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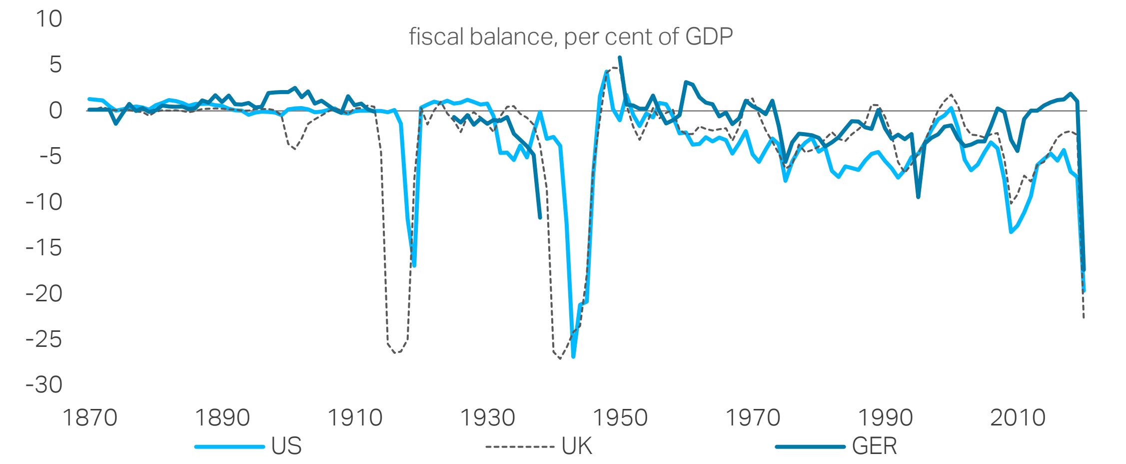
Macro Picture

FIRE STARTER?

Dario Perkins

Globally we are seeing a massive fiscal response to COVID-19, with policymakers quick to draw comparisons to wartime economics. But wars are also associated with high inflation, which has spooked some investors. We think it is premature to worry about inflation. Yet COVID-19 could reinforce other dynamics to create to a 'fiery' endgame.

Chart 1: Two world wars and one global pandemic



Source: MacroHistory database, TS Lombard forecast based on announced measures plus assumed 'auto stabilizers'

HEATING UP?

Global policymakers have implemented a 'wartime' response to COVID-19. Since these policies are often associated with rampant inflation, some economists are warning about imminent price spirals. Today's policy mix is certainly more stimulative than the monetary actions of the last decade, but large/persistent shortfalls in demand mean it is premature to worry about inflation.

EVERYBODY BAILOUT

COVID-19 has triggered a fiscal response that it unprecedented in peacetime. In doing so, the virus has accelerated the transition from monetary to fiscal dominance, a policy shift that looked inevitable even before the pandemic. In another throwback to wartime financing, this could see central banks relegated to the role of 'capping' bond yields to support fiscal sustainability.

FIERY ENDGAME

In the short term, COVID-19 is likely to conform to previous global pandemics, discouraging spending and reducing equilibrium interest rates. But the longer-term implications could be very different, creating an inflation bias in macro policy and accelerating de-globalization, populism and income redistribution to usher in a 'fire regime' that will replace the post-1990s 'ice age'.

FIRE STARTER?

Policymakers all over the world have responded forcefully to COVID-19, using war-time analogies to justify massive expansions in their budget deficits. With governments adding up to 20% pts of GDP to their national debts, their words are no exaggeration – a fiscal easing of this magnitude is unprecedented in peacetime. Meanwhile, there are other similarities to wartime economics, including widespread supply disruption and the fact most people are unable to engage in regular activities. But is 'war' the correct analogy for COVID-19? History suggests military conflicts and pandemics have had quite different macroeconomic consequences. Whereas wars are highly inflationary, pandemics are often deflationary. In the short term, the war analogy can only apply if the authorities are successful in keeping death rates down and plugging deep holes in their economies. We see little prospect of a serious inflation outbreak during the next 18 months. The economic recovery from COVID-19 is sure to be slow, which means shortfalls in demand could persist into the second half of 2021. Even after the authorities have contained the disease (which could take more than one "lockdown"), unemployment will stay above pre-virus levels, while consumers and businesses will be more reluctant to spend.

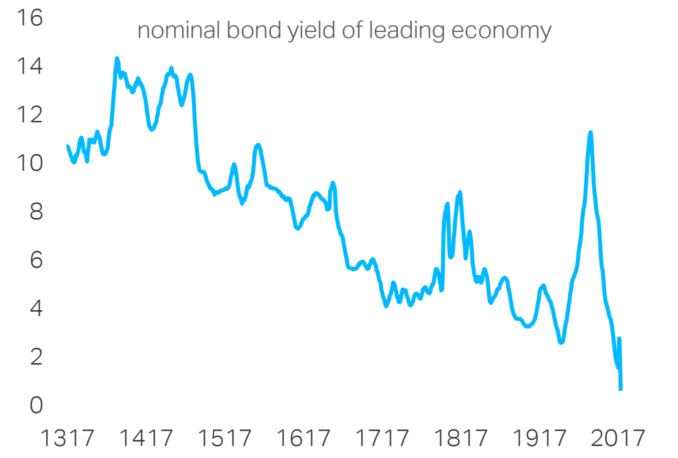
The implausibility of a quick, 'v-shaped' recovery reflects the magnitude of the economic disaster, not the failure of the authorities to act decisively. In fact, the global policy response has been far more radical than anyone could have imagined even a few months ago. Governments now have three clear budget priorities: (i) fighting the infection itself, which requires a massive increase in health spending; (ii) disaster relief, targeted on those people and sectors suffering the greatest economic fallout from COVID-19; and (iii) sustaining aggregate demand and employment. While the speed and size of this policy response has been impressive, it also accelerates an overdue transition from monetary to fiscal tools, a shift that was primed even before this virus. Policymakers not only recognize the limits of having relied too heavily on monetary policy, they are also responding – at last – to the lowest government borrowing costs in 700 years. The consensus view about what constrains public debt has changed in radical ways. Rather than monitor traditional metrics such as debt-GDP ratios, many economists now believe inflation is the only limit on government borrowing. And with central banks open to the idea of 'capping' long-term interest rates, nobody is scared of the bond vigilantes anymore.

By adopting a wartime response, governments are diluting the anti-inflation bias they built into macro policy institutions after the 1970s. Even if this is unlikely to cause immediate price spirals, it hints at a longer-term 'fire regime' that will replace the current 'ice age'. On the fiscal side, there will now be a lasting temptation to use fiscal policy without limit, perhaps in a futile effort to restore post-war growth rates. When the current health emergency is over, other spending priorities will appear – such as the 'war on climate change'. Or a 'war on poverty'. On the monetary side, central banks will face a much stronger challenge to their independence, which could ultimately loosen the 'nominal anchor' from their inflation targeting frameworks. Capping yields is definitely not the same as 'monetary financing' – a popular misperception that seems to be adding to the current inflation narrative – but any longer term tendency for prices to rise could exert huge pressure on central banks not to tighten policy (particularly if the sustainability of government finances depends on it). Still, in the end, the inflationary consequences of COVID-19 will depend on much deeper influences than the bias it has created for fiscal and monetary policy. Anti-globalization and income redistribution offer a greater challenge to bond investors.

