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MARKET COMMENTARY

Ashmore

Macroeconomic control regimes

By Jan Dehn

Everyone knows why the Soviet Union and the Eastern Bloc countries lost the Cold War: economics. US President Ronald Reagan's escalation of the Arms Race may have been the catalyst, but it was the superior capacity of Western market economies to innovate and generate wealth that ultimately did in the Eastern Block. Their inefficient centrally planned economies collapsed from within.

Despite strong evidence that market economies are superior to centrally planned ones, many Western economies are today drifting towards far greater centralised control over key macroeconomic variables, such as interest rates, credit spreads, stock markets, even wages. The dramatic expansion of government involvement in key markets – call it macroeconomic control regimes – brings them closer in style to conventional central planning systems.

This should worry investors. The expansion of government control is at the expense of markets. Moreover, government controlled prices result in wedges between markets and fundamentals and undermines economic efficiency. Macroeconomic control regimes also introduce distortions in global asset allocation. The inefficiencies increase over time and become progressively more difficult to reverse. Unless Western countries find ways to break with the current trend of ever greater government encroachment into the erstwhile domain of markets, their fate could well be one of gradual 'death by economy', that is, a fate not dissimilar to that which befell the planned economies of the Eastern Bloc some thirty years ago.

Central planning systems versus market economies

At first sight, it may seem absurd to even compare the planned economies of the Eastern Bloc with today's Western market economies. After all, the two systems are about as different as they come. In centrally planned economies, capital is owned by the state, which also sets production targets and the prices of inputs and outputs for the entire economy, usually through a specially designated agency. By contrast, in market economies the means of production, property, and financial wealth are in the hands of millions of individuals and corporations, who each decide how much to produce, given prices, which are formed as a result of all their transaction decisions, each one taken freely and independently. Moreover, in market economies governments are supposed to play only a minor role, intervening in markets to nudge the business cycle once in a while as well as to providing social safety nets and, perhaps, should the need arise, addressing market failures, usually with some form of regulation.

At first sight, it may seem absurd to even compare the planned economies of the Eastern Bloc with today's Western market economies

Market economies are generally regarded as far more dynamic and efficient than central planning systems for two specific reasons. First, by allowing private ownership market economies offer the prospect of wealth accumulation, which creates incentives for individuals and companies to apply more effort and to innovate. Second, capital, labour, and technology are free to move continuously to where they deliver their highest marginal return, since ownership, production decisions, and price setting are all completely decentralised, assuming sound regulation.

Macroeconomic price controls

Yet, despite widespread recognition of the advantages of market economies with only modestly sized governments, many Western governments have in recent years put policies in place, which have reduced the role of free markets and introduced far greater centralised government control. Governments have particularly increased their influence over key macroeconomic prices, such as interest rates, spreads, stock prices, trade taxes, etc. (see Box for a list of key macroeconomic prices that are already under direct or indirect government control or may fall under greater government control in the near future).

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What macroeconomic prices are being controlled?

The most heavily manipulated prices in Western market economies today are ***interest rates***, that is, the price of capital. Having cut policy rates to zero, central banks are now controlling term yields using government bond purchases. Currently open-ended in the US, Europe, and Japan, Quantitative Easing (QE) operates like a giant subsidy of capital, which helps to suck in financial from elsewhere. Real yields have been at historically low levels since 2008/2009.

Governments also control **credit spreads**. Spreads form an important part – sometimes the most important part – of the cost of capital for corporations.

Central banks have been buying investment grade corporate credit and mortgage credit for some time, but the US Federal Reserve and the European Central Bank (ECB) just recently expanded their purchases to include high yield credit (via ETFs). Japan already buys equities (via ETFs). The entire spectrum of credit markets in developed countries is therefore now subject to central government control. This implies, of course, that companies are being kept alive by artificial means, when they ought, for the sake of the health of the wider economy, be allowed to die and free up resources be deployed more effectively elsewhere.

Stock prices are manipulated indirectly. By subsidising the cost of capital of listed companies using bond purchases, central banks enable corporations to issue debt more cheaply, which enables them to buy back shares. The US government has also intervened in the markets for ***steel, oil, banks, and cars***. Protectionism, which grants a measure of control over the markets for ***traded goods and services***, has recently become a central pillar of government policy in the United States.

