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The future of policy

Trends post COVID-19

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A decade on from the global financial crisis (GFC), the world economy is facing an even more severe downturn — one unprecedented in modern times. Unlike 2008, the catalyst is not financial, but rather a pandemic affecting the entire world at once. Government-mandated lockdowns around the globe to contain the spread of COVID-19 have caused the sharpest economic contraction since the Great Depression. Policymakers have reacted rapidly in an attempt to mitigate lasting economic damage. The intention is to position economies for recovery by providing temporary liquidity to businesses and replacing lost income of idled workers.

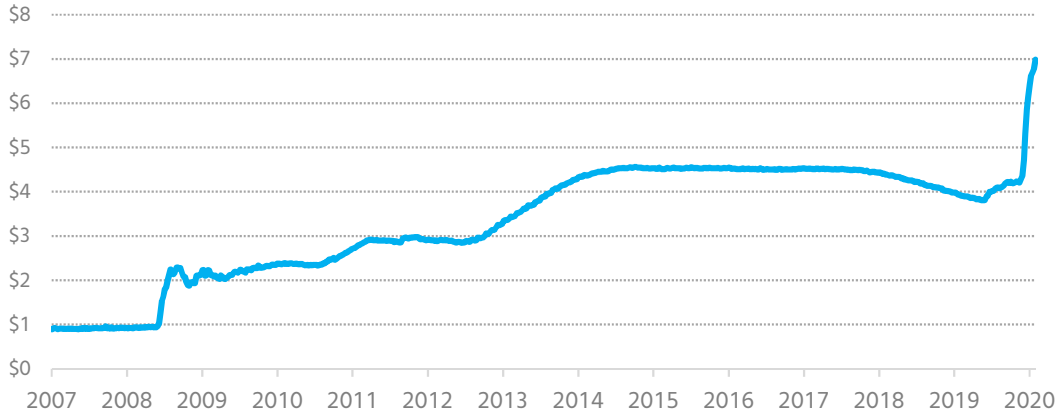
A notable shift from the financial crisis is that fiscal policy has come to the forefront. Central bankers have also made active attempts to minimize the impact on the broader financial landscape. As we look beyond the current recession to the recovery and future cycles, policymakers could look to fiscal policy to manage the economy, supported by increasing monetary policy coordination.

Most central banks entered this recession with little if any room to lower benchmark interest rates, amid concerns that going below zero does more harm than good. Low interest rates are supposed to encourage borrowing and, by extension, spending and investment. However, tight financial conditions did not cause this recession, and so lowering rates will have a limited impact.

Consequently, central bankers are addressing the crisis through quantitative easing (QE) and emergency lending programs. The GFC showed that these programs are effective at preventing liquidity-driven tightening in financial conditions, thereby helping to avert a downward spiral in the economy and markets. In hindsight, however, QE was less effective at stimulating real economic growth. It did not appear to encourage businesses to invest more. Rather than causing consumer price inflation, it facilitated asset price inflation.

In the current crisis, central bankers have again used QE and lending facilities to provide liquidity to markets. The US Federal Reserve (the "Fed") has aggressively expanded its balance sheet (figure 1). In addition, it has coordinated with the US Treasury to buy corporate debt and provide direct financing to businesses. The Fed's actions eased financial conditions and put a short-term floor underneath markets. Of course, QE by itself cannot provide the direct support to households to make up for lost wages, nor does it provide small businesses that do not raise capital in the market with a lifeline to survive the lockdowns.

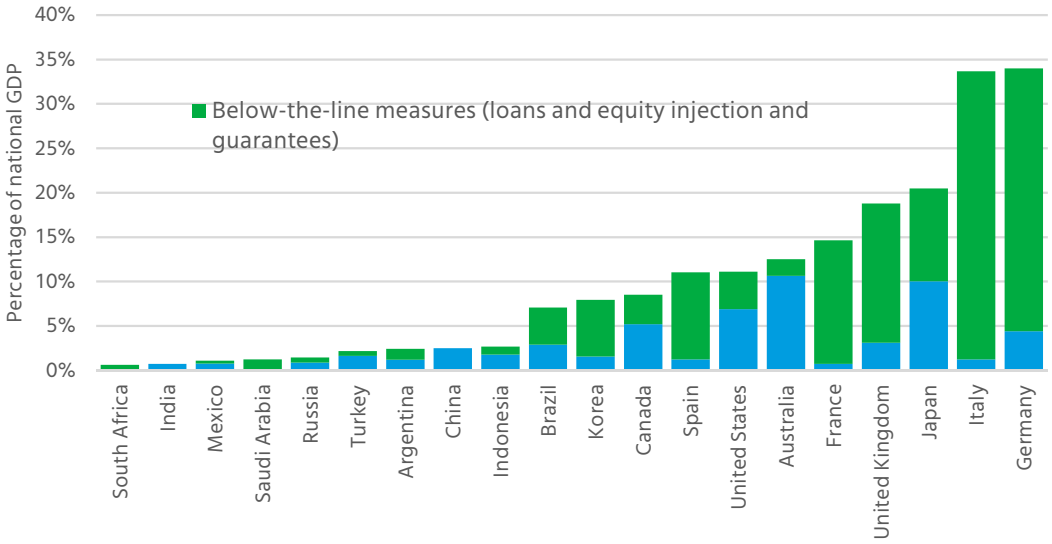
Figure 1. Federal Reserve assets ($trillions)



Source: Bloomberg

Policymakers have recognized this. Governments around the world have taken steps to provide fiscal support to households and businesses to bridge the gap until lockdowns can end (figure 2). The US, for instance, passed plans totaling more than 10% of GDP, including a mixture of household payments and business loans, and further support is under negotiation.