1. HEATING UP?

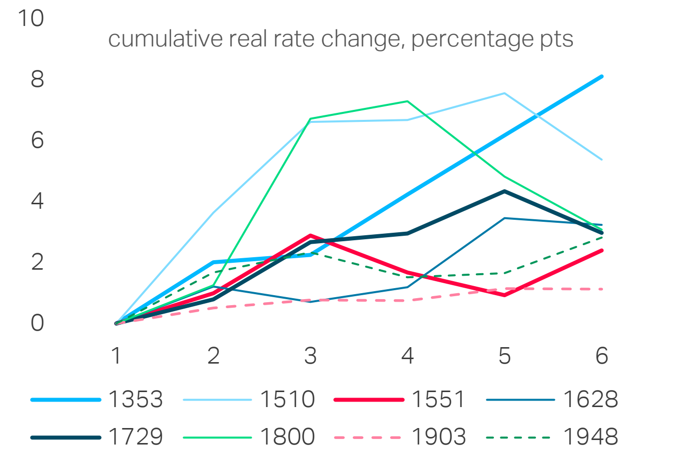
Global policymakers have responded remarkably aggressively to the COVID-19 threat. Not only is around 50% of the global economy now in 'lockdown', but the authorities have taken unprecedented fiscal and monetary actions to try to cushion the economic fallout of a situation where most people are not allowed to work or engage in regular commerce. In short, governments have shut down their economies and are using their own balance sheets to replace a significant proportion of national income. Interestingly, policymakers all over the world are using the same historical analogies to justify what they are doing – they say they are fighting a war, a conflict where 'every country is now on the same side'. In part, this is a rallying cry intended to motivate courageous 'frontline workers' and lift the spirits of 'civilians' who are stuck at home, unable to lead their normal lives. But it is also a message that has resonated with many investors, who seem convinced wartime policies will lead to a wartime outcome – inflation!

Chart 2: Bond yields stuck at historic lows



Source: Bank of England

Chart 3: But tend to bounce at historic events



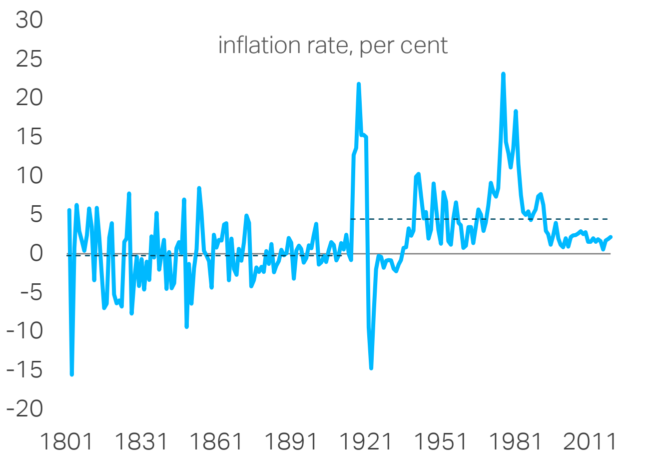
Source: Bank of England paper on rate reversals

Wars and inflation

According to the popular narrative (which has roots in John Kenneth Galbraith), 'every major military conflict has been associated with spiralling prices'. This was certainly true for the two world wars of the twentieth century, which both triggered double-digit inflation rates. WW1 was particularly inflationary, with European prices growing faster than 10% per annum for more than six years. And the reasons are fairly intuitive. Military conflict causes massive supply disruption, just as governments redirect their economies' productive capacities to bolster military output. Demand comfortably outstrips supply, especially for non-essential, non-war goods. War can also be a time of political unrest, social disorder, loss of faith in institutions and monopolistic profiteering[1]. How governments choose to finance these conflicts is also important. Remember, central banks were explicitly created to fund governments' wartime spending, taking over from the traditional method of taxation. They engaged in 'proper' debt monetization, suspending the convertibility of their currencies into precious metals and massively expanding the non-interest-bearing supply of notes and coins. By definition, central banks tried to 'inflate away' their government's extra borrowing, such that public debt would quickly decline to pre-war levels.

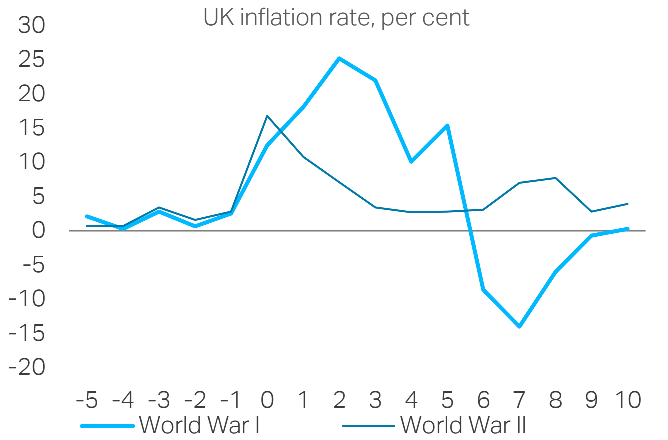
[1] Galbraith believed monopoly power was a big part of the wartime inflation story. He argued companies always kept some pricing power in reserve and would unleash this during times of military conflict, exploiting consumers. Fortunately we are yet to see the likes of Amazon and Netflix hiking their prices despite their dominance of online retail and media!

Chart 4: Two inflation regimes in history



Source: Bank of England database, TS Lombard

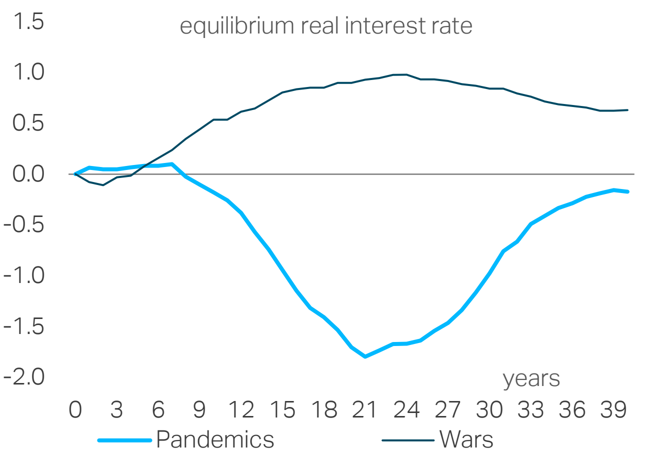
Chart 5: Wars are notoriously inflationary