It is likely that other key macroeconomic prices will soon be manipulated too, including ***wages and currencies***. QE has, if anything, worsened income inequality, because the incomes of relatively asset-poor middle and lower income earners have failed to keep up with the incomes of asset-rich higher income earners.

There is growing support in many quarters for universal basic income, 'living wages', 'Green New Deal', and Modern Monetary Theory (MMT). The latter ludicrously holds that fiscal deficits do not matter at all.[1] Stephanie Kelton, one of best-known proponents of MMT, is considered by some as suitable for a seat on the FOMC, which testifies to the influence of her ideas.

Manipulation of currencies seems likely to happen soon as well, because real exchange rate overvaluation tends to become an ever more pressing problem in countries that neglect reforms in favour of price controls, protectionism, and deficit spending.

Investors have been quick to realise that markets now play second fiddle to governments as far as the big prices in the economy are concerned. The mantra 'Don't fight the Fed' has been taken to an entirely new level. This is most clearly manifested in the observation that stock markets now regularly rally after bad economic news. This is clearly not because bad news is good for companies. Rather, the counter-intuitive price action reflects an expectation in markets that central banks will intervene to prop up financial asset prices, regardless of, or, perhaps because of, what is happening to fundamentals.

That is not to say that markets do not matter. Far from it. In contrast with traditional central planning systems, the new macroeconomic control regimes in developed economies do not prevent relative prices from adjusting. Nor do they bar anyone from transacting at whatever prices they find suitable. Ownership of wealth and property and capital also remains in private hands.

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The really big difference between conventional market economies and macroeconomic control regimes is that the most important macroeconomic variables, such as interest rates, stock prices and variables of similar importance to the macro-economy are controlled directly by governments to a completely unprecedented degree. Markets are in effect being used as a tool to manage the economy. Given the environment of general economic malaise, all the important macroeconomic prices are currently being maintained at levels, which are significantly higher than they would be if markets were left to their own devices. All 'lesser' prices, such as the prices of factor inputs, products of all kinds, and individual financial assets price off these 'big' prices and hence all prices in the economy are distorted. Resources are therefore not optimally allocated either, which undermines productivity growth and ultimately harms living standards.

[1] For a discussion of MMT and growing fiscal risks in developed countries see: *'Beware of Big Fiscal'*, The Emerging View, 3 April 2019.

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A bit of macroeconomic price manipulation may, at first sight, seem fairly innocuous. Supporters of government intervention – that is pretty much everyone in financial markets and most government officials – will argue that the policies currently in place, such as Quantitative Easing (QE), are worthwhile arrangements designed to cope with a strictly transitory cyclical downturn. However, the truth is that more than ten years have passed since the 2008/2009 crisis, so the claim that these policies are temporary is beginning to ring a bit hollow. In fact, macroeconomic price controls are far more sinister than they first appear. They introduce wedges – distortions that is – in both domestic and international markets, which have profound effects on asset allocation and the efficiency of whole economies. They also interact with and compound existing market failures, such as bubbles and sudden stops. They tend to worsen income inequality. Finally, they are difficult, if not impossible to reverse and they tend to end in economic collapse and wholesale regime change.

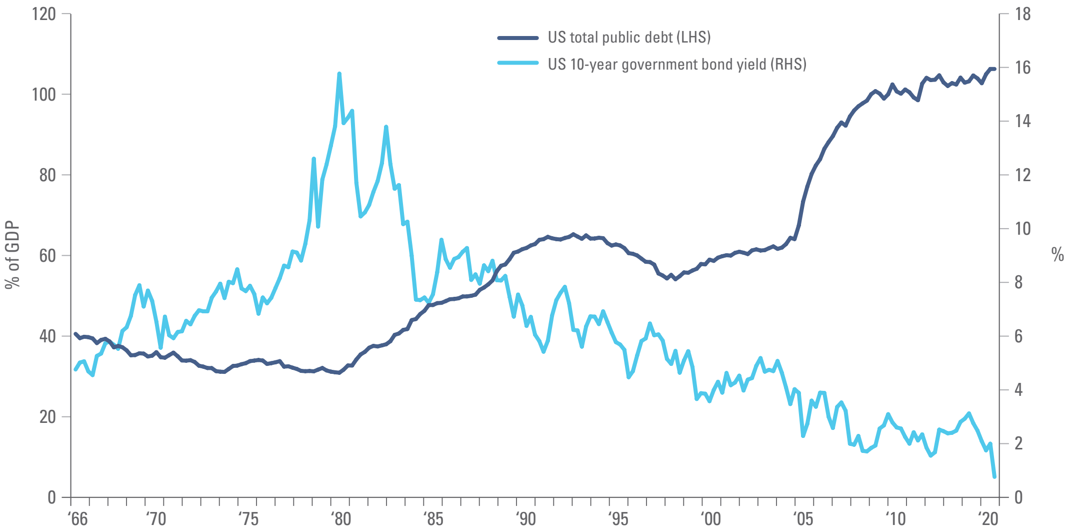
The following sections discuss these features of macroeconomic control regimes in greater detail.

