TS Lombard

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Economics / Politics / Markets

Macro Picture

POLICY SUPERCYCLES

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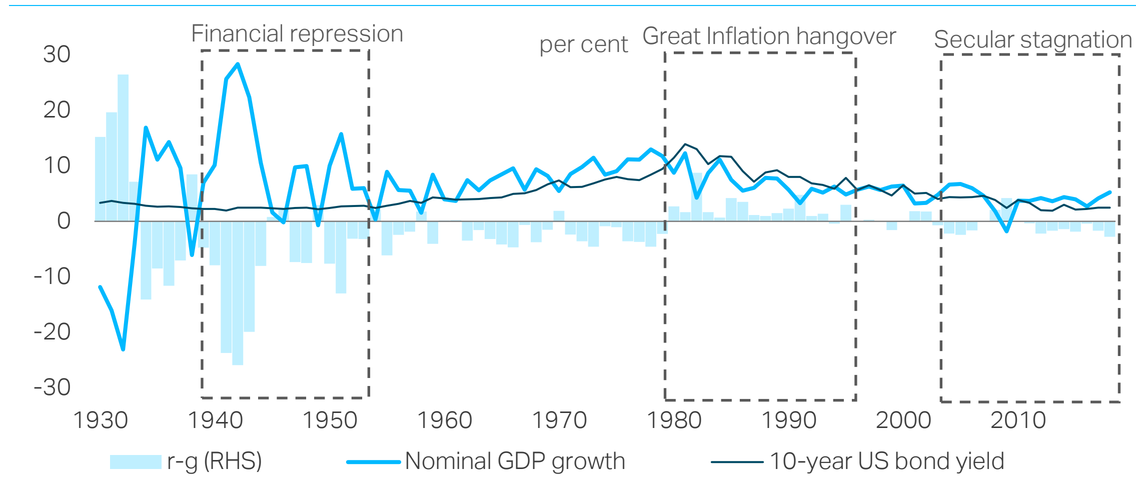
With monetary policy running out of ideas about how to revive nominal GDP, the debate is moving decisively towards fiscal activism. This retraces a long 'supercycle' in macro policy that started in the 1920s. Fiscal 'solutions' seem inevitable after the next recession. The only question is how far they will dilute central-bank independence.

Chart 1: Fiscal-monetary regimes



Source: MacroHistory database, TS Lombard

OPPORTUNISTIC REFLATION

Central banks are doing their best to extend the current global expansion. They realize another recession could be disastrous, both in terms of their policy options and ultimately their independence. While these efforts have so far proved successful – financial conditions have rebounded in 2019 – the December crash showed how precarious the outlook has become.

HISTORY LESSONS

There is a growing consensus that the next recession will require a fiscal response. The current debate has echoes of the 1930s, when economists concluded that monetary policy was like 'pushing on a string'. In fact, we can identify a long 'supercycle' in macro policy, which involved pushing monetary policy to its limits and then using fiscal policy to try to inflate away the debt.

FISCAL DOMINANCE

After the next recession, we are likely to see much closer co-ordination between fiscal and monetary policy (as in the WW2 era). The only question is whether central banks will keep their independence, continuing to pursue long-term price stability, or whether the fiscal authorities will take over. The debate about MMT could be more significant than investors realize.

POLICY SUPERCYCLES

The perma-bears seem frustrated – central banks reacted much more quickly to the December market crash than they were hoping, which (in their minds) has added more 'artificial stimulus' to global markets, preventing them from reaching their 'fair' values. Stock markets bounced strongly and financial conditions have eased significantly – even as global macro data have continued to deteriorate. But was the quick response from the authorities really so surprising? Inflation has stayed subdued and with serious doubts about central banks' ability to pull their economies out of another recession, policymakers realised they must try to postpone these problems. Interest rates are already close to the lower bound (especially in Europe), so central banks are desperate not to overtighten. This is a clear break from the way they behaved in the past, when 'opportunistic disinflation' was a popular strategy. Still, the December selloff showed how precarious the global outlook has become. A decade-long search for yield has inflated corporate debt, leaving markets and economies vulnerable to rising interest rates. The dangerous feedback loop between tighter financial conditions and deteriorating global growth – which policymakers temporarily broke with their swift response – will surely return at some point.

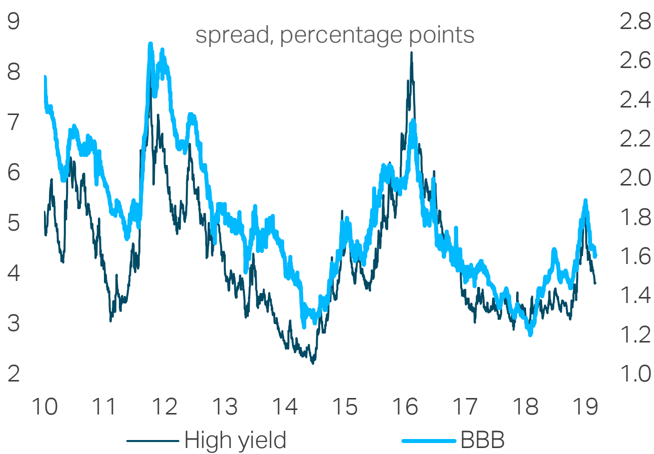
Central banks are right to worry about how they will handle the next recession. Interest rates could quickly hit the lower bound, while Japan's recent experience highlights the limits of QE. Monetary policy appears to be running out of ideas. In fact, the consensus among academics and investors has already moved on – most now believe the next recession will require a fiscal response. This shift in macroeconomic thinking has echoes of the 1930s. After monetary policy had dominated as a stabilization tool through the 1920s, economists realized that central banks couldn't cure a deflationary bust or eliminate a large debt overhang. In a chronically depressed economy, monetary policy was like 'pushing on a string'. Fiscal policy took over, with WW2 delivering a powerful fiscal boost that finally ended the Depression. Fiscal dominance continued until the 1970s, with monetary policy relegated to either pegging government yields (until the mid-1950s) or stabilizing the exchange rate. It was the errors of the 1970s and the outbreak of the Great Inflation that finally restored monetary policy to a dominant position. Central banks could not 'push the string' to drive prices higher, but they could certainly pull on it to drag inflation down. Independent central banks with inflation targets restored the 'nominal anchor'.

How will the seemingly inevitable shift back to fiscal policy affect our current policy setup and macro institutions? In principle, central banks could continue to operate as they have done over the past decade – keeping interest rates low in pursuit of their inflation targets. QE might be explicitly linked to yield targets, without necessarily compromising central bank independence. But there are some economists who want to go further. One idea is for central banks to pursue 'helicopter money', using money-financed fiscal interventions. While 'pure' helicopter money is practically impossible, central banks could use their balance sheets to 'hide' government borrowing. Modern Monetary Theory (MMT), which is rapidly gaining traction in some policy circles, would push the helicopter money theory even further. MMT would strip central banks of their inflation mandate, giving the role to national Treasuries instead. It is easy to understand why these ideas are catching on – the case for independent central banks rests exclusively on preventing the repeat of a very unique period in economic history – the Great Inflation of the 1970s. This has not been the environment of the last 30 years. But, while there is a case for using fiscal policy more actively, MMT pushes this strategy to dangerous extremes – dislodging inflation expectations, abandoning the 'nominal anchor' and trying to recreate a bygone era of capital controls and state intervention. No wonder central banks want to avoid this outcome.

1. OPPORTUNISTIC REFLATION

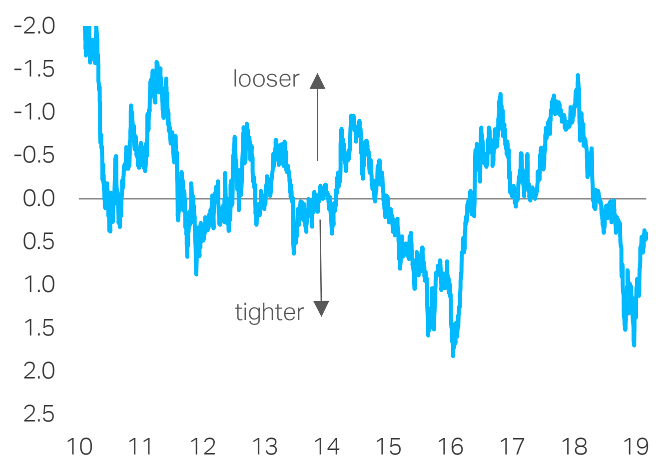
Not long ago, central banks would tighten policy deliberately early after a recession in order to lock-in low inflation. This practise of 'opportunistic disinflation' was symptomatic of a monetary regime that had a built-in anti-inflation bias. Today we seem to have the reverse of this post-1970s approach to monetary policy – 'opportunistic reflation'. Central banks are prepared to take chances with inflation because they are much more worried about economic growth. They realise they have limited ammo to fight the next downturn and would rather take modest action early rather than wait and have to try more drastic measures later. This is presumably why central banks responded much faster to the December market crash that anyone expected. The Fed quickly put interest rates on hold and said it would adjust the pace of QT, China injected new credit into its troubled banking system, and the ECB unveiled new liquidity support for banks.