Source: Bank of England database, TS Lombard

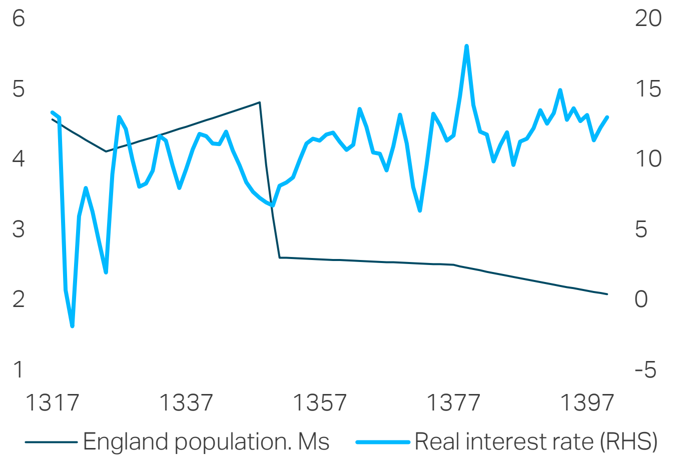
Given some of the similarities to the situation we face today, it is easy to understand why investors find the 'return of inflation' narrative appealing. Not only are we seeing massive supply disruption - with people unable to work, factories shut and some countries closing their borders (destroying complex international value chains) – but governments are also ramping up their spending in a way that is unprecedented in peacetime. Chart 1 (front page) shows governments could be running fiscal deficits similar to those recorded during the two World Wars. The inflation narrative also has some high-profile proponents, including the influential UK academic Charles Goodhart. Professor Goodhart published a blog on Vox recently, claiming inflation rates would hit 10% in 2021. Not afraid to make bold statements, Goodhart concludes '*the coronavirus pandemic, and the supply shock it has induced, will mark the dividing line between the deflationary forces of the last 30 to 40 years, and the resurgent inflation of the next two decades. Secular stagnation and 'lower for longer' will be relegated to the attic of defunct ideas*'.

Chart 6: Pandemics unlike wars



Source: Jorda, Singh and Taylor 2020 (paper here)

Chart 7: The devastating Black Death

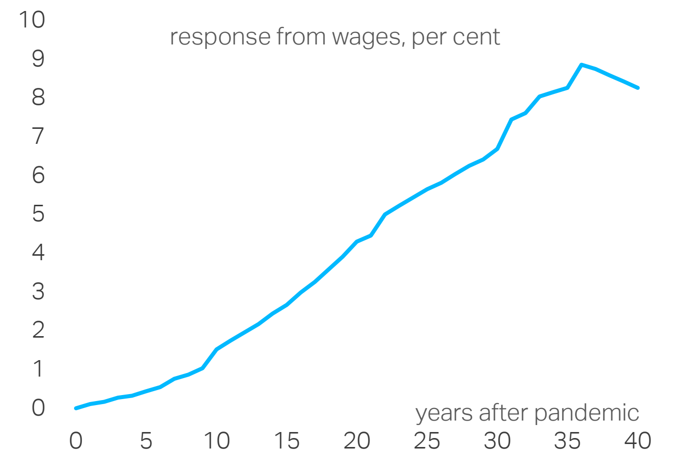


Source: Bank of England, TS Lombard

Previous pandemics were deflationary

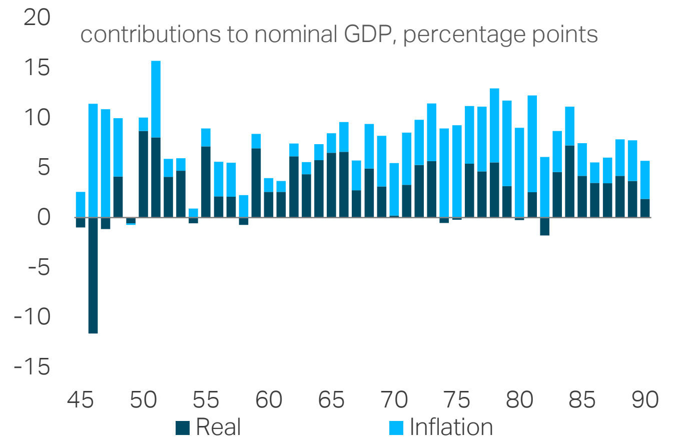
While appealing, the inflation narrative doesn't sit well with the experience of past pandemics. A recent study by the San Francisco Fed illustrates this point, by looking at what happens to equilibrium interest rates based on the Bank of England's long historical database. Whereas military conflicts cause underlying bond yields to rise (consistent with the inflation narrative, since these are needed to restrain post-war booms), pandemics usually cause long-term rates to decline. On average, the previous 15 pandemics (defined as those that caused more than 100,000 deaths) triggered a 200bps decline in equilibrium interest rates that lasted 40 years. Admittedly this is a small sample from which to draw firm conclusions. We should also bear in mind that the economic impact of history's worst pandemic – the Black Death, which killed 40% of Europe's population – remains controversial[2]. But the analysis still highlights an important difference in the effects of wars vs pandemics. While both wars and pandemics have been responsible for huge numbers of deaths, eliminating large parts of the labour force (which caused wages to rise), wars also destroy the capital stock. After major military conflicts, countries must 'rebuild' their economies – remember the post-war booms in Europe, Japan, the US and Korea. But pandemics leave a traumatized population determined to save rather than spend, and a labour-capital ratio that has fallen to levels that undermine the incentive to invest.

Chart 8: Labour scarcity boosts wages



Source: Jorda, Singh and Taylor 2020 (paper here)

Chart 9: Post WW2 rebuilding (US)



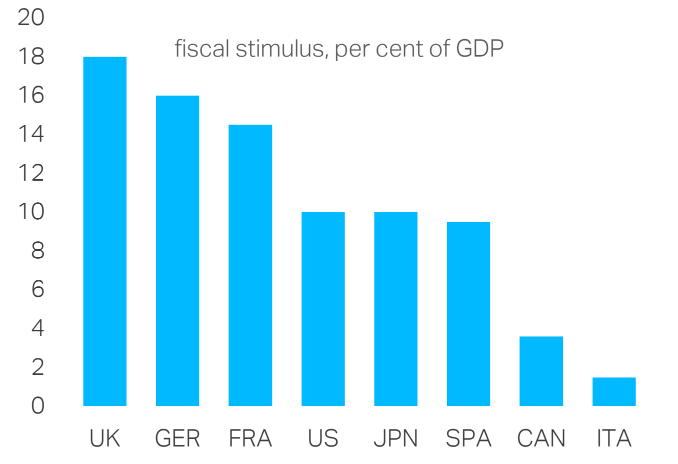
Source: BEA, TS Lombard

Historical analogies for COVID-19

While it is tempting to look at history to understand COVID-19, we doubt any of these past episodes provide a perfect template for the situation we face today. Yes this is a global pandemic, not a war, but we are (hopefully!) not looking at a disease that will wipe out 40% of the world's labour force. Scientists think the true mortality rate will be less than one per cent, while the authorities are making a massive, unprecedented effort to keep infection rates down. Don't forget also that the death rates associated with COVID-19 are also skewed towards the old, which also has implications for its impact on the labour force. Ultimately, however, the war vs pandemic debate will surely depend on the success of the measures the authorities have put in place. If they can keep death rates down while plugging the large hole in the global economy, inflation worries are perhaps more justified. This is certainly the critical assumption in Charles Goodhart's inflation thesis, because he thinks the economy will bounce back immediately. If instead the virus lingers and there is a persistent shortfall in global demand, deflationary forces will surely dominate into 2021 – even with supply disruption and massive policy stimulus.

