

What's the end game for emergency fiscal and monetary policy?

With monetary firepower largely spent, and fiscal deficits surging, governments may well increasingly look towards a form of monetary financing as a way to exit the recent emergency measures



There's seldom a straightforward return from unorthodox policies

The last few weeks have seen an unleashing of fiscal and monetary firepower that overshadows that seen during the global financial crisis. Some central banks have cut rates to levels never previously reached. Others have reverted to quantitative easing. Still others have started unorthodox measures for the first time ever. This monetary firepower is nothing though compared to the weight of fiscal stimulus measures.

These stimulus packages are growing by the day, but seem to be converging on rates equalling or in some cases, exceeding 10% of GDP. Fiscal deficits for these countries, as a proportion of GDP, will be much larger still, as tax revenues collapse along with the GDP denominator. We're mulling deficits in the 25% of GDP range for some major economies, including the US and Japan. But despite huge existing piles of debt, governments and central banks know they must spend now, and worry about the consequences later, or risk losing a huge chunk of their normally productive

economies, for ever.

The experience of the global financial crisis has shown that unorthodox monetary policy is something of an “event horizon”, from which there is seldom a straightforward return. A good case in point would be the European Central Bank, which took until 2018, 10 years after the financial crisis, to stop its own quantitative easing programme, but never managed to shake off negative deposit rates and is now back on QE. Sweden’s Riksbank too has famously tried to return to normalcy, raising its repo rate to zero in December 2019. That timing looks spectacularly ill-fated now.

Japan has been in this situation since at least 2001 and there is almost no chance of them pulling away from the vicious circle of low (negative) rates and low productivity that seems to be gripping most major nations (Japanification). Only the US successfully flirted with a return to normal monetary policy in 2018, and that didn’t last long either, though they did better than most.

Fiscal policy is doing the heavy lifting in this crisis

Part of the problem here is the non-linearity and non-symmetry of monetary stimulus. At low (even positive) rates, policy stops having a beneficial impact, and indeed can become detrimental to growth. But it doesn’t seem that raising rates back again is actually beneficial, taking central banks to the ‘damned if you do, damned if you don’t’ black hole of monetary policy. That looks likely to be the experience of many central banks currently trying to help their governments by lowering their borrowing costs as they try to spend their way out of the crisis.

Fiscal policy is no less easy a way out, though in the short-term, it provides a much bigger lift to the economy, so it is clear why so many governments are making it their principal tool given the paucity of monetary ammunition available to many of them.

What should be done with all the extra debt?

But the problem with a 10% stimulus package this year, is what to do the following year? Failure to replicate means a switch from fiscal boost to fiscal drag. And like any drug, going ‘cold turkey’ after a massive fiscal binge will rarely end happily. So governments tend to keep spending just to stay out of technical recession. It doesn’t take too many years of this to end up like Japan, and debt-to-GDP ratios in excess of 300% - with no credible possibility of ever conventionally returning to sub-100% levels.

The answer is monetary financing of the deficit. In its most innocuous form, this could entail a nation’s central bank converting its direct holdings of government securities purchased through quantitative easing, into non-interest bearing perpetual bonds. This is almost the same as saying that the debt has been annulled, but avoids the central bank having to write off its capital and perform yet another monetary conjuring trick of recapitalising itself with printed money. It is though, without the same fanfare, equivalent to what is otherwise called ‘helicopter money’. Such policies had already been considered a likely endgame for economies such as Japan. Now, most economies will find themselves in a similar position.

So if not now, when?

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