Chart 2: Credit rebounds



Source: Bloomberg

Chart 3: Financial conditions ease



Source: Goldman Sachs US index on Bloomberg

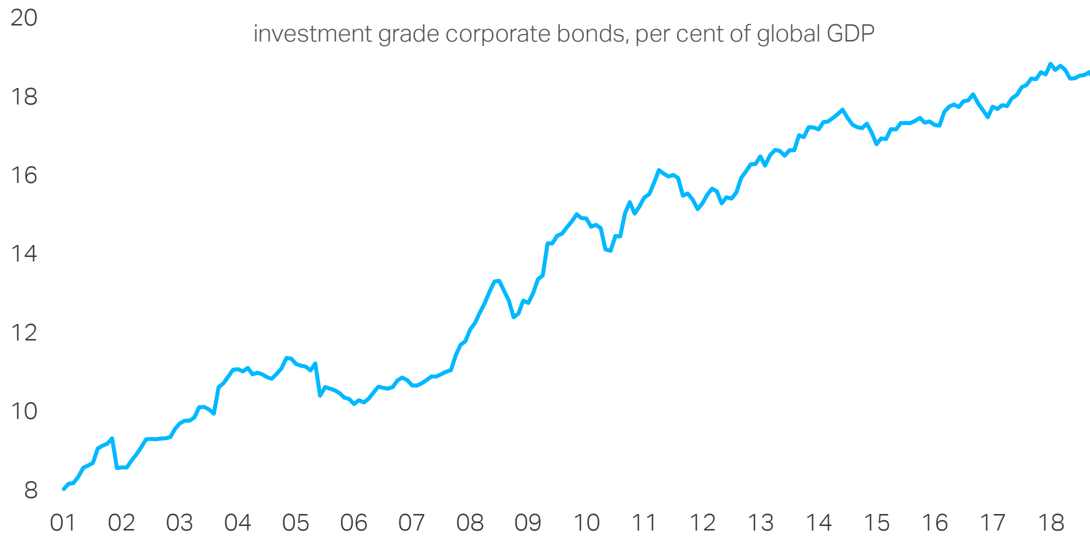
Synchronized policy action has had a powerful impact on market sentiment. Global stock markets have rebounded, credit spreads have narrowed and financial conditions have eased. It's almost as if the turmoil of late 2018 never happened. Investors were clearly impressed with how quickly central banks responded, particularly given a widespread belief that policy overtightening was the likeliest cause of the next global recession. According to a theory that was popular before the December crash, central banks were destined to raise interest rates too far because this is what they always do. Sell-side economists, in particular, thought policymakers would be obsessed with model-based inflation forecasts (the Phillips curve) and, given the usual long and variable lags, would keep tightening policy until their economies started to contract. By then, it would be too late to stop the recession. So central banks have proved surprisingly pragmatic.

Crash postponed?

Yet it would be wrong to dismiss the December crash as a regular market correction. At a minimum, the selloff confirmed that global markets are extremely sensitive to monetary tightening and the prospect of higher interest rates. Worse, the turmoil reminded us of the dangerous feedback loops that can develop between financial markets and the real economy. A decade of low interest rates produced a powerful search for yield. While not as dangerous as the subprime bubble, this search for yields has had important macroeconomic consequences. In particular, an insatiable demand for positive-yielding securities fuelled a surge in corporate debt, which gave many low-quality/high risk companies easy access to funds. Higher interest rates are

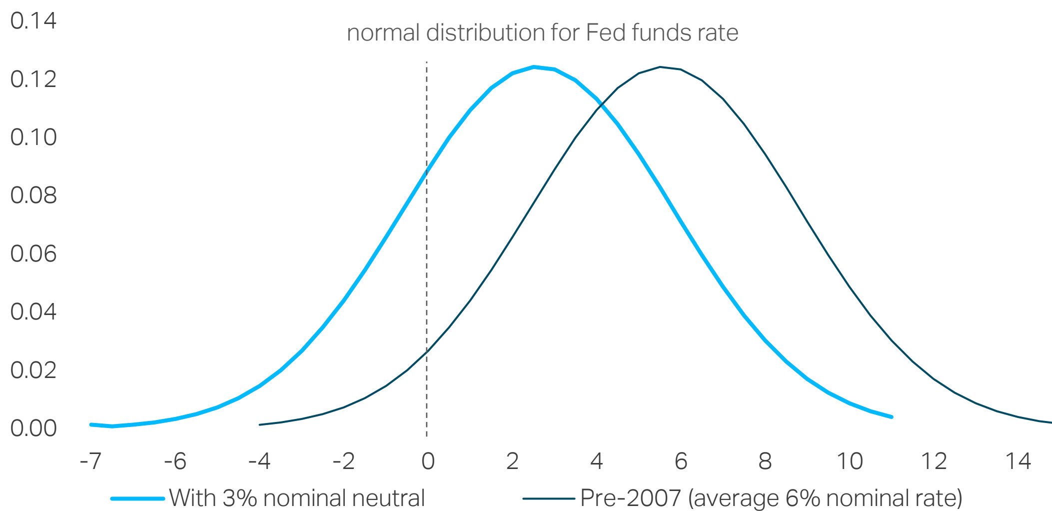
dangerous because: (i) they threaten to reverse the search for yield, and (ii) they could cause serious balance-sheet problems for a fat-tail of over-indebted corporate borrowers. Easier monetary policy since the start of the year has arguably just postponed these problems.

Chart 4: Corporate debt bubble



Source: TS Lombard estimates based on Barclays Bloomberg indices, IMF

Chart 5: Lower bound will bite more often



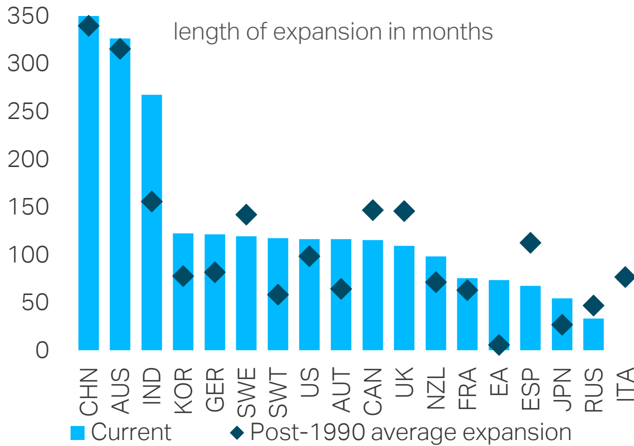
Source: TS Lombard based on Kiley and Roberts (Federal Reserve) model

The next recession

By taking decisive action early, global policymakers are trying to extend what has already become one of the longest economic expansions in history (Charts 6 and 7). Yet according to a recent Wall Street Journal survey, 90% of economists still believe there will be a US recession by the end of 2021. It is highly unlikely the rest of the world could 'decouple' from a US downturn (assuming it isn't already in recession by then). For the global expansion to end by 2021, it is clear that policymakers would either need to lose control of the current situation or be unable to react as quickly as they did in December. We see two potential scenarios. The first would involve

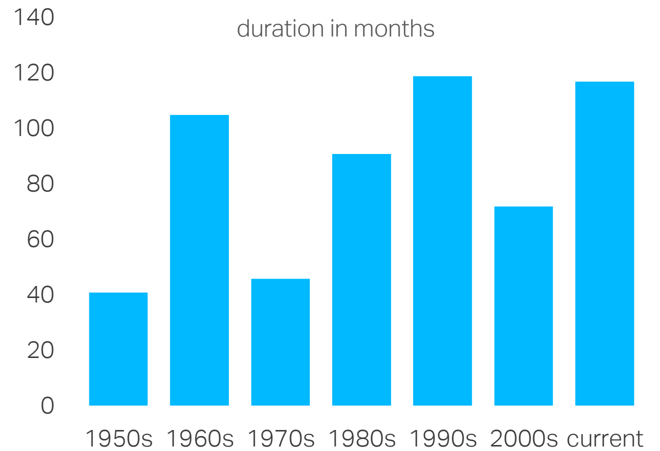
a major inflation surprise, which would force central banks to start tightening again. This is possible, though we suspect the authorities' tolerance for inflation is actually higher than most commentators realise (for reasons already explained). But there is also a second scenario in which inflation stays low and financial conditions continue to rebound. This would reflate the global search for yield and 'Buyside Bubble' until it eventually bursts under its own weight.

