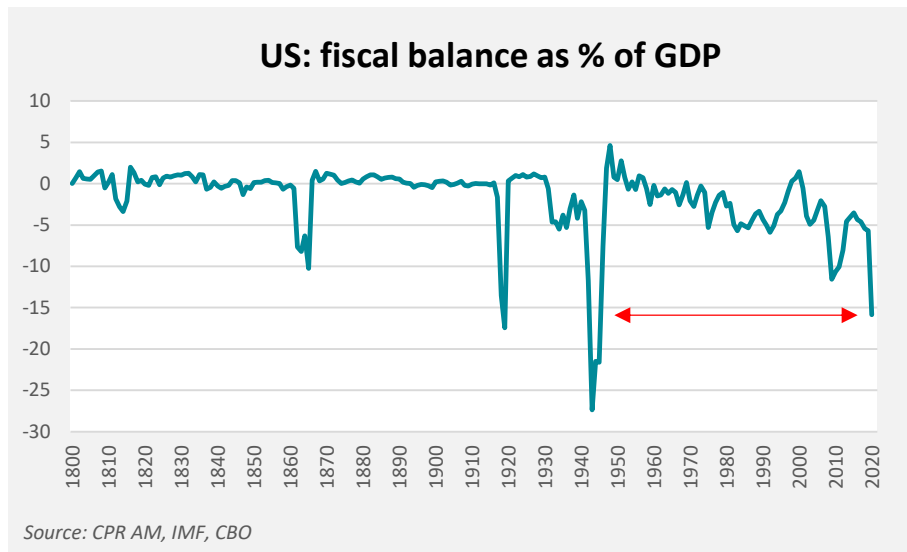
It is clear that the large-scale financing of government spending by monetary creation opens up prospects in the largest monetary zones, especially with regard to possible new social and environmental policies (we will see in our next paper that central banks are working on new themes). However, the episode of sharply rising commodity prices and accelerating inflation shows that the "magical" money creation can have costs, which central banks would be well advised to measure finely.

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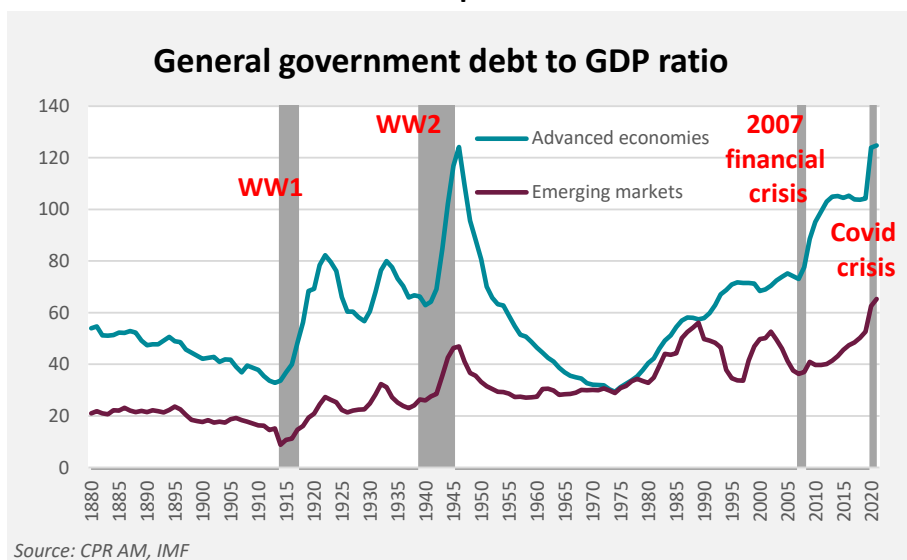
¹ Milton Friedman, 1980, « Free to choose »