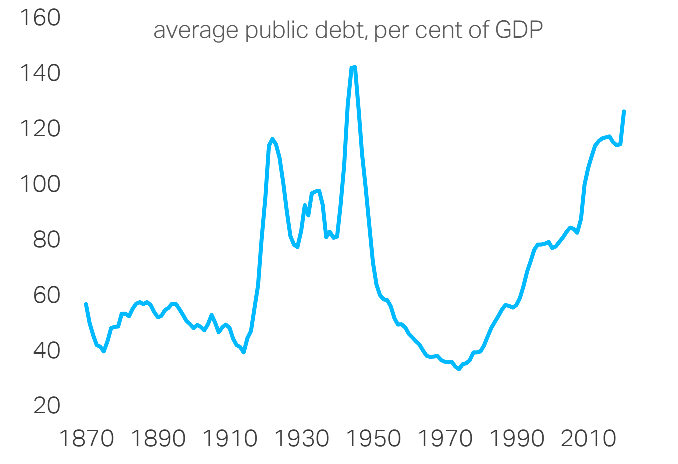
[2] The Black Death caused a surge in grain prices and other studies (reproduced in Chart 6) suggest equilibrium interest rates actually increased. There are even reports of a consumer boom after the pandemic, as people realized they should make the most of life. Wages certainly increased, as workers became scarcer.

Chart 10: Massive fiscal response to COVID-19



Source: TS Lombard estimates based on announcements

Chart 11: Adding to wartime debt



Source: IMF, TS Lombard

We think it is premature to worry about a sustained surge in inflation. With the virus set to remain a problem for up to 18 months, causing further stop-start economic restrictions, plus the collateral damage this will cause – especially via rising unemployment and severe strains in corporate debt markets – we think any economic recovery will be slow and hesitant. We also expect precautionary savings to rise and investment to sag, even when the current lockdown ends. As far as consumer prices are concerned, large relative price shifts are much likelier than sustained increases in aggregate. Both demand and supply have plunged in 2020 but the balance of this will not be the same across all sectors. Some areas will experience inflation (e.g. food), others will see big relative declines (e.g. energy, tourism and airlines). This means any anxiety about inflation must be focused on the longer-term context, once the global economy is operational again. And this is where the big policy shifts we are seeing become more relevant.

2. EVERYBODY BAILOUT

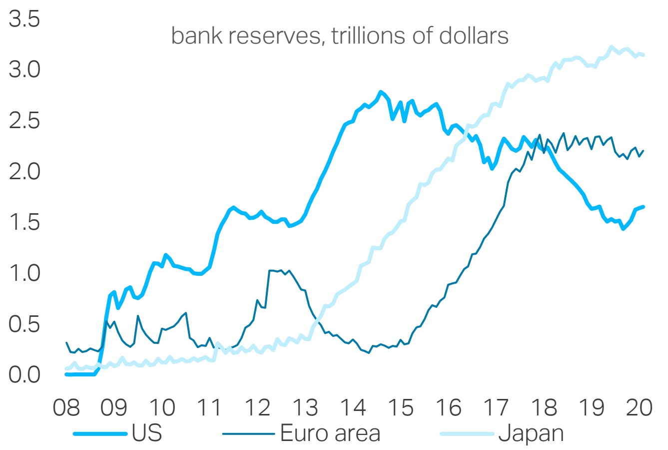
There is no doubt we are now witnessing some hugely important changes in global policy frameworks. The fiscal response, in particular, has been spectacular. Based on what governments have announced so far, Chart 10 shows our estimates of what the authorities will spend in 2020 as they try to plug massive holes in their economies. These sums are in addition to the usual automatic stabilizers, the deterioration in government finances we would expect to see during a recession. Remember, as output falls, tax revenues decline and governments must spend more on existing entitlements such as unemployment insurance. Recent studies show these 'automatic' effects are particularly powerful in countries that already have a large public sector (such as Scandinavia, and to a lesser extent the euro area). As a rule of thumb, every 1% decline in GDP typically adds 0.3-0.6% pts to the fiscal deficit. This means the fiscal deterioration in 2020-21 will be even larger than what governments are planning far.

Fiscal emphasis

As Olivier Blanchard has explained, the global fiscal response now has three main objectives: (i) to fund the fight against the virus, by increasing the capacity of the health sector (especially for intensive care units); (ii) to provide 'disaster relief', by providing fiscal support to the people and sectors that social distancing and economic lockdowns have hit hardest (especially to prevent bankruptcies and sustain employment); and (iii) to increase aggregate demand. While objectives

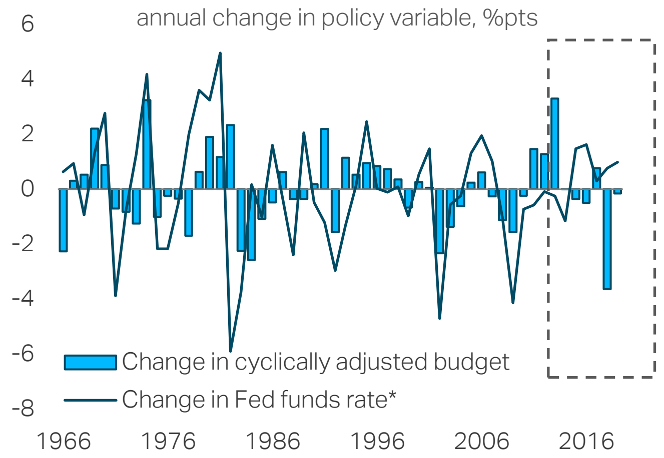
(i) and (ii) reflect the specific nature of the COVID-19 crisis, objective (iii) is actually part of a broader transition in economic policy that has been primed for some time – a recognition that the power of central banks has been waning in recent years and monetary stimulus is no longer sufficient to 'reflate' the global economy. We have written about this issue extensively in previous macro pictures, showing that all parts of the monetary transmission mechanism have weakened since the late 1990s. Not only is consumer spending and business investment less responsive to falling interest rates, but FX and wealth effects have also diminished. Right now, central banks can only try to prevent market amplifiers from making the situation worse.