Chart 6: The global expansion



Source: TS Lombard estimates

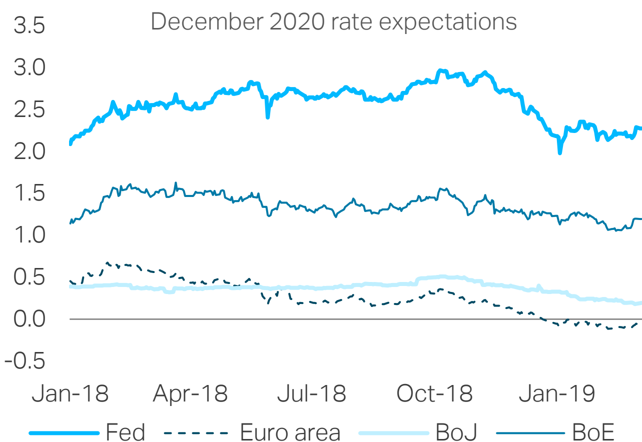
Chart 7: US expansion breaking records



Source: NBER, TS Lombard

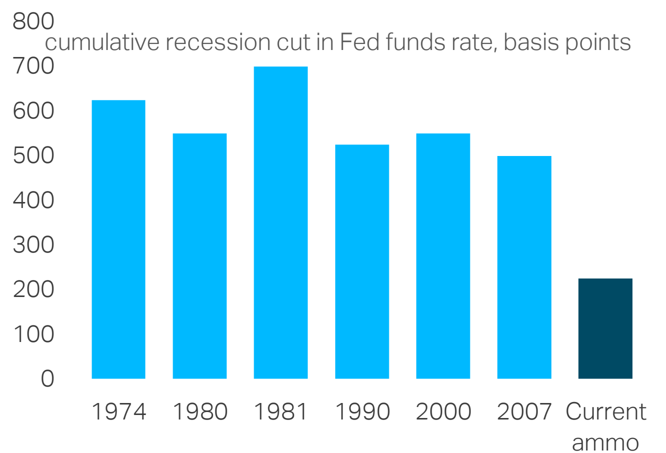
Putting aside the precise triggers or timing of the next global recession, it is clear why policymakers are worried. Based on current market pricing, the Federal Reserve will only be able to reduce interest rates by around 230 bps (less than half their historical recession move of -575 bps) and central banks in Europe won't be able to cut interest rates at all. The underlying problem is that equilibrium interest rates are much lower than in the past, which means they are likely to hit the lower bound more frequently than they used to. A recent Fed study, for example, showed that the lower bound could bite around 40% of the time. While there is scope to expand QE in some jurisdictions, you have to wonder whether the recent experience in Japan has already discredited this form of stimulus, pushing QE to its limits without breaking deflation.

Chart 8: Limited conventional ammo



Source: Bloomberg

Chart 9: Even the Fed is constrained

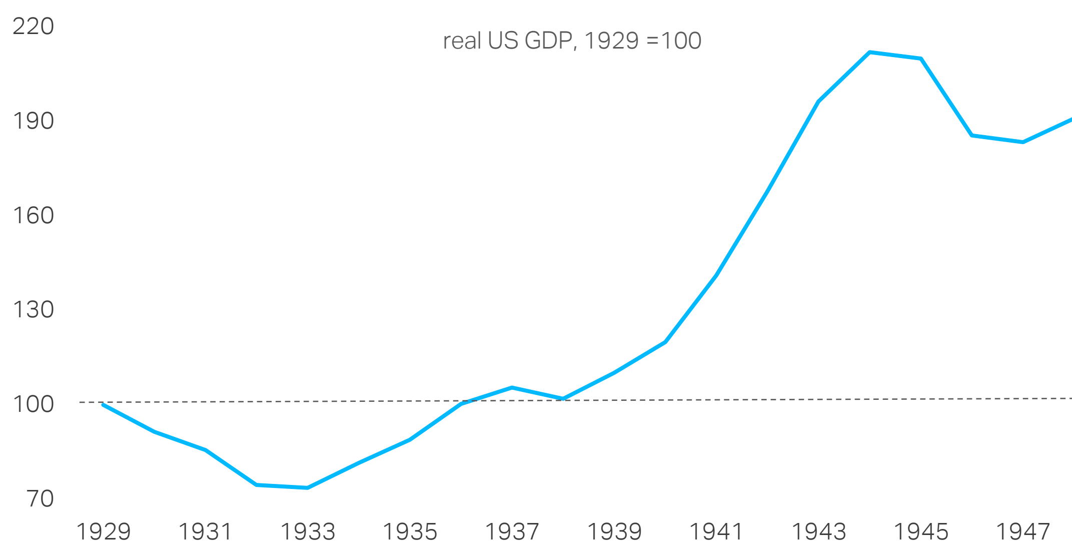


Source: TS Lombard estimates

2. HISTORY LESSONS

With monetary policy apparently running out of ideas, it is not surprising the debate is shifting to fiscal policy. Most economists now agree that the next global recession will require a much larger fiscal response, with monetary policy perhaps relegated to a supporting role. This would be a big shift compared to the consensus of the last forty years, particularly the last decade in which central banks have had to use monetary policy to try to boost growth even as governments have pursued vigorous fiscal austerity. Yet history shows that the relative popularity of fiscal and monetary policies has oscillated widely over time, loosely linked the underlying trend in inflation (with has also fluctuated widely). We call this the policy 'supercycle'. Broadly, it involves pushing one set of policies (e.g. monetary) to an extreme, running out of options, then switching to the other (e.g. fiscal) – producing very different macro outcomes.

Chart 10: Great Depression lasted until WW2



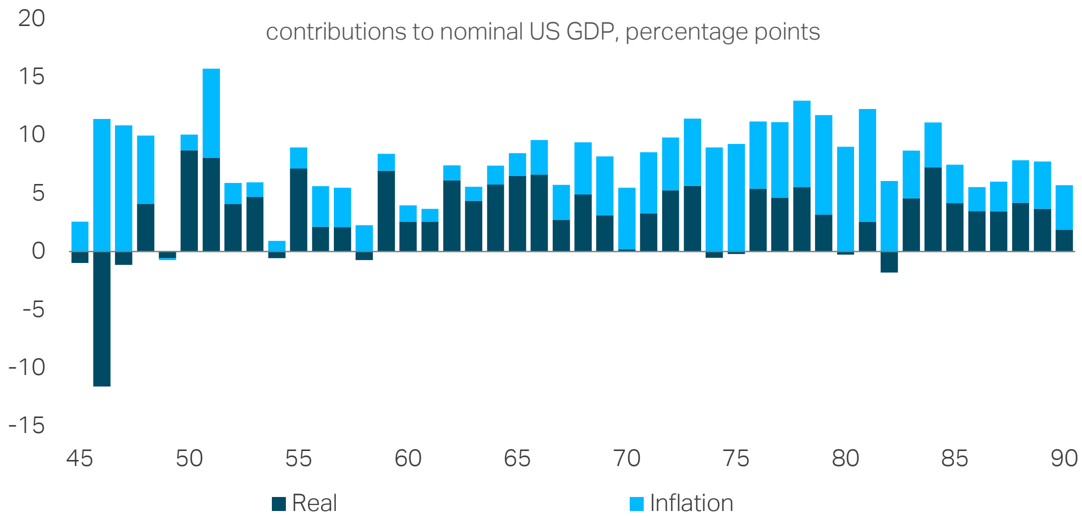
Source: Fred, TS Lombard

Monetary versus fiscal policy

The debate we see today is remarkably similar to the 1930s. After the creation of the Federal Reserve in 1913, monetary policy dominated through the 1920s. Central banks seemed remarkably successful at fine-tuning their economies, delivering unprecedented improvements in wealth (i.e. the Roaring Twenties). But serious imbalances were developing below the surface, including overvalued stock markets and dangerous credit bubbles. The Great Depression changed everything, bringing a huge stock-market crash, widespread bank failures, mass unemployment, persistent deflation and a serious debt overhang. By the mid-1930s it was clear governments needed to intervene and monetary policy didn't seem to have the answers.

During the 1930s, economists concluded that using monetary policy in a chronically depressed economy was like 'pushing on a string'. Central banks could 'pull on the string' to reduce inflation in normal times but they could not 'push' on the string to make prices accelerate. The world was stuck in a liquidity trap, an idea that gained further prominence after John Maynard Keynes published his 'General Theory' in 1936. Keynes argued forcefully that only fiscal policy could end the Great Depression. By the 1940s, there was clear evidence to support his claim. Somewhat inadvertently, massive military spending in the run-up to World War Two finally pulled the world out of the Great Depression, with GDP breaking materially above its post-1929 trend.