Domestic wedges

The first problem with macroeconomic price controls is that they introduce wedges into markets within the countries in which they are applied. Specifically, they distort the relationship between valuations in markets and underlying economic fundamentals. For example, it is abundantly clear that the US Federal Government's cost of borrowing now no longer bears any relation to the stock of outstanding debt (Figure 1). The US Federal Reserve (Fed) keeps interest rates artificially low by buying bonds, but at the same time this incentivises the US government to borrow and spend more in preference to undertaking economic reforms. This is bad for both debt dynamics and productivity growth. Companies are also induced by low rates and artificially depressed credit spreads to issue debt to finance share buybacks rather than to invest in the real economy, also undermining productivity.

Macroeconomic price controls introduce wedges into markets within the countries in which they are applied

Fig 1: **US 10-year bond yield and total public debt to GDP**



Source: Ashmore, Bloomberg. Data as at 31 March 2020.

There is every reason to expect the wedges between valuations and fundamentals will widen further over time

There is every reason to expect the wedges between valuations and fundamentals will widen further over time. By intervening to support financial assets when the news is bad, central banks remove any downside risks in financial markets, even if the underlying fundamentals actually worsen. Worse, the healthy process of economic rejuvenation that occurs in periods of volatility and business cycles is rendered ineffective, which results in the gradual stultification of the economy. Perversely, market participants and governments can absolutely be counted upon to lobby for increased interventions as the gaps between valuations and fundamentals expand, because this is the least painful way to avoid a large financial crash. As financial assets assume an aura of impregnability to shocks, more capital gets sucked into financial markets as the expense of investment in the real economy.

With the onset of recession in the US and other developed economies, it is almost certain that government spending will increase significantly, not least in order to subsidise low income groups as unemployment rises. The US Federal Government debt stock is expected to exceed 100% of GDP in 2020, according to the latest estimate from the Congressional Budget Office (CBO), but the CBO's longer-term projections show that the US government's debt dynamics will continue to

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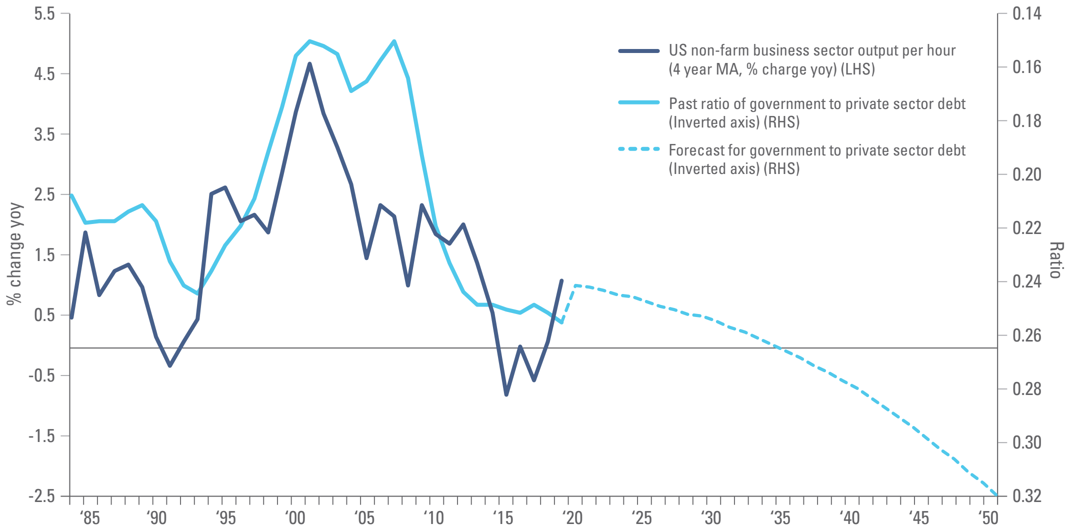
The US government's debt dynamics will continue to worsen so that the debt stock hits 180% of GDP by 2050. This bodes poorly for productivity growth. There is a strong negative correlation between productivity growth and the stock of government debt relative to private sector debt