Appendices

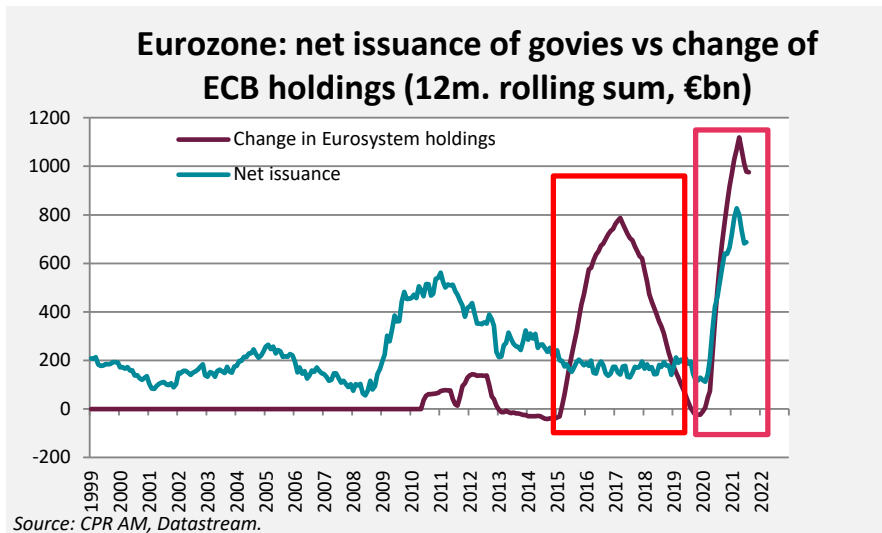
Graph 1



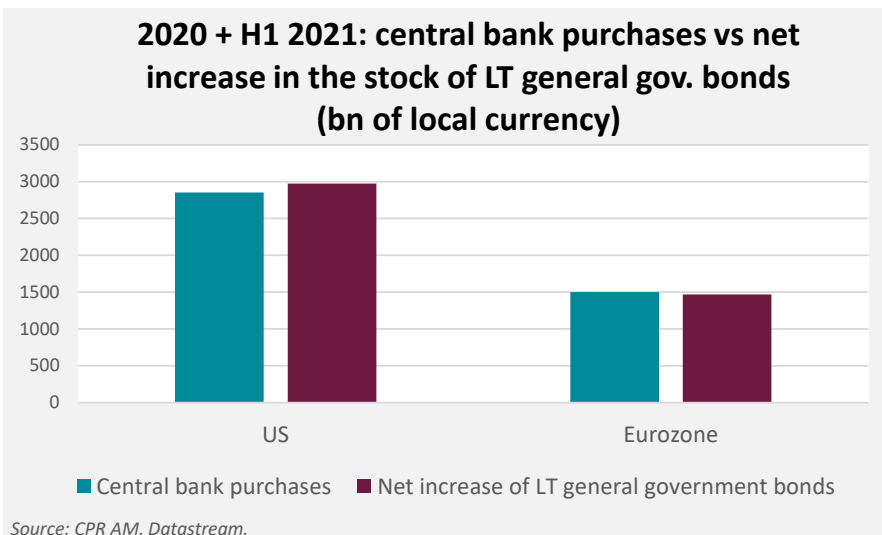
Graph 2



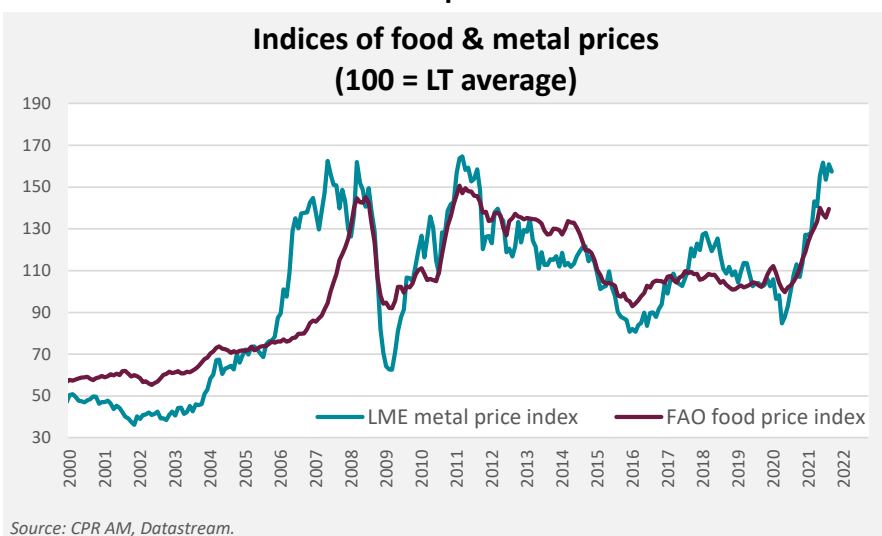
Graph 3



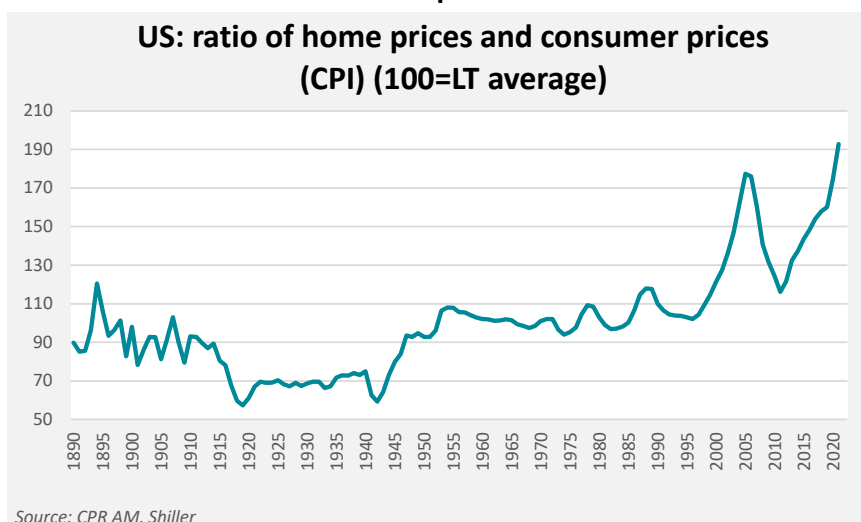
Graph 4



Graph 5



Graph 6



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