Chart 11: Nominal boom after World War Two

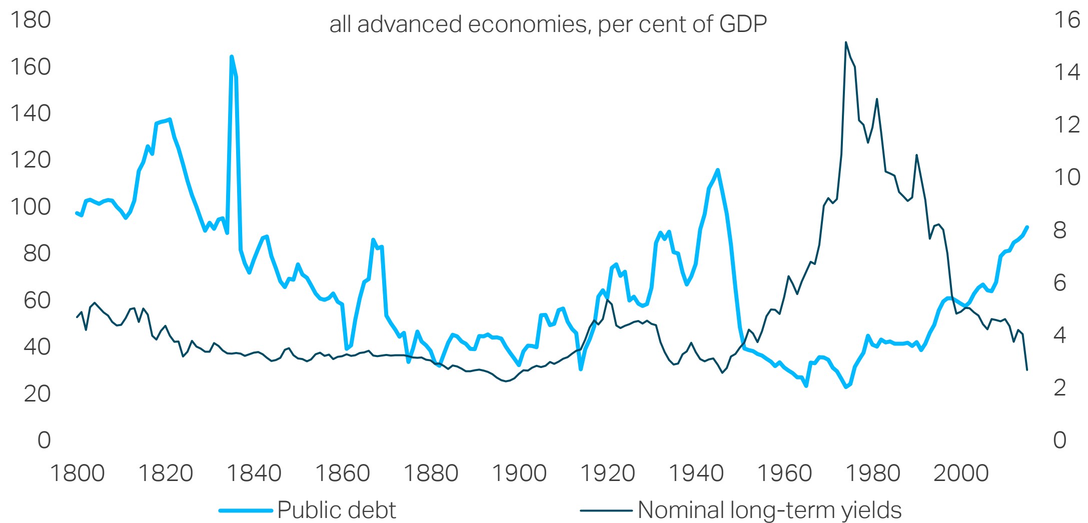


Source: Fred, TS Lombard

'Keynesian' World War II

It is surprising that fiscal stimulus didn't come into play earlier during the Great Depression. To quote Christina Romer, this was 'not because fiscal policy did not work but because it was not tried'. Fiscal measures were introduced but they were quickly reversed. The outbreak of the Second World War changed all that, producing a massive and sustained increase in government spending that was not funded with higher taxes. US military spending started to rise rapidly in 1940 to assist the British and by 1942 defence spending made up 45% of US GNP, with the military employing around 18% of the workforce (the unemployment rate was zero). US GDP, which in 1940 was still running 20% below its pre-1929 trend, accelerated rapidly – comfortably closing the large output gap that had developed during the Great Depression. Given this shift in performance, it is not surprising some economists believe Keynesianism ended the Depression.

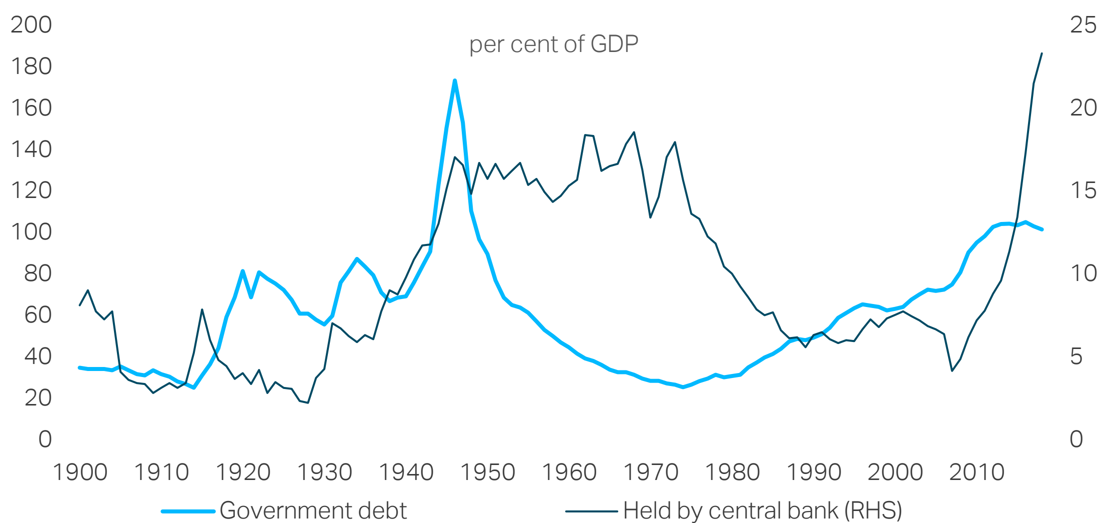
Chart 12: OECD Public debt



Source: IMF debt database

Of course, not everyone agrees with the Keynesian interpretation of World War II. For a start, there are obvious questions about the accuracy of wartime data. Governments intervened heavily in markets, which distorted price deflators and measures of 'real' output. Given the size of the fiscal stimulus, there are also questions about the true size of the 'multipliers' – some have argued they were a lot smaller than the Keynesians acknowledged. And others have highlighted the role of non-fiscal forces in driving war-time growth, including rapid technological change and vast improvements in productivity. But regardless of the specific role fiscal measures played in ending the Depression, it continued to dominate macro policy long after WW2. In fact, through the 1940s and early 1950s, monetary policy was relegated to a sort of debt financing role, pegging interest rates at low levels in order to support public spending.

Chart 13: Debt monetization



Source: IMF

Debt monetization

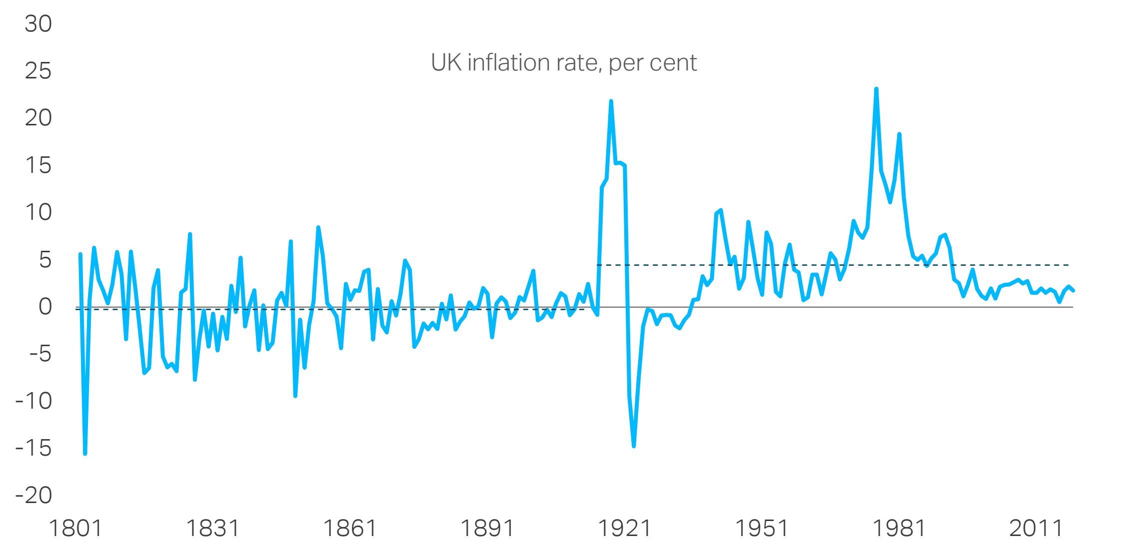
Government debt increased dramatically during WW2 and central-bank 'debt monetization' helped to keep bond yields below their natural level through at least the 1950s. For a while, this policy combination was remarkably successful. Despite periodic outbreaks of severe inflation (particularly after the end of price controls and wartime rationing), real GDP increased rapidly after WWII – a natural response to post-war reconstruction, rapid population growth and half a decade of pent-up demand. Yet it isn't true that central banks simply 'inflated away' the government debt, despite what some economists have claimed. Chart 11 shows that both nominal and real output grew rapidly throughout the period 1945-1970. And by the mid-1950s, central banks were starting to reassert their independence – particularly in the United States and Germany. The Federal Reserve signed an 'accord' with the Treasury that ended its obligation to intervene in bond markets (though it didn't actually stop interest rate 'pegging' until 1953), while an independent Bundesbank emerged in 1957, promising a new anti-inflation regime.