Chart 12: QE only pumped up bank reserves



Source: Fed, BoJ, ECB, TS Lombard

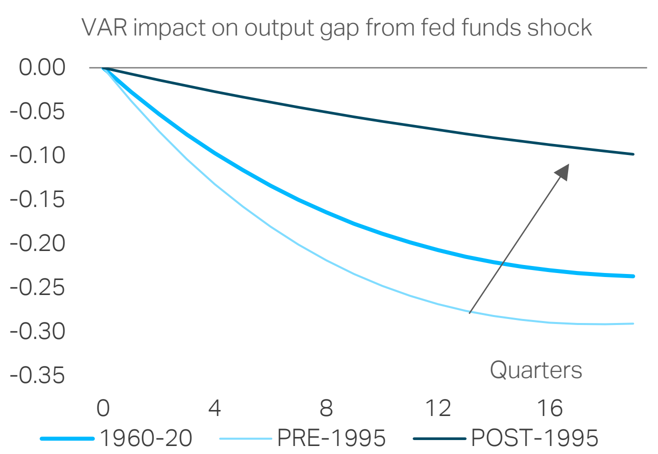
Chart 13: Policy mix was all wrong after 2010



Source: OECD, TS Lombard, *includes Fed shadow QE interest rate

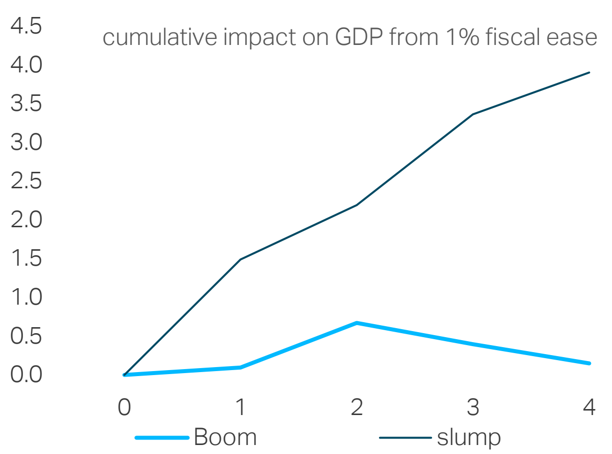
The good news is that the same forces that have gradually undermined the power of monetary policy over the last decade have also rendered fiscal policy much more effective. With little prospect of central banks raising interest rates and no chance of 'crowding out', most studies suggest fiscal 'multipliers' are currently unusually large – especially for government spending (more than tax cuts). Recent Peterson Institute estimates suggest the fiscal multiplier could be in the 1.5-4.0 range during recessions, which means every one percentage point easing in fiscal policy will have a much larger impact on overall economic growth. There is no doubt this sort of policy response is more meaningful than anything the central banks have done over the past decade, a point many of the investors who are worried about inflation have acknowledged.

Chart 14: Monetary effectiveness declined



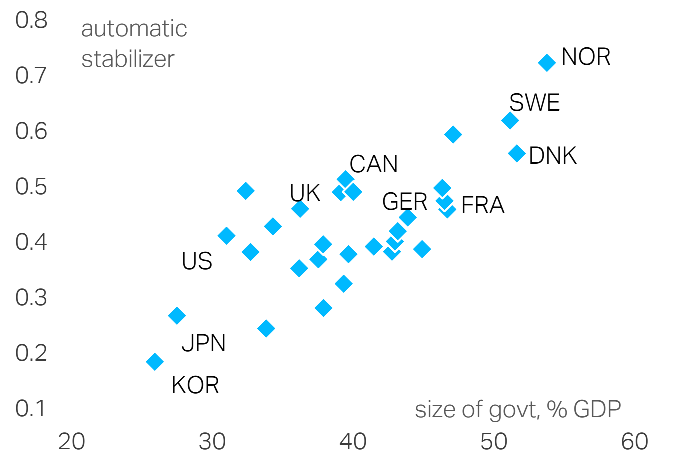
Source: TS Lombard estimates

Chart 15: Fiscal effectiveness increased



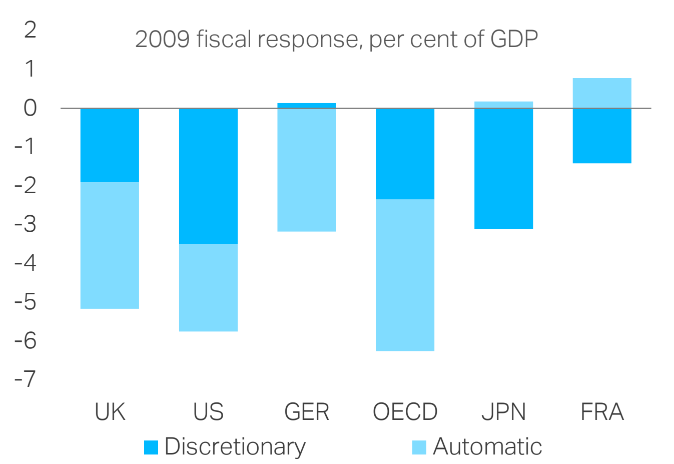
Source: Peterson Institute (2019 paper)

Chart 16: Big government – big stabilizers



Source: Antonio Fatas INSEAD (2009)

Chart 17: The fiscal response to subprime



Source: OECD, TS Lombard bases on OECD structural deficits

Fiscal stimulus beats QE

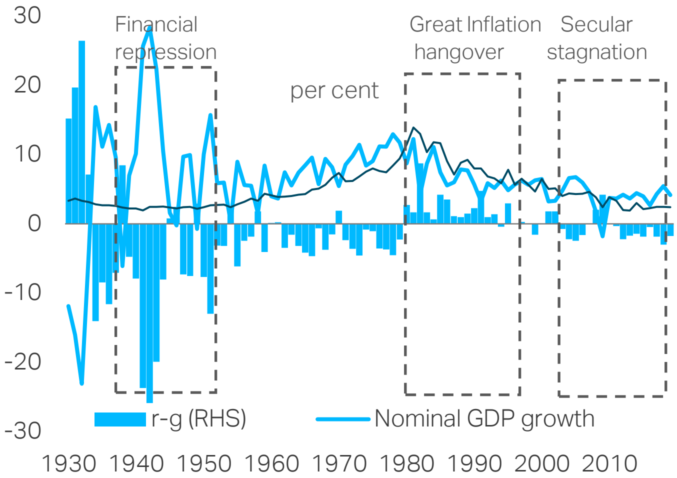
Based on our interaction with investors, it seems the people now concerned about inflation are not necessarily the same people who wrongly diagnosed an inflation problem ten years ago. QE was largely meaningless from an inflation point of view. It just swapped one near-zero yielding security (government bonds) for another (bank reserves), shortening the average maturity of government liabilities but providing no real macro boost[3]. Once governments went full 'austerity', within a couple of years of the crash, there was no way central banks could offset the impact of aggressive fiscal tightening. In fact, the last decade produced a highly unusual combination of tight fiscal policy and easy monetary policy, which did nothing to pull the world out of its secular funk. Is it not surprising bond yields plunged to 700 year lows. The bond market was screaming for a different combination of policies. Now we have big fiscal easing, which is a more effective policy tool, but it is happening with a spectacular collapse in private demand. This mean, even if the policy mix 'works', it will be a while before this shows up in higher inflation and bond yields.

Can we afford it?

The proven inadequacy of monetary policy is an important reason COVID-19 has triggered such a quick transition to fiscal policy. But there is also another reason – a shift in how economists think about 'debt sustainability'. For decades, the authorities placed huge emphasis on arbitrary metrics, such as the size of their latest deficits or the ratio of public debt to GDP. This was obvious in Europe with the infamous Maastricht criteria, but it continued in the 2010s with the publication of Reinhart and Rogoff's notorious study, linking large debts to persistently weak GDP growth. Fortunately, the consensus on fiscal policy has moved on. A decade of historically low interest rates has forced the authorities to adopt a more 'dynamic' approach to budget sustainability, focusing on the *evolution of debt*, which depends on 'r-g', the difference between long-term growth rates and the cost of borrowing. As long as interest rates stay low, there is no reason for governments not to run deficits, especially if they invest in public works with decent long-term returns. Some economists now want to go even further, using central banks to suppress borrowing costs. If successful, there is only one constraint on public debt – inflation.

