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Can Government Financial Support Pump the Crypto Market?

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Introduction

The COVID-19 crisis has required an incomparable volume of financial aid all over the world. Some estimates say that during only the first two months of the lockdown, governments had announced more than $10trln in financial help to businesses and households. This unprecedented government intervention has brought a kind of new normality to capital markets. Pricing of financial assets has become strongly dependent on the new financial stimulus packages that come out of vague political discussions. That is why investors all over the globe must be aware of the latest news about the fiscal and monetary policies of the major nations. Crypto asset investors are no exception. In this article we will try to understand which considerations about the influence of macroeconomics and government support on the crypto market an investor should keep in mind during the current crisis.

Major financial support programs in brief

In the context of the lockdown, governments have focused on support of consumer spending, employment and the prevention of a wave of corporate bankruptcies. This section provides a short summary of the financial stimulus packages provided by the governments of the United States, the European Union, Japan and the United Kingdom.

The United States

The first sizable package arrived in March, 2020. It provided nearly $200bln for sick leaves, medical services and components, food assistance, transfers to states to fund expanded unemployment insurance, and small business subsidies. Shortly after that in March, 2020, the biggest one-time package (CARES Act) saw the light. It consisted of $2.3trln in financial assistance to individuals, companies, medical entities and local governments. $293bln was distributed among the citizens as a one-time tax rebate; another $268bln was used to expand unemployment benefits. This means that $561bln was paid directly to individuals. Nearly $350bln was given to small businesses in the form of loans and guarantees to retain workers. In April, 2020, an additional $483bln was provided by the federal government, $321bln of which was directed to small business as loans to pay wages. All in all, the government stimulus has amounted to $3trln, while an additional $0.5 to $1.5trln package is currently under consideration.

Fiscal stimuluses are accompanied by loose monetary policy. The FED funds rate is now set at 0 – 0.25%. There is some evidence that in the near future the rate may even become negative, although FED officials claim they are not considering this measure.

All in all, the US government has already provided $3trln (15% of the 2019 GDP) to the economy, and the larger part of this sum has gone to individuals and SMEs. Future fiscal stimuluses are inevitable; the main question is the volume of these stimuluses, with estimates ranging from $500bln to $1.5trln. FED rate adjustments for the most part suggest that the present loose monetary policy will remain in place for at least another year.

Other countries

The European Union has also focused on employment and small and medium businesses support. There are two levels of fiscal measures: state fiscal stimuluses and central EU assistance. The total volume of state fiscal measures of European countries has reached €3.6trln, while the central EU government has provided another €610bln. In total, European countries have already announced €4.2trln of financial assistance. This assistance is combined with a loose monetary policy: the interest rate on the main refinancing operations (which provide the bulk of liquidity to the banking system) is 0%.

Japan developed two aid packages in March and May, each of which amounted to 117trln yen, equalling nearly $1.1trln. Therefore, the total amount of economic stimuluses has already reached $2.2trln. The Bank of Japan interest rate is set at −0.1%.

Great Britain is planning to inject an extra £192bln during this financial year to mitigate the consequences of the pandemic crisis. Nearly half of this amount is to be transferred to individuals as a means of employment protection and welfare support.

In total, major governments have announced packages worth more than $10trln, or approximately 7% of the global GDP as of 2019. These enormous injections are supported by a loose monetary policy conducted by the most powerful central banks, a policy that includes zero or even negative interest rates and expanded asset purchasing programs.

Consequences of the support measures

As discussed above, the economic measures taken have mostly focused on support of consumer demand and the financial sustainability of SMEs. Hence, these measures can have an inflationary effect in the event that the total demand recovers more quickly or the decline is less dramatic than the national governments expect.

Figure 1 shows the influence of government aid packages on the US dollar money supply, which has rocketed from $4trln in the beginning of 2020 to nearly $5.5trln in mid-2020.

Figure 1
Money supply M1 aggregate, $bln

Source:
tradingeconomics.com

The growth of the money supply has had a well-understood impact on inflation expectations. Figure 2 shows that after the financial stimuluses in March and May were announced and individuals received the tranches of the financial aid, inflation expectations jumped from 2.54% in March to 3% in May, with some correction during June and July. Even the summer numbers, however, indicate that expectations of inflation have noticeably risen.