The mistakes of the 1960s/70s

While many central banks were free from pegging bond yields by the mid-1950s, the Bretton Woods system of fixed exchange rates remained an important constraint on their actions. This was a more flexible version of the Gold Standard because it allowed for periodic currency realignments. Yet the Bretton Woods regime started to unravel by 1971, giving national policymakers much more discretion to use fiscal and monetary policy. In effect, the world was

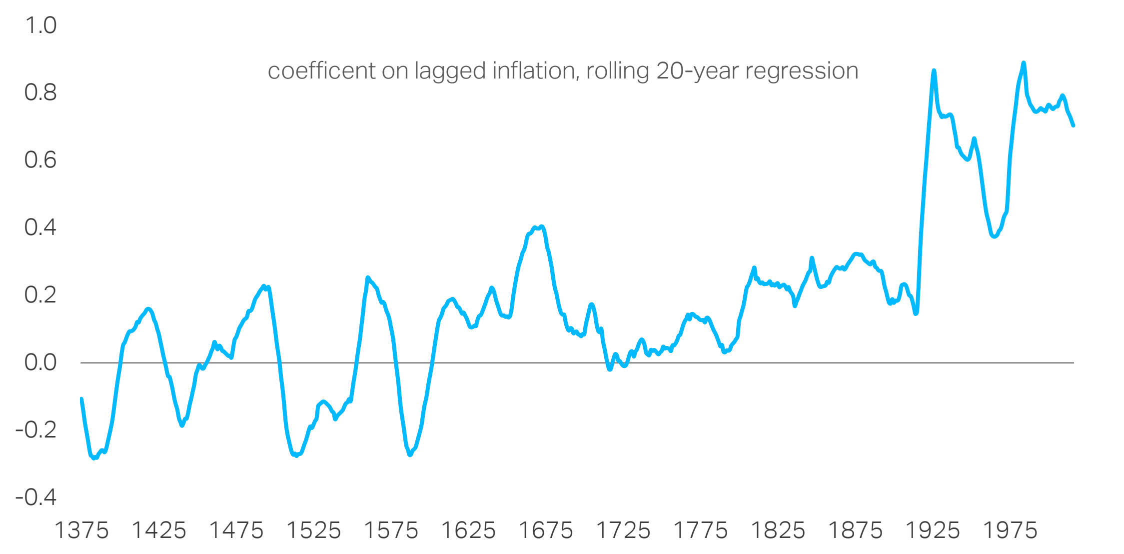
losing its 'nominal anchor' and this freedom produced a series of large policy mistakes. The most serious error was that both fiscal and monetary policymakers perceived a permanent trade-off between unemployment and inflation (thanks to the newly discovered Phillips curve), arguing higher inflation was a cost worth paying in order to secure full employment. Starting in the late 1960s, the authorities also seriously overstated the supply capacity of their economies, just as productivity everywhere started to slow. Interest rates were kept too low and fiscal policy continued to play an important macro stabilization role, with governments running large and sustained deficits for the first time outside of major military conflicts. The situation became particularly bad after the two oil price shocks in the 1970s, which produced powerful wage-price spirals and rising unemployment – stagflation that seemed a paradox to Keynesian theory.

Chart 14: The 1970s was highly unusual



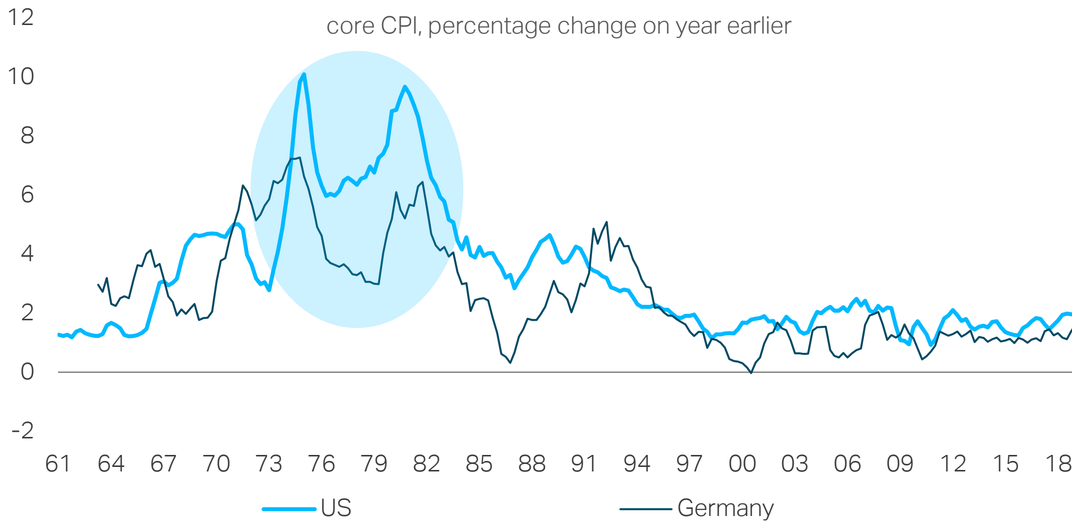
Source: Bank of England, TS Lombard

Chart 15: Inflation became more persistent



Source: Bank of England, TS Lombard estimates

Chart 16: The Great Inflation

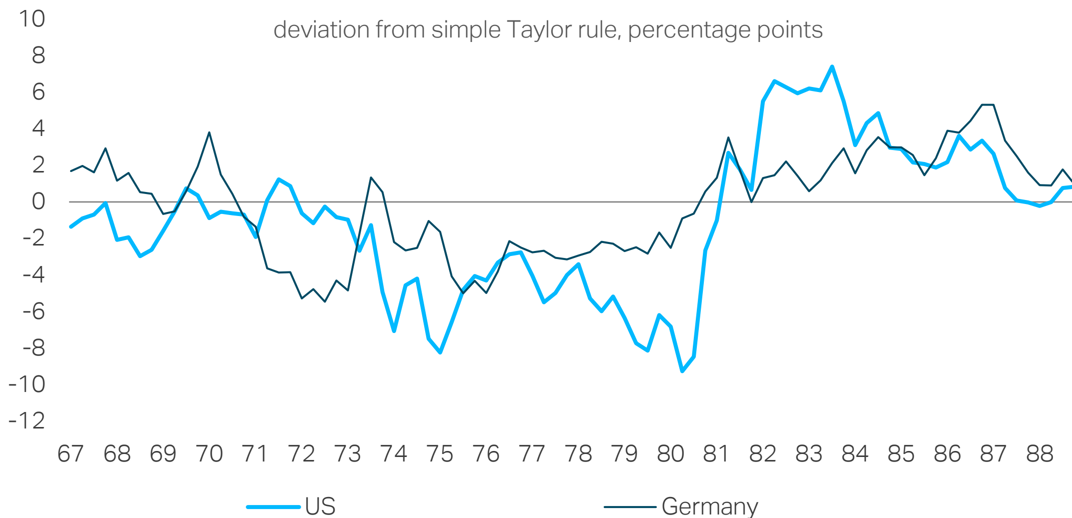


Source: OECD, W Germany before 1991

Germany avoided the Great Inflation

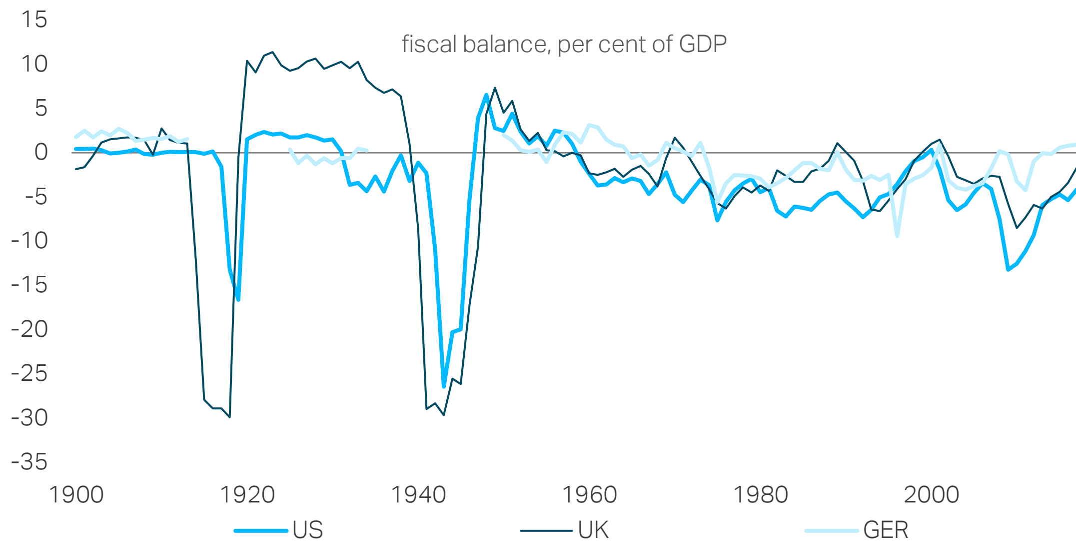
There is a debate among economic historians about whether the 1970s oil spikes were a 'supply shock' (caused by OPEC) or a demand shock (caused by economies that were already overheating). Certainly inflation had already picked up sharply even before the surge in oil prices, which made existing controls on commodity prices unsustainable. In any case, the impact on global inflation rates was severe. Prices accelerated everywhere, to levels not seen outside of major military conflicts (see Chart 14). These effects continued long after oil prices had stabilized, feeding through into nominal wages and non-energy prices. Not only was inflation higher after the 1970s, but it also became more persistent. Chart 15 shows this by running a simple regression of inflation on lagged inflation and plotting the coefficient on the lag over time. During the Gold Standard and Bretton Woods eras, inflation behaved liked 'white noise' – after the 1970s it started to follow a random walk, meaning price shock had longer-lasting effects.