worsen so that the debt stock hits 180% of GDP by 2050. This bodes poorly for productivity growth. There is a strong negative correlation between productivity growth and the stock of government debt relative to private sector debt in the United States. The size of the respective debt stocks of the public and private sectors merely reflect their past levels of spending. Higher levels of US public sector spending relative to private sector spending are associated with lower overall productivity growth, because the productivity of the US public sector is far lower than the productivity of the private sector. As it happens, US productivity declined 2.5% qoq saar in Q1 2020 just as the fiscal deficit jumped, but the link between government debt and productivity is obviously structural as shown in Figure 2.[2] The dotted line incorporates CBO's projections for the rise in the US government debt stock and suggests much lower productivity growth in the United States in the coming decades.[3]

Fig 2: **US productivity growth and the government's share of total debt**



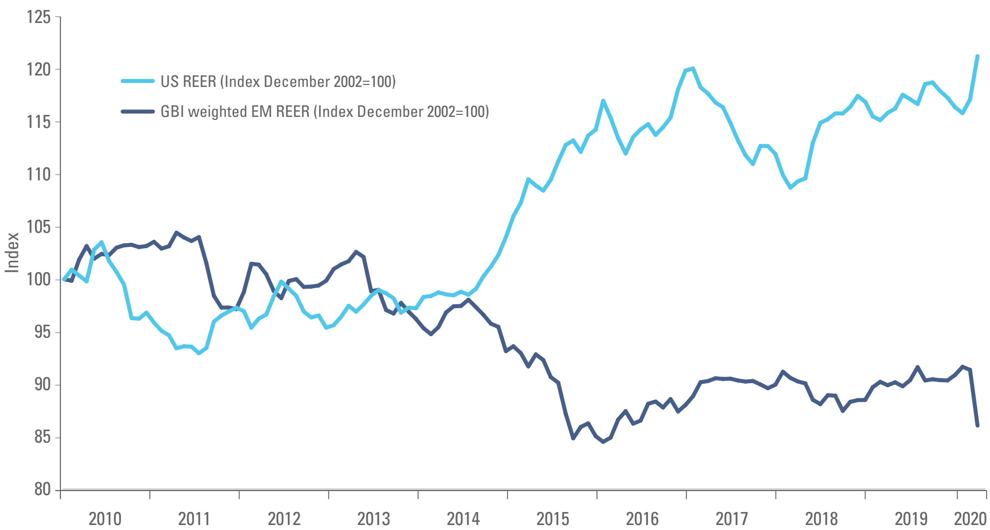
Source: Ashmore, US Treasury, Congressional Budget Office (CBO), Bloomberg. Annual data as at end-2019 and projections based on CBO and Ashmore analysis.

International wedges

Macroeconomic price controls also create wedges between markets in countries with controls and markets in countries without controls. Wedges of this kind have been in evidence since the onset of QE, although they became particularly pronounced in the years during and immediately after the so-called Taper Tantrum.[4] They declined in size during the Fed's hiking cycle, when the implicit subsidies in the US declined at the margin, but are now widening again as the Fed has once again cut rates and intensified its control over markets. This is most evident in currencies (Figure 3).

Macroeconomic price controls also create wedges between markets in countries with controls and markets in countries without controls

Fig 3: **Real effective exchange rates – US versus EM (GBI-EM GD weighted)**



Source: Ashmore, JP Morgan, Bloomberg. Data as at 31 March 2020.

[2] Debt stocks are a good summary measure of past spending.
[3] See: https://www.cbo.gov/publication/56335
[4] For a discussion of the enormous distortions in the allocation of global capital between the QE economies and EM, see: *'What goes around comes around: a short note on Dollar risk'*, Market Commentary, 17 January 2020.