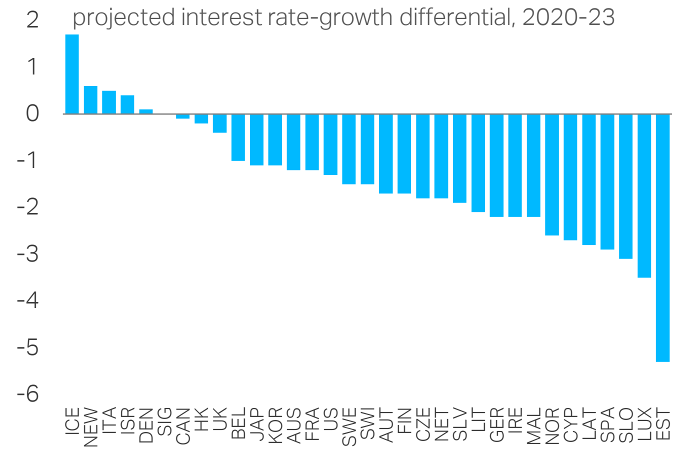
[3] This was explicitly not monetary financing, contrary to the widespread misperception at the time (a misperception that continues to this day, see Section 3 for the explanation).

Chart 18: History of policy regimes



Source: TS Lombard

Chart 19: 'R' to stay below 'G'



Source: IMF estimates, pre-COVID

'Willingness not ability'

The idea that inflation is the ultimate constraint on public debt is usually associated with MMT, yet it is also influencing mainstream views. These days there is no shortage of economists who believe governments that can print their own currency will never default (i.e. they will only default in real terms). Larry Summers, the former US Treasury Secretary, has even suggested that debt sustainability is all about 'willingness to repay' government debt rather than the 'ability to repay'. He points out that most countries only default when they have underlying 'governance' issues, such as excessive populism. But the nature of the debt also influences willingness, especially its currency denomination. This is the reason the United States has been able to absorb large and unexpected increases in public borrowing, while other countries such as Greece and Argentina (which have weak governance and tend to borrow in external currencies) have suffered dangerous crises. During the Cold War, for example, the US funded a massive multi-year fiscal expansion and there was no sign of the dreaded 'bond vigilantes'.

3. FIERY ENDGAMES

The policy shifts we have identified, which were primed even before the outbreak of COVID-19, are profound. They do not mean the world is on the brink of an imminent inflation surge – particularly if the plunge in global demand is as extreme and persistent as we expect – but they do suggest a future 'inflation bias' in macro policy, something that has been absent for more than thirty years. In effect, the authorities' 'wartime' emphasis is recreating a policy framework their predecessors had dismantled after the Great Inflation of the 1970s, a regime in which fiscal policy was dominant and the 'nominal anchor' from monetary policy became dangerously loose. This could mean, when the global economy has recovered, a 'fire' regime of higher inflation and higher bond yields is much likelier – especially if COVID-19 also triggers other socio macroeconomic shifts. To see why, let's consider the main elements of this new regime.

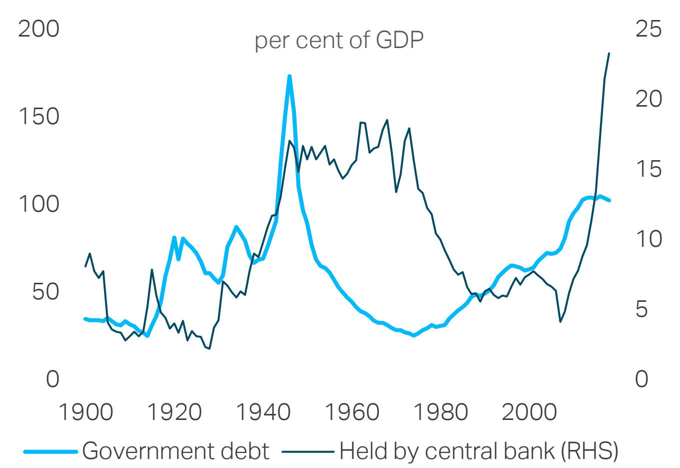
Fiscal dominance

Fiscal policy has taken over as the main macro-stabilization tool. Even if the massive expansion in budget deficits is not enough to restore full employment in 2020-21, there will be a clear bias to keep using the government's balance sheet to try to restore former macro glories. Once the current emergency has passed, new public spending priorities will appear – the 'war on the coronavirus' could become a 'war on climate change', perhaps even a 'war on poverty'. Europe is arguably closer to this shift than the United States, but the US could get there too. If interest rates stay low in the short term, there is no reason why the austerity emphasis that was so strong after the subprime recession would reappear after COVID-19. Politicians now accept that austerity has failed and some even suggest 'instead of bailing out bankers, we need to bailout regular people[4]'. If inflation becomes the only constraint on budget deficits, it must also be the likeliest endgame – especially as elected officials have a real problem when it comes to fighting inflation. The traditional 'time consistency' problem seems to be making a comeback.

Monetary 'anchors'

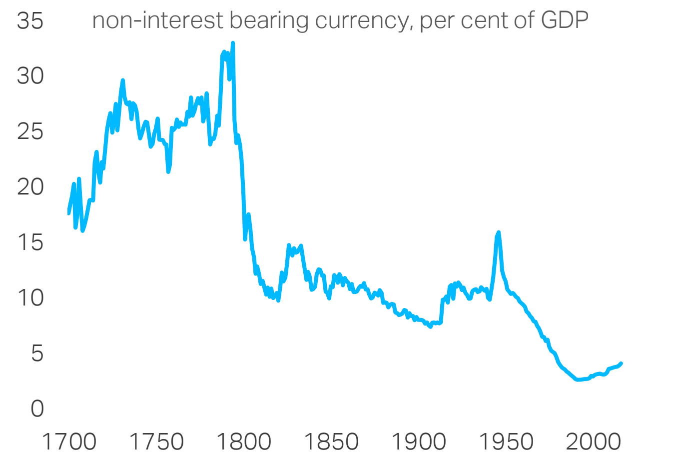
Central banks, of course, deny they are facing a situation of 'fiscal dominance'. For now, they have retained their official independence and will continue to target medium-term inflation. Yet, for more than a decade they have been doing things that have blurred the boundaries between fiscal and monetary policy, especially measures that involved much wider distributional impacts than traditional interest-rate setting. Post COVID-19, this is hitting new extremes and will likely reach the point where central banks start capping bond yields, providing a clear incentive for governments to ramp up their spending. This is an obvious throwback to wartime monetary policy, where central banks' main role was to support debt sustainability keeping borrowing costs down. It is not surprising some people are already using the label 'monetary financing'.