Chart 17: Bundesbank made fewer policy errors



Source: TS Lombard based on standard Taylor rule and headline inflation rates

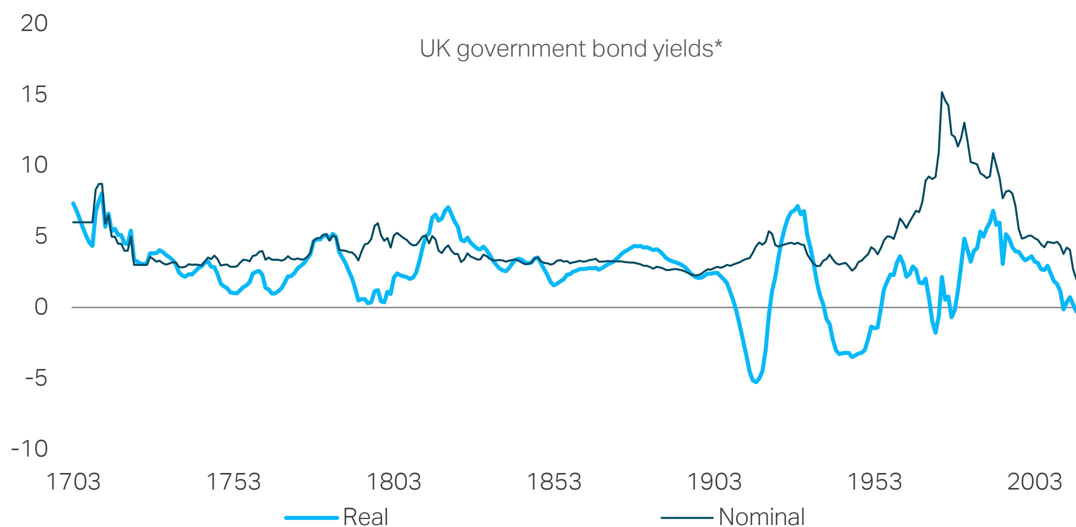
Chart 18: Unusual peacetime deficits in the 1970s



Source: Macrohistory database

Among the major economies, only Germany 'opted out' of the Great Inflation. The Bundesbank was relieved of its Bretton Woods responsibilities in 1973 and while it failed to keep inflation down after the first oil shock in 1974, it reacted much more aggressively to the second (1979) shock. The central bank introduced a rigid framework that targeted the monetary aggregates and it made these more restrictive after the energy shock, showing it was determined to keep inflation down. The policy was credible and remarkably successful, with Germany avoiding the extreme second-round effects that appeared in the United States and other European nations. In a recent review of the episode, the ECB concluded that Germany's success was down to two things: (i) providing a nominal commitment to low inflation, which anchored expectations, and (ii) placing much less emphasis on (erroneous) output gaps estimates than other central banks. This strategy delivered a powerful appreciation in the currency, which damped import prices.

Chart 19: The 1970s was unusual for bonds markets



Source: Bank of England, *UK consols before 1929

The post-1980s regime

Persistently high inflation proved extremely costly and restored monetary policy to a dominant position. The authorities knew they could 'pull on the string' to force inflation down, by causing deep recessions and mass unemployment. The experience also prompted a fundamental rethink in the way monetary policy would operate. Milton Friedman had always argued there was no long-run trade-off between inflation and unemployment. Ultimately, unemployment was 'structural' and unresponsive to monetary policy. This meant central banks' main contribution was to keep inflation expectations anchored, by credibly committing to stable inflation. The academic literature began to emphasise the importance of independent central banks, free to pursue price stability without worrying about elections or supporting the public finances.

The new framework, an 'expectations-augmented Phillips curve', did not mean Keynesian economics was dead. Instead, 'New Keynesians' accepted that Friedman's theory was true in the long term but argued that central banks could still exploit a short-run trade-off between inflation and unemployment, as long as they were ultimately committed to keeping inflation low. These ideas would come to dominate macro policy for at least the next forty years. And with even the Keynesians giving up on fiscal measures (outside of severe recessions), the dominance of monetary policy went largely unchallenged.

So, as a summary, macro policy has evolved considerably over the last century

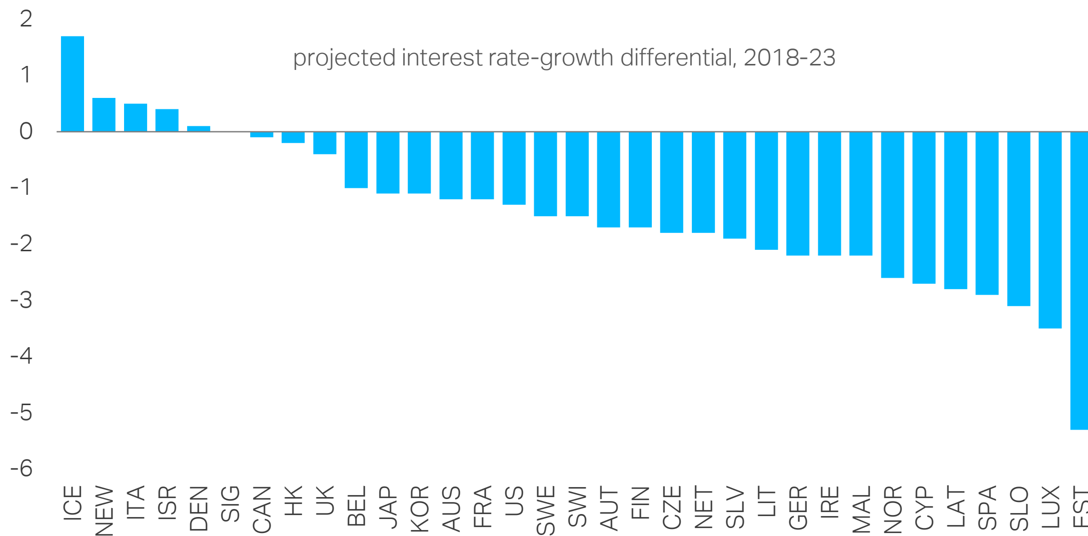
- 1920s: Monetary policy dominates – seemed successful until the Great Depression;
- 1930s: Monetary policy seemed ineffective, fiscal policy starts to take over;
- 1940s: massive fiscal stimulus ends Great Depression. Monetary policy targets yields;
- 1950s: rapid nominal growth 'inflated away' WW2 debt. Bretton Woods fixed FX;
- 1960s: benign macro environment but policy errors building – economies overheating;
- 1970s: fiscal profligacy and unprecedented inflation – monetary tightening takes over;
- 1980s-2000s: complete dominance of monetary policy (at least outside of recessions)
- Post 2010: The Great Confusion – fiscal austerity versus monetary stimulus

3. FISCAL DOMINANCE

Why the long history lesson? This background is important because it seems monetary policy's dominance is now coming to an end. Not only is the consensus clear that the next recession will require a large fiscal response, but some commentators also want to dilute our existing policy frameworks and reshuffle responsibilities. It seems everything is now up for discussion, including inflation targets and even central bank independence. Given the macro performance of the last decade, this is not surprising. Central banks have struggled to lift nominal demand, while median incomes have stagnated and inequality has widened. Many people feel disillusioned. Remember also that our current policy frameworks were designed to prevent a repeat of the Great Inflation, which was a unique period in macro history and very different to the climate we face today. For the first time since the 1970s, even serious commentators are starting to wonder whether our current monetary institutions and policy frameworks are still fit for purpose.

To explore this debate in more detail, let's assume the sell-side consensus is correct and there is another global recession within the next two years. Central banks cut interest rates to zero but activity fails to rebound and fiscal policy takes over. What form should this fiscal stimulus take and – more importantly – how should it interact with monetary policy? Right now there is a range of views, from 'plain vanilla' fiscal stimulus (plus QE), to helicopter money and even 'full MMT'.

Chart 20: Almost everyone has fiscal space?