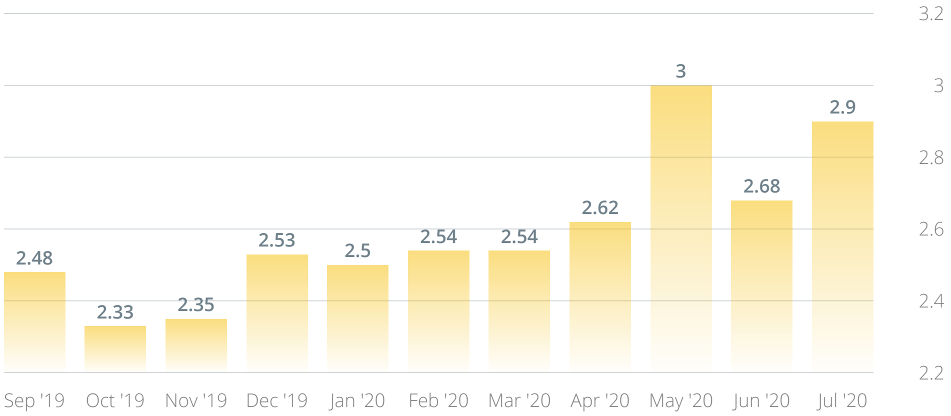

Figure 2
Inflation expectations in the US, %

Source:
tradingeconomics.com

Economic theory says that during a period of increased inflation, the best performance is shown by assets that can be regarded as a store of value—gold, for example. Gold, however, has already reached its all-time high and looks to be overbought. Some experts believe that BTC can be regarded as a store of value too, and while the value of the dollar is been eroded by inflation, BTC price could become much higher.

Another important fact is that US citizens have substantially raised their savings rate. Figure 3 indicates that whereas before 2020 households on average saved 7 – 8% from their disposable income, the pandemic has forced families to reconsider their behavior and save much more. It may be concluded that individuals have saved a larger part of the subsidies they received from the government.

Figure 3
Household saving rate, %

Source:
tradingeconomics.com

What is more, the majority of these funds are still deposited in bank accounts at very low rates. Figure 4 shows that starting from March, the total balance sheet of banks has increased by $2trln.

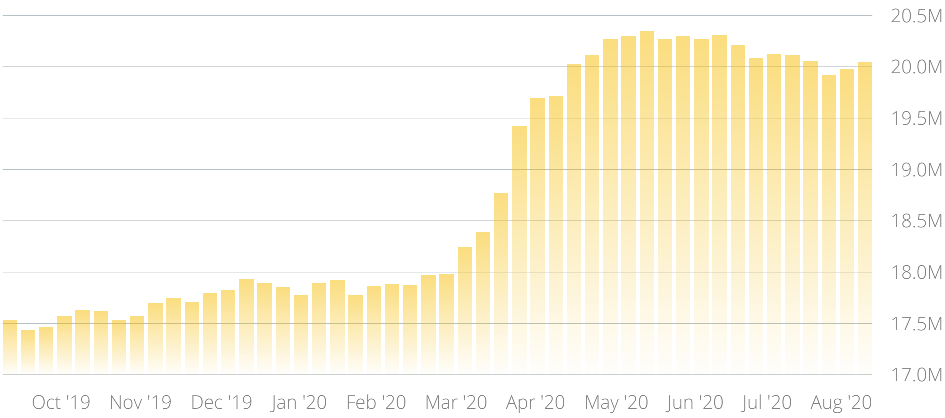

Figure 4
Banks balance sheet, $mln

Source:
tradingeconomics.com

This evidence can be regarded as proof of a great opportunity for crypto markets. The logic is that if individuals have accumulated a large volume of funds and their consuming behavior has become more conservative, then in the conditions of very low bond yields and overheated equity markets, people will turn to crypto currencies that offer higher potential income than traditional instruments, given that the recent realized growth of the equity markets has made the risks of investment in equities and in crypto currencies at least comparable. But in our view this logic is questionable.

BTC and ETH during the pandemic

The dynamics of two major crypto currencies BTC and ETH during the COVID crisis are quite similar to those of the S&P500 index.

Figure 5.1
BTC, $

Source:
tradingeconomics.com

Figure 5.2
ETH, $

Source:
tradingeconomics.com

Figure 6
S&500, points

Source:
tradingeconomics.com

After the drop in March, the prices of all mentioned assets have steadily grown to pre-COVID levels. ETH has jumped even higher than it was in March, 2020, but this can be explained by the expectations of the Ethereum 2.0 implementation. Now ETHUSD is 20% higher than it was in March of 2020, while BTCUSD is trading practically at the same level. The conclusion could be that the analogous dynamics of the asset prices is triggered for similar reasons: huge liquidity injections and the downtrend of the US dollar against other fiat currencies. These graphs may indicate that the prices both of the SP500, on the one hand, and of BTC and ETH, on the other, mostly reflect the $10trln liquidity injection that was described above.

Reasons to be cautious about potential inflows into the crypto market

Despite the fact that US households have increased their savings, there remains a question: for what purpose have they done so? The government expected that households would use the funds for consumption, which can stimulate total demand in the economy. But in reality, individuals decided to save the money they received from the government or to pay off debts.

The indebtedness of US households is still very high and amounts to 75% of GDP. What is special about the pandemic crisis is that a person can lose any means of living at any time. This is the case of citizens who are employed in the services sector, which accounts for 65% of US GDP. The lockdowns caused by new potential COVID-19 waves will immediately influence a major portion of US households.

A reasonable response from households is to use government subsidies to pay off debts in order to mitigate the risk of going bankrupt. Figure 7 confirms this hypothesis: after households had received government subsidies, private sector credit began to decline.