Chart 20: Post war 'helicopters'



Source: IMF, TS Lombard

Chart 21: Monetary financing now impossible



Source: Bank of England database, TS Lombard

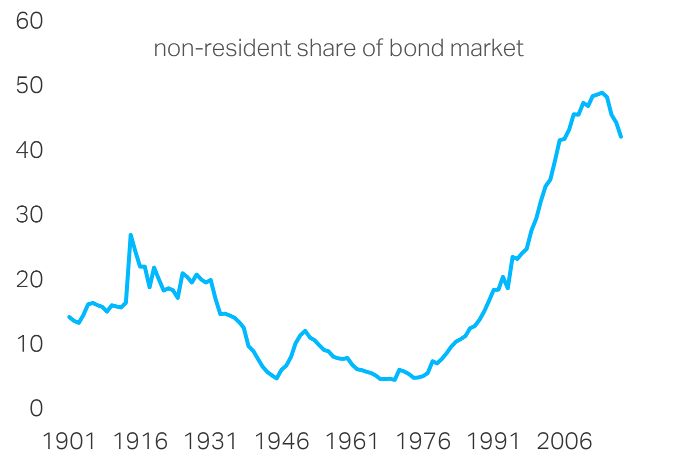
The Japanese are already targeting bond yields, while officials in other countries have signalled they are open to the idea, including at the Federal Reserve. Fed staff have recently gone to great lengths to remind investors that the central bank had success with these types of policies in the past, especially after World War II (see here). But the ECB is in a different position, given that progress towards Eurobonds has again run into opposition from certain northern EMU nations. While the ECB has already abandoned the self-imposed limits that prevented it from ramping up its QE programme, ultimately the authorities could adopt a GDP-weighted 'shadow' Eurobond target, even if there is no further agreement on 'mutualized' debt issuance.

[4] Mario Draghi has gone further than most, urging governments to absorb the losses of the private sector by lending to businesses and then writing off the debt entirely, adding it to the public debt.

Helicopter money

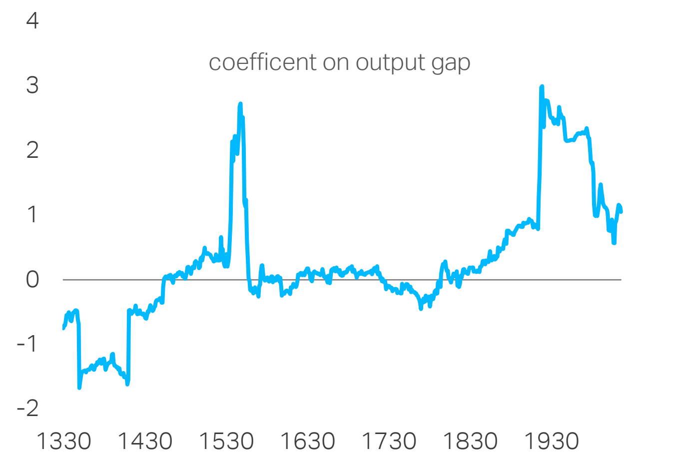
We should be clear that capping bond yields is not necessarily 'helicopter money', especially in an environment where there is no tendency for yields to rise. True monetization means central banks must increase the amount of (non-interest bearing) cash in the economy enough to lift nominal spending so that people will hold this extra cash. The government's debt is literally inflated away and aggregate public borrowing – including central bank liabilities – doesn't increase[5]. A recent Fed paper looked at this issue in detail, running simulations on the staff's economic models. Officials showed 'classic' helicopter money is practically impossible. This is because: (i) the amount of notes and coins in the United States and other DMs is too small relative to GDP (i.e. the tax base for the inflation tax is not large enough – Chart 21[6]), which means it requires extremely large CPI increases to inflate away the debt; and (ii) central banks – if they retained their long-run inflation objectives – would always have an incentive to renege on helicopter money, tightening policy as soon as prices started to spiral higher.

Chart 22: Globalization of bond markets



Source: IMF paper on monetary financing, TS Lombard

Chart 23: Phillips curve appeared in 20th century



Source: Bank of England, TS Lombard

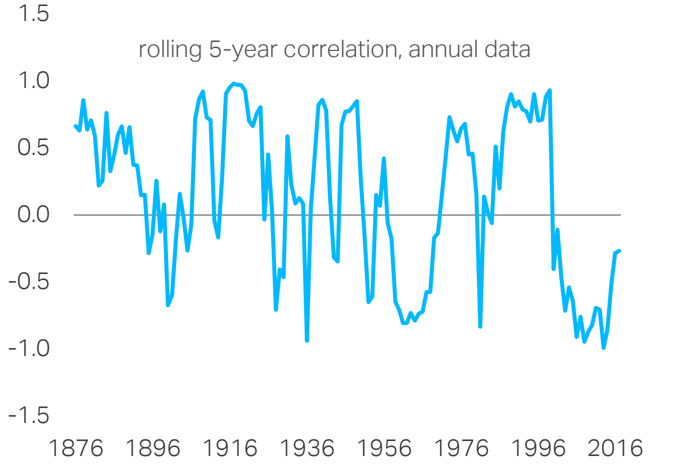
With yield caps, central banks can transfer purchasing power from their balance sheets to the Treasury but the consolidated level of public debt (treasury plus central bank) will still increase. The government is simply hiding its borrowing on the central bank's balance sheet. The policy would only become monetary financing if it causes a large increase in prices, generating enough seigniorage to cover the debt (as in World War 1). Inflation is a feature, not a bug – so it is inconsistent with central banks retaining their inflation targets. Most of the commentary about monetary financing (and fears about imminent inflation) misses this crucial point. The more relevant question is not whether these policies are inflationary today, but whether they will become inflationary over the longer term. If prices eventually accelerate and yields increase, will central banks be willing to tighten policy or will the fiscal authorities curb their independence (to

[5] The critical point about 'true' helicopter money is that public debt must not increase. This will only happen if the central bank can generate enough inflation such that the Treasury earns sufficient future seigniorage to offset the cost of the scheme. To do this, the bank must issue permanently-zero-interest liabilities (or commit to a zero policy rate). This way, when inflation rises and interest rates increase, there will be no offsetting impact from the liability side of the central bank's balance sheets. This is also why QE, which created interest-bearing reserves, was strictly not 'debt monetization'. As the Fed raised interest rates, its remittances to the Treasury declined – there has been a fiscal impact.

[6] The underlying problem, as Gerard MacDonell from Front Harbor points out, is that the non-interest bearing currency stock is too small relative to GDP, which means the 'tax base' for the inflation tax isn't large enough. The smaller the noninterest bearing currency stock, the larger the increase in prices needed to fully monetize the additional government debt. Gerard has shown, for example, that with the US currency stock of $1.75 trillion, a helicopter scheme worth $500bn for two years would need a 40% rise in the price level – something no central bank would ever allow.