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The mechanisms that cause macroeconomic price controls to shift capital from countries without manipulation to those with manipulation are straight forward. First, investors prefer capital gains to yield when central banks actively subsidise capital. Second, the orchestrated subjugation of volatility is generally welcomed by investors, even if the lower volatility derives from government intervention. Of course, regulation also tends to favour lower volatility markets in terms of capital requirements, although regulations change less frequently.

Interaction terms

In addition to creating wedges between markets, macroeconomic price controls also interact with and compound existing problems in market economies, such as market failures and income inequality. *Bubbles* are among the most frequent market failures in capitalist economies and known to inflict huge costs when they burst. QE contributed significantly to re-inflating the stock and bond market bubbles after 2008/2009, but central bank policies have since become geared more and more towards keeping the bubbles inflated, almost at any cost.

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Macroeconomic price controls have also contributed to an increase in the frequency of equally damaging market failures called *sudden stops*. Sudden stops, which are the opposite of bubbles, have generally become less systemic in EM in recent years, because many EM economies now finance themselves in their own domestic bond markets. However, the poorest EM economies do not have large domestic bond markets so they still depend on foreign capital. For every Dollar that sits in a QE sponsored bubble market there is one Dollar less in EM's already finance-starved economies.[5] In this context, bouts of risk aversion can quickly cut them off from foreign capital entirely and plunge them into full-blown economic catastrophes. If these traumas in turn foster disillusionment with markets then development can be set back many years.

The gradual erosion of economic performance under macroeconomic control regimes also increases the incidence of *negative externalities*.[6] Weak economic performance fuels populism and nationalism. Populists favour short term gain in spite of long-pain, which typically results in lower priority being assigned to environmental policies. Nationalism recently prompted the US to withdraw from the Paris Climate Agreement, illustrating perfectly how deteriorating economic circumstances at home are less than conducive to solving international problems. In the same vein, economic nationalism prompted the US to embark on a trade war with China, which has weakened the economies of both countries.

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However, the most damaging interaction is with income inequality.[7] QE type manipulation of the cost of capital in developed countries has already triggered enormous capital flight from EM, which, if it continues, could put into reverse the decline in income inequality seen across countries since the 1970s (it was mainly due to faster growth in EM countries). Inequality within countries has increased in the last few decades, most recently because macroeconomic price controls have contributed to a disproportionate rise in wealth among the asset-rich, principally by pushing up stock prices. Meanwhile, the widespread neglect of economic reform has meant stagnation for lower income groups. The incentives for the 'have-nots' to apply effort and innovate have therefore dulled, but also made them angry. They have rejected establishment politicians at the ballot box in favour of populists, who offer social safety nets. However, such policies dis-incentivise the 'haves' from investing, so the economy weakens further.

Tough to change course

Despite the drawbacks associated with macroeconomic price controls, Western economies will probably not deviate from their present course. How do you downsize a government in the middle of recession? How do you reverse rising inequality without massively increasing public spending? How can you raise interest rates, when there is so much debt outstanding? How can you tackle reforms if you want to get re-elected? Developed economies found it difficult to tackle these issues well before the crisis of 2008/2009. Today, the challenge is even greater.

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Politicians will be particularly mindful that unemployment will remain high for some time. Companies will be slow to re-hire staff due to inventory overhangs, lingering uncertainty, and weaker demand. Unemployment will erode household finances leading to delinquencies and eventually defaults on credit card debt, car loans, student loans, and mortgages. Defaults may also rise in corporate bond

5 Most EM economies are severely finance constrained. Across EM as a whole, stock and bond markets only make up about 90% of GDP compared to 360% in developed economies. In African countries, finance only makes up about 30% of GDP, or less than 10% of the finance available in the typical developed economy. For a further discussion of this see page 3 in this publication: *'What goes around comes around: a short note on Dollar risk'*, Market Commentary, 17 January 2020.

6 Negative externalities are economic costs, which are not fully captured in prices. They are to blame for the destruction of ecosystems and species depletion ('tragedy of the commons'), pollution, such as plastics in oceans, and climate change.