Figure 2. Fiscal policy responses to COVID-19 – April 2020



Source: IMF

We expect this to begin a trend towards more active fiscal policy that could outlast the current downturn. With the rise in populism in many countries over recent years, concerns over governments' deficits have generally receded across the political spectrum. Combined with the mixed success of QE, more policymakers are advocating for broader fiscal tools. The COVID-19 crisis has accelerated the call for more coordination between monetary and fiscal authorities.

Modern Monetary Theory (MMT) is a school of economic thought that advocates combining monetary and fiscal policy. Proponents of MMT suggest that monetary policy alone is inadequate for managing downturns. Rather than relying on independent central banks and interest rate policy, governments should assume primary responsibility for managing the business cycle through spending, taxes and debt management. The theory is that a government that issues its own currency has considerable capacity to run budget deficits when the economy is operating below capacity. It calls for governments to run significant budget deficits during downturns funded primarily by money creation rather than debt issuance. This should eliminate output gaps and return the economy to full employment quicker than traditional monetary policy supplemented by more limited fiscal stimulus. Some proponents further argue for a job guarantee to ensure full employment at all times.

Advocates of MMT view real productive capacity of the economy as the only constraint on spending. When the economy is operating at capacity, inflationary pressures will begin to increase, at which point governments could increase taxes, reduce spending and tighten monetary policy to prevent inflation rising above target.

The premise of this framework might help explain why QE was not as successful in stimulating economic activity in the aftermath of the GFC. The trend toward fiscal austerity throughout the developed world that began in 2010 meant that QE only altered the maturity profile of government debt, by substituting overnight bank reserves for longer-maturity bonds. This likely compressed term premiums on longer-duration bonds and reduced borrowing costs, but its impact on credit creation and demand was limited. The constraint on credit creation did not result from a lack of bank reserves, but rather a combination of tighter bank regulations and low demand for credit as the private sector increased savings.

The idea that monetary and fiscal policy should be coordinated, however, is not a new one. "Helicopter money" was a concept outlined by the economist Milton Friedman and highlighted by the former Chair of the Fed, Ben Bernanke, in 2002. The theory is that the central banks could seek to lift inflation and stimulate economic growth by transferring cash to households or by directly funding fiscal stimulus. In contrast to typical fiscal stimulus, helicopter money would be funded by a permanent increase in the money supply, instead of bond issuance to the public.

Those skeptical of MMT, helicopter money and other similar proposals fear that a loss of central bank independence will put more of the power to create and allocate money, credit and spending in the hands of politicians. This could potentially lead to a misallocation of capital and crowd out the private sector. Politicians, as elected officials, are less likely to have the discipline to "take away the punch bowl" when economies are at their productive capacity, especially since the next election is always in view. MMT opponents further argue that such approaches are likely to lead to slower economic growth and higher inflation, while sowing the seeds for larger crises in the future.

The COVID-19 crisis has emboldened policymakers to use unconventional policies, including aggressive fiscal measures. The current coordination between the Fed and the US Treasury is one example. The Fed's pledge to carry out open-ended purchases of government securities, at the same time as having massive fiscal deficits, arguably crosses the threshold into helicopter money and debt monetization. This could prove to be just the beginning. As the global economy emerges from lockdown, infrastructure and education might attract spending from further rounds of fiscal stimulus. Looking to the intermediate term, there might be political demand to keep household-income support policies in place, perhaps eventually leading to universal basic income or perhaps enhancements to existing elements of social safety nets. A number of politicians also see an opportunity to address climate-change risks and other key issues.

In view of this unprecedented crisis, the strong fiscal and monetary responses are necessary temporary measures to alleviate human suffering and avoid, to the extent possible, permanent damage to the economy. The direction that fiscal and monetary policy takes after this crisis passes could have profound long-term implications. If combined fiscal and monetary responses gain traction and are used prudently to manage future downturns, while facilitating long-term investments in infrastructure and education that improve productivity, they could improve trend growth rates and mitigate disinflationary pressures. However, prudence demands a degree of skepticism. We fear that politicians are unlikely to have the discipline to raise taxes and reduce spending when economies begin to overheat.

Investment implications

The potential for more aggressive fiscal policy suggests the most prevalent downside scenario could gradually shift from deflation to stagflation; as such, we suspect markets are underpricing long-term inflation risk. Market-based inflation measures continue to suggest that central bankers will fail to meet their inflation targets. To paraphrase Ben Bernanke, determined governments can always create inflation. If markets begin to expect governments to embrace money-financed fiscal largesse beyond the current recession, long-term interest rates should rise to compensate for higher inflation risk.

Although this is not likely to lead to inflation rising to the level of the 1970s, even mid-single-digit inflation could be destabilizing for a heavily indebted world and for asset markets priced for low inflation forever. In such a scenario, fixed interest bonds would no longer serve as an effective hedge against equities. Asset owners, particularly those with inflation-sensitive liabilities, could look to increase exposure to inflation hedging assets such as inflation-linked bonds, or inflation-sensitive assets such as carefully selected infrastructure and real estate. Gold also has appeal in an environment of negative real interest rates and upside inflation risks.

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