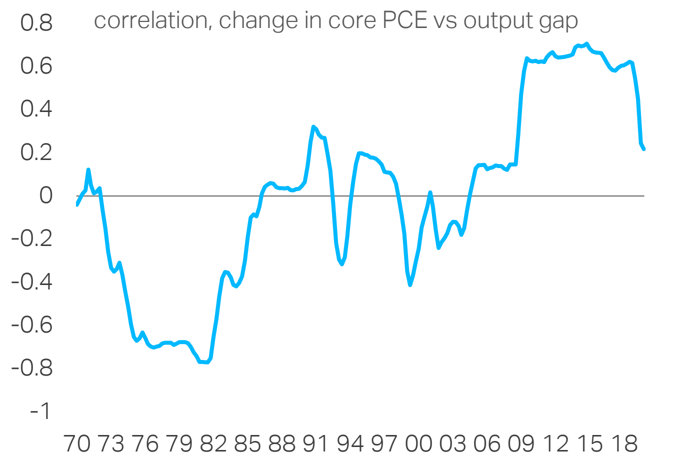
protect public debt sustainability)? By adopting yield caps, central banks are undermining their own independence and, in doing so, weakening their 'nominal anchor'. At some point, bond yields should adjust to this future risk, especially given the current (very low) term premium.

Chart 24: Ice versus fire correlation



Source: MacroHistory database, TS Lombard

Chart 25: Pro vs anti-cyclical inflation

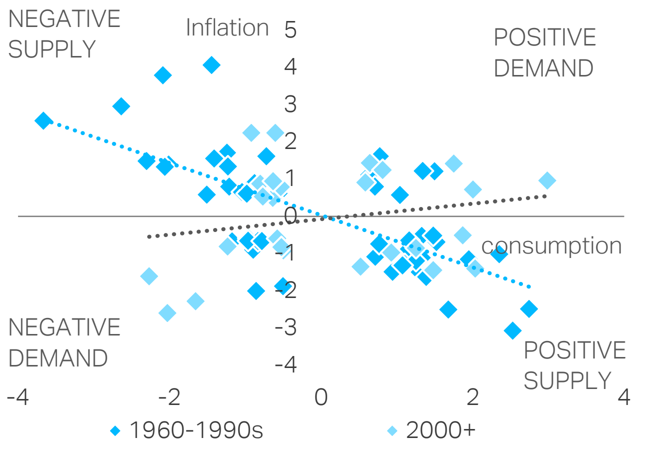


Source: BLS, TS Lombard

The new 'fire' regime

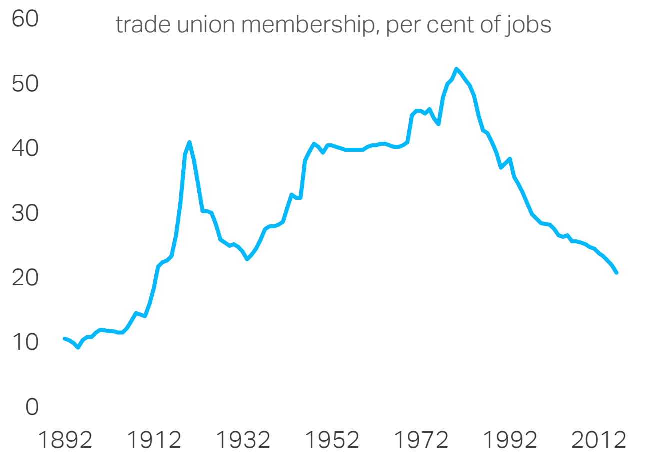
Even if macro policy now has an implicit inflation bias, ultimately the nature of the 'shocks' we face will have a powerful bearing on macroeconomic outcomes. We showed in previous work that the post-2000 'ice age' has been an environment where demand shocks were dominant, which means inflation and GDP moved in the same direction. This created a negative correlation between bonds and equities (the 'ice correlation'). But the historic (pre-2000s) environment was quite different. Bond and equity returns moved together, while output and inflation had a negative correlation. Our previous research also made the comparison between the post-subprime period and the Long Depression. The Long Depression ended in the late 1800s, producing a powerful revival in bond yields and a shift from the 'ice' to the 'fire' correlation. The new regime was associated with important socio-economic changes, including populism, the first 'socialist' parties, the creation of the welfare state ('big government'), de-globalization, the reorganization of workers into trade unions, income redistribution and a powerful recovery in wages. It seems plausible COVID-19 will trigger similar socio-economic change and – with fiscal and monetary policy now set up to accommodate this – ultimately usher in a new fire regime.

Chart 26: Demand shocks have dominated



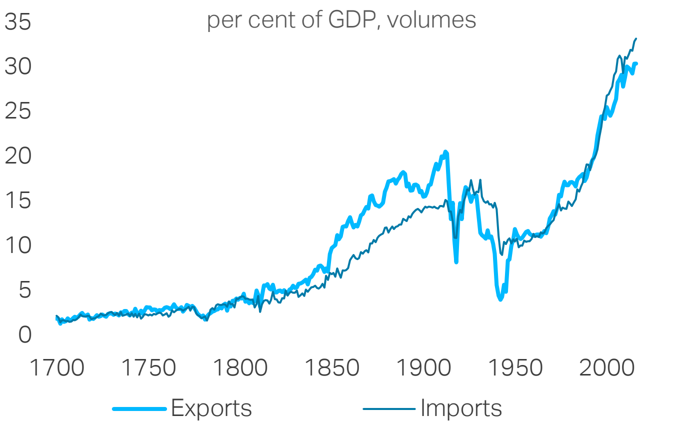
Source: TS Lombard based on US data

Chart 27: A big post-war shift



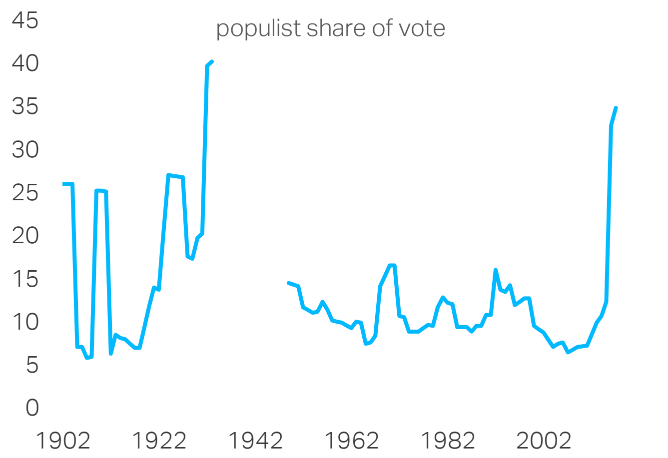
Source: Bank of England

Chart 28: Long Depression and de-globalization



Source: Bank of England historic database, TS Lombard

Chart 29: Populism will only get worse



Source: Bridgewater

Bottom line

Many investors are starting to worry about inflation. The massive policy response to COVID-19, especially the popular wartime analogy, is clearly a big part of this. We suspect these inflation worries are premature. Global demand has plunged further than supply and the eventual recovery is likely to be slower than most investors realize, creating a shortfall in demand that will persist into 2021. That said, it is clear that we are seeing some important shifts in fiscal and monetary policy, creating a longer-term inflation bias that has been absent for much of the last 30 years. Fiscal policy has taken over from monetary policy and though central banks are not yet conducting 'monetary financing', they are doing things that will jeopardise their long-term independence. Ultimately, COVID-19 could reinforce the transition to a new 'fire' regime that will replace the post 1990s 'ice age', especially if it triggers other large socio-economic shifts.