7 For a rich source of information on inequality see: https://www.wider.unu.edu/project/wiid-world-income-inequality-database

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markets as bankruptcies rise. The pain in the leveraged loan market could prove truly formidable. Many cases will go to courts, where they will linger for months or years. The resulting credit impairment prompts banks to restrict credit, which in turn leads to yet more layoffs and even higher unemployment.

This downwards spiral only stops, when wages have fallen sufficiently to clear the labour market (at a significantly lower real wage). However, the exchange rate also needs to adjust to restore export competitiveness. This is where macroeconomic price controls make their final sinister appearance. Since governments will do what they can to support the jobless, labour markets will actually take longer than necessary to clear. Similarly, the Fed's support of stock markets will delay the required adjustment of the Dollar without which American companies will not regain the competitiveness in global markets.

The end game

In their final stage, macroeconomic control regimes collapse for same reasons that the economies of the Eastern Bloc fell, namely that a kind of economic osteoporosis takes root

Markets are unlikely to play a major role to bring change for the obvious reason that markets become progressively more shackled as the end game approaches

Macroeconomic control regimes are unsustainable. Once embarked upon they become permanent fixtures, because they simultaneously inflate bubbles and weaken the underlying economy, particularly productivity growth.

In their final stage, macroeconomic control regimes collapse for same reasons that the economies of the Eastern Bloc fell, namely that a kind of economic osteoporosis takes root. As productivity declines, debts rise and real exchange rates become ever more overvalued, governments eventually find themselves unable to generate the surpluses required to sustain financial market valuations, salaries, and currencies.

However, one thing sets the final collapse of macroeconomic control regimes apart from collapses of conventional market economies with unsustainable macroeconomic balances, namely that markets are unlikely to play a major role to bring change for the obvious reason that markets become progressively more shackled as the end game approaches. Hence, the demise may not only take an excruciatingly long time, but the final *coup de grace* is also likely to happen as a result of broad-based social discontent rather than a short, sharp financial shock.

Once the regime goes, however, it really goes. The collapses of the control regimes in the Eastern Bloc were accompanied by truly massive repricing of both financial and real assets to bring these into line with their true value. Regime collapse is also likely to unleash an almighty spike in inflation as the credibility of central government institutions, such as central banks take a huge hit and supply contracts more than demand. Finally, currencies have to fall significantly. Of course, in this respect Western economies are very different from the Eastern Bloc in that Western currencies currently fill the vaults of central banks the world over. Hence, when the collapse finally happens central bankers the world over will face, more than anyone else, the true cost of never having respected the First Rule of Asset Management: diversification.

It is no small irony that investors in global financial markets favour markets where governments are now encroaching ever more on free markets

Conclusion

Macroeconomic control regimes are a half-way house between free markets economies and conventional central planning systems. Property remains in private hands and most markets are free, but the key prices in the economy around which all other markets revolve are centrally controlled. Macroeconomic control regimes are both inefficient and unsustainable. They lead to lower productivity growth and ever wider wedges between valuations and fundamentals. Eventually, they collapse.

It is no small irony that investors in global financial markets favour markets where governments are now encroaching ever more on free markets. There is no doubt that the global economy would grow faster and be a safer place to invest if capital was distributed more efficiently, that is, if central banks were not distorting markets.

However, there is no sign that this will happen anytime soon. In fact, it is far more likely that governments in developed countries will double on their policies to shore up financial markets as their underlying economic fundamentals worsen.

It is therefore up to individual investors whether they want to risk it in the developed market Ponzi Schemes or seek to avoid them. The trade-off is clear. Avoiding the control regimes means earning more in yield and being invested in sustainable stories, but experiencing plenty of volatility. Staying in the control regimes ensures a far less volatile ride, because governments gradually remove more and more of the noise, but returns are low and will diminish further over time and one day the whole thing will come crashing down. Ladies and gentlemen, place your chips!

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Contact

Head office

Ashmore Investment Management Limited
61 Aldwych, London
WC2B 4AE

T: +44 (0)20 3077 6000

@AshmoreEM

www.ashmoregroup.com

Bogota
T: +57 1 316 2070

Dubai
T: +971 440 195 86

Dublin
T: +353 1588 1300

Jakarta
T: +6221 2953 9000

Mumbai
T: +9122 6269 0000

New York
T: +1 212 661 0061

Riyadh
T: +966 11 483 9100

Singapore
T: +65 6580 8288

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