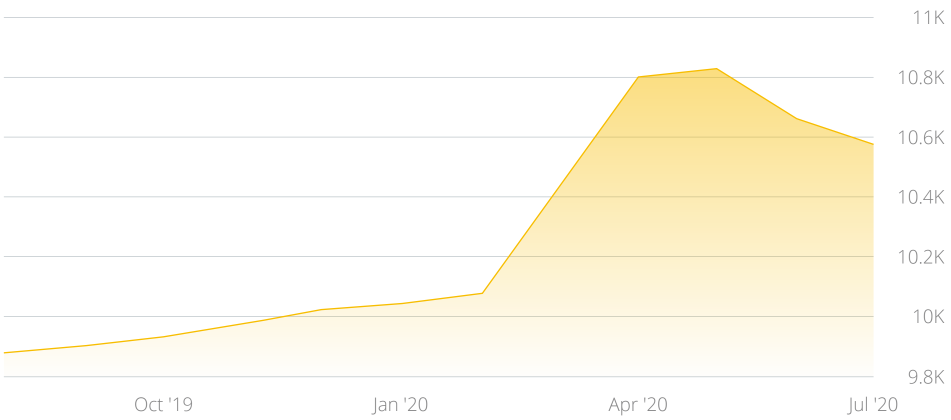

Figure 7
Private sector credit, $blns

Source:
tradingeconomics.com

Another factor to be considered is the effect of delayed demand. The funds that are now deposited in banks can be spent for consumption instead of investment if the pandemic downtrends and economic conditions become more favorable. This idea is supported by the fact that the University of Michigan's US consumer sentiment stopped its slump and has even slightly recovered (see Figure 8).

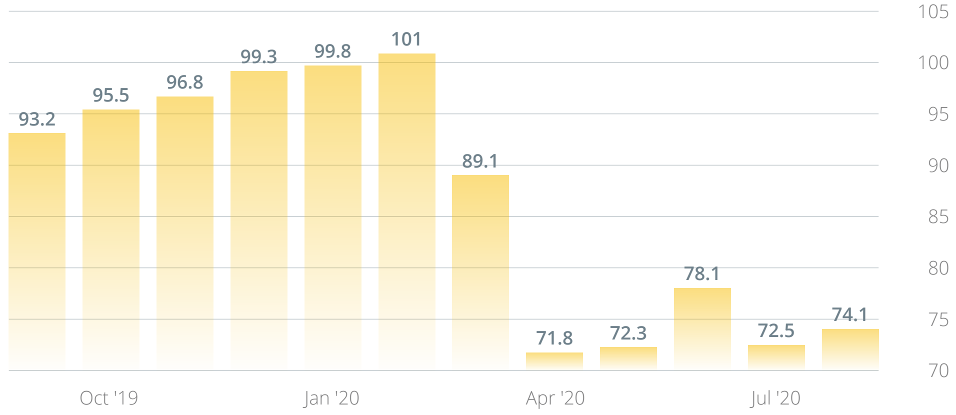

Figure 8
The University of Michigan's consumer sentiment, points

Source:
tradingeconomics.com

The last but not least consideration is of future government financial aid packages. US government debt has increased by 15% from the beginning of the year and equals $26.7trln, or 125% of GDP. Political uncertainty before the presidential election also makes the development of new fiscal packages rather challenging. Thus, it seems reasonable to assume that the government has a very limited opportunity to support citizens using direct fiscal measures. If so, the welfare of individuals can worsen in the near future leaving little room for further retail investment in crypto assets. Hence, in case the future stimulus packages are less than expected by the market, and the economy continues to suffer from pandemics, we can easily foresee another wave of risk-off decisions that will put the prices of crypto assets under pressure.

These three factors (usage of government subsidies to pay off debts, delayed demand, and uncertainty about future government financial aid) may constitute barriers to potential inflow into crypto markets.

Conclusion

In this article we have considered major government stimulus packages and their potential influence on crypto markets. By the beginning of September, total government financial aid has surpassed $10trln. This injection of funds has supported financial markets: the SP500, for example, has already recovered from the collapse that took place in March. BTC and ETH prices also exceed pre-COVID levels. Some experts, however, believe that crypto currencies may still skyrocket because traditional assets are expected to give very low upside from the current levels, and the expanded USD money supply will lead to high inflation and depreciation of the value of the US dollar.

These considerations are quite reasonable, and it may be that crypto assets and especially the majors such as BTC and ETH can seriously benefit. There are, however, several points that an investor should keep in mind.

First, government subsidies can be used by individuals and SMEs for debt repayment. In view of this fact, crypto investors should monitor the total indebtedness of households and the personal savings rate. In the event that indebtedness does not strongly contract and the savings rate is still at a higher level than usual, crypto markets can receive the additional inflow of cash.

Second, consumption may be delayed, so the funds that are now accumulated in bank accounts may be spent in the future rather than invested. To identify this trend, crypto investors should monitor the consumer sentiment index. In case of a quick recovery of consumer confidence, crypto markets risk not receiving additional funds.

Third, it seems that the crypto market has already priced the existing stimulus packages. Thus, investors should mainly consider future stimulus packages that can trigger additional growth of crypto assets. However, there are reasonable doubts that, given increased government debt and diminished tax proceeds, governments will be able to agree upon new large fiscal measures.

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