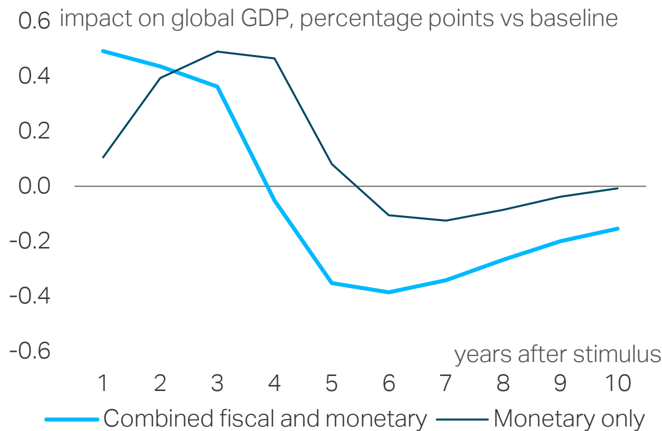
Source: IMF Fiscal Monitor

'Plain Vanilla' Fiscal stimulus

To see how the consensus for fiscal policy has moved, we only need to follow the career of former IMF Chief Economist Olivier Blanchard. While Blanchard was one of the architects of the IMF's austerity drive in 2010, by 2013 it was clear he was beginning to rethink the dangers of fiscal tightening, concluding in an influential blog that these policies had been far more damaging than the IMF had assumed. And by 2019, after leaving the IMF, Blanchard had gone even further – arguing, because the interest rate on government debt would stay below the nominal growth rate (see Chart 20) – there was no problem with the sustainability of public debt. "Put bluntly", he concluded, "public debt may have no fiscal cost" – it would pay for itself. Other economists agree, including those who work for the OECD. In its latest Economic Outlook, the Paris-based institution included a simulation showing that a large, co-ordinated fiscal spending programme could provide a powerful response to the next recession (Charts 21 and 22).

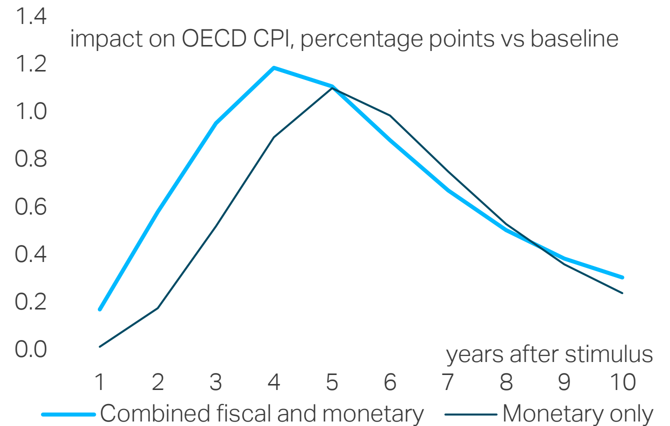
What about monetary policy? Right now, the consensus is for no major revolution in monetary policy. Most commentators think central banks should continue to do what they have been doing over the past decade, keeping interest rates low and restarting QE. While this would support fiscal policy, providing a ready buyer for government bonds, any 'coordination' between fiscal and monetary policy would be casual, with central banks staying independent. Even in a scenario where central banks targetted specific yields, as the Bank of Japan is now doing, the monetary authorities would retain their inflation objectives – they would only hold yields down to the extent this policy is consistent with 2% inflation. So this would not be a form of helicopter money, unlike what happened when central banks pegged yields in the post-WW2 era.

Chart 21: GDP impact of policy co-ordination



Source: OECD simulation, assumes 0.5% fiscal stimulus plus QE

Chart 22: Inflation impact of policy coordination

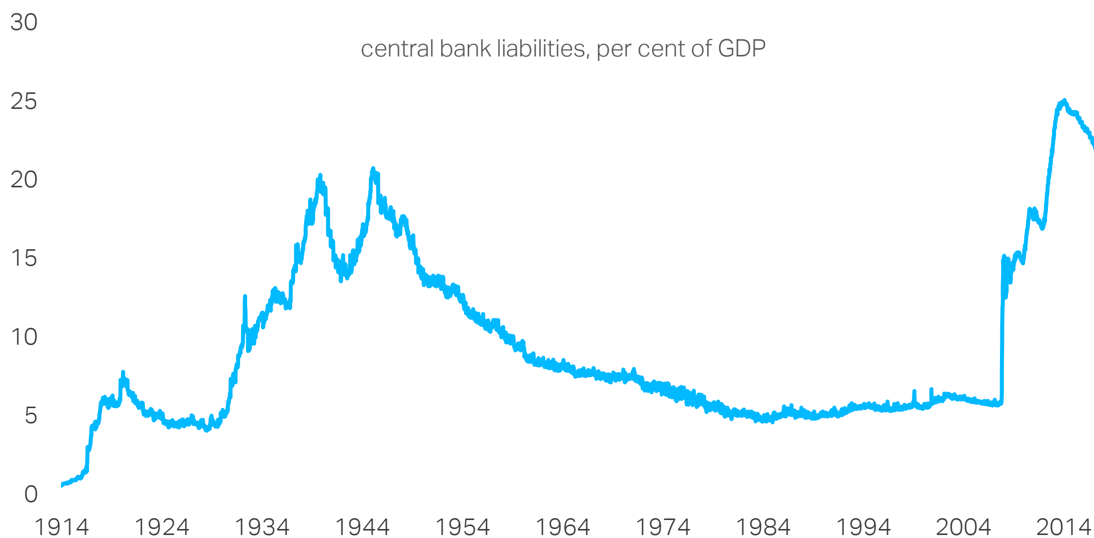


Source: OECD simulation, assumes 0.5% fiscal stimulus plus QE

Helicopter money

The problem with 'plain vanilla' fiscal policy is that households and businesses know the authorities must eventually tighten policy, which could mute the impact of stimulus. In economic theory, this is sometimes called Ricardian Equivalence (RE). RE is highly controversial, particularly as it only seems to apply in Germany, but even the OECD's recent simulations assumed that any short-term fiscal stimulus would be followed by significant tightening, damping the effectiveness of the policy. So an alternative idea, which is becoming increasingly popular among academics, is for the central bank to fund the fiscal expansion by injecting cash directly into the economy – the 'helicopter drop'. This could take a variety of forms, including actual cash injections to private individuals, or central-bank purchases of specific government securities dedicated to fund new government programmes (e.g. People's QE). The important point is that the increase in the stock of currency must be permanent – nobody, either public or private, has to repay the funds.

Chart 23: The Federal Reserve's balance sheet



Source: Federal Reserve, TS Lombard

In the textbook version of helicopter money, it is seigniorage that funds the increase in government spending. Seigniorage is the difference between the face value of notes and coins

and the cost of producing physical cash. The central bank has to increase the amount of cash in the economy enough to lift nominal spending so that people want to hold this higher level of cash. The government's debt is literally inflated away, such that aggregate public borrowing – including the central bank's balance sheet – does not increase. A recent Fed paper looked at this issue in detail, running various simulations on the Federal Reserve's economic models. Officials showed that 'classic' helicopter money is almost impossible to do in practise. 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[1]), which would mean it would take extremely large increases in the price level 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.

While 'classic' helicopter money is practically impossible, there are plenty of economists who think central banks could still use their balance sheets to fund extra government spending. This is not pure monetary financing because the consolidated government balance sheet (which includes the central bank) would deteriorate. In other words, central banks would be running with negative net worth, with their liabilities exceeding their assets. This happens because e.g. crediting household accounts with newly created money would raise the central banks' liabilities (i.e. reserves) but leave its assets unchanged. While there is no economic reason why central banks could not operate in this position, the policy would reduce central bank remittances to the Treasury, resulting in implicit fiscal tightening (which is why it isn't really helicopter money). More worrying from the central bank's perspective, the 'hole' in its balance sheet would eventually get larger if it ever tried to raise interest rates, since it pays interest on its liabilities (reserves). The central bank could face a difficult choice – stop paying interest on reserves (compromising its ability to control interest rates) or request a capital injection from the treasury.

Examples of helicopter money

Monetary financing has been used before, esp. between 1930 and 1970. Classic examples:

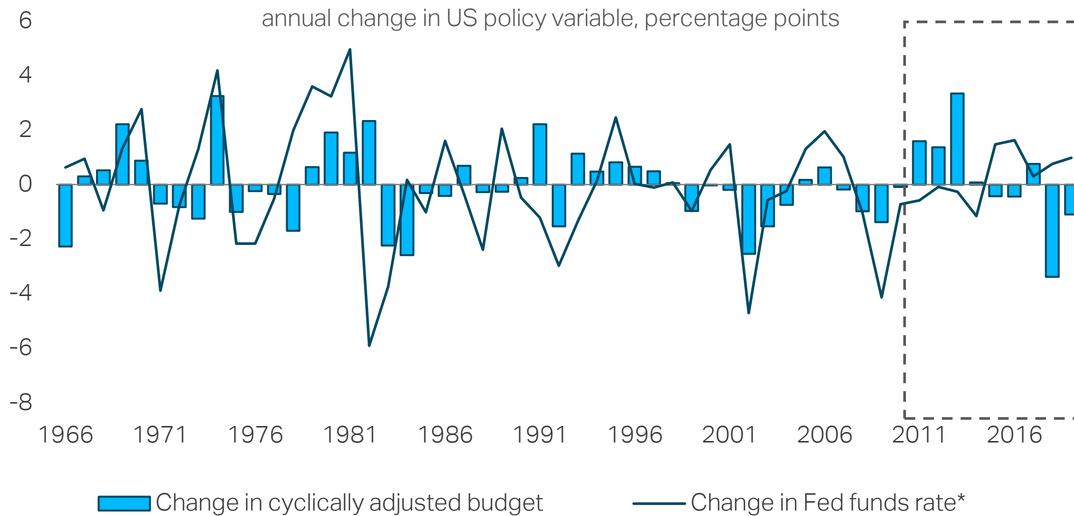
- US civil war: The government issued unbacked paper currency (greenbacks) to finance war expenditures that totalled 10% of pre-war GDP;
- France after WW1: The government allowed the franc to decline by 80% and engineered a huge expansion in the money supply before re-pegging to gold in 1926;
- US after WW2: The Federal Reserve purchased a very large fraction of outstanding Treasurys in order to keep yields at 3/8 per cent. By the end of 1945, high-powered money had roughly doubled from its pre-war level;
- UK in the 1960s: The Bank of England (not independent) allowed a huge increase in the price level in order to accommodate large fiscal stimulus in pursuit of full employment;

While there are a growing number of economists who favour of helicopter money, pointing out that 1930-1970 was a period of strong real growth and improving public finances, most of these episodes involved very large increases in the price level. As Fed officials point out, this is a feature of pure money financing, not a bug. The policy is extremely risky, not least because the central bank is effectively giving up its nominal anchor. Where these policies worked in the past, it was only because the authorities re-established inflation credibility, usually by re-pegging their currencies to precious metals. In the post-Bretton Woods era, this is much harder. The UK

[1] Note that in classic helicopter money, seigniorage pays for the extra government spending. So the central bank has to increase the currency stock, not the money supply. This is because most central banks now pay interest on reserves.

experience in the 1960s, which did not have an independent central bank, highlights the dangers. Inflation expectations spiralled and the United Kingdom was left with persistently higher and more volatile inflation required aggressive monetary tightening to eventually break.

Chart 24: Policy uncoordinated since 2010 (fiscal vs monetary)



Source: OECD, TS Lombard, CBO

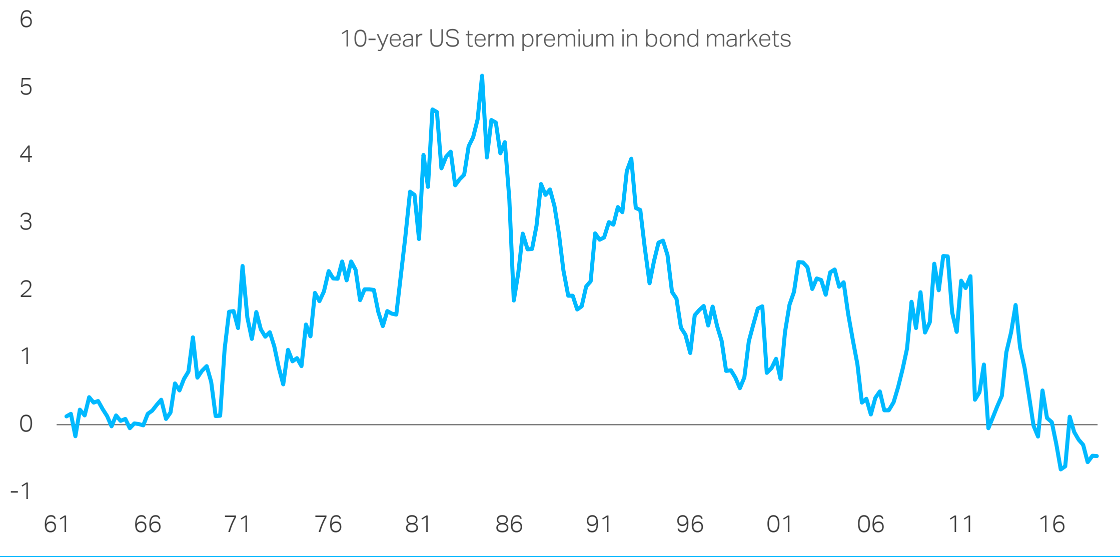
Modern Monetary Theory

Fiscal-monetary policy coordination is a threat to central bank independence. For helicopter money to be successful, the central would have to abandon its inflation target, at least temporarily. This would clearly dilute the policy frameworks governments established after the Great Inflation. Yet there are a growing number of politicians and academics who are calling for exactly this, especially those of a Modern Monetary Theory (MMT) persuasion. Perhaps the most controversial part of the MMT doctrine is its support for 'functional finance'. Broadly, MMT wants national treasuries and central banks to swap roles, with the treasury responsible for achieving full employment (subject to an inflation target), while central banks keep interest rates down to keep the public finances sustainable. If inflation became a problem, it would be the government – not the central bank – that would tighten policy in order to curb demand. MMT assumes that inflation is the only constraint on fiscal policy, because the central bank can always buy government debt to keep the cost of financing down. Sound familiar?

MMT is remarkable because it is the exact opposite of the policy framework that has been in operation since the 1970s. Perhaps this is just the natural response to two decades in which deflation has taken over from inflation as the number one monetary problem. MMT is also an understandable reaction to the self-defeating austerity that so many government adopted after 2010. In fact, many MMT'ers have a long list of left-wing spending priorities they want to see re-introduced, such as job guarantees, efforts to halt climate change and policies to tackle poverty. While it is not our job to assess the merits of such policies – they are ultimately a political choice – we are struck with how far the policy debate has shifted over the last few years. And we would remind investors that the discussions we hear today are remarkably similar to the 1940s. Instead of a war on the Nazis, MMT advocates 'a war on climate change'. In fact many key MMT policy prescriptions – including capital controls, credit restrictions and central banks that are

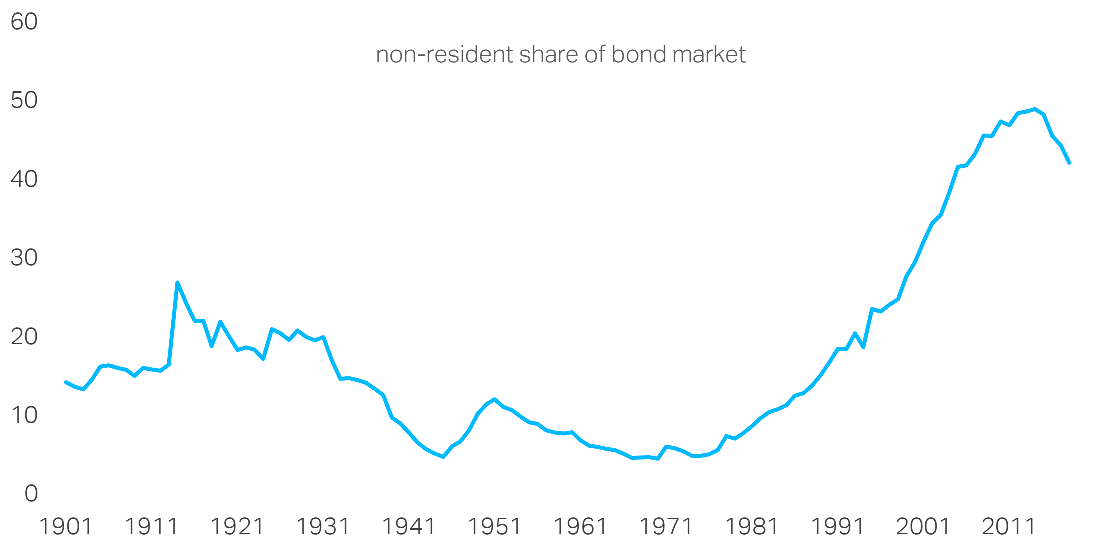
subservient to national treasuries – seem specifically designed to try to recreate the post WW2 macro environment, before the days of globalization and independent central banks.

Chart 25: The Great Inflation term premium



Source: New York Fed model (ACM)

Chart 26: The OECD bond market has changed since the 1940s



Source: IMF estimates

Surely we can do better

The obvious danger with MMT is that is ignores the lessons of the Great Inflation. In giving macro stabilization back to governments rather than independent central banks, MMT would be removing the nominal anchor that kept inflation low, while reintroducing a 'time inconsistency' problem into policy. We know from experience that national treasuries are not good at tightening policy when needed. Long term, this can only mean higher inflation and rising bond yields. Our analysis suggests there are already good structural reasons for yields to start trending higher in,

reversing the post-1983 moderation. But now we also have a policy reason to expect higher yields – the historically low term premium in bond markets should start to rise. Chart 25 shows how the US term premium spiralled higher during the Great Inflation, before independent central banks successfully pulled it back down towards 1960's levels.

Surely we can do better than just repeat the 'supercycle' of the last century. From our brief review of economic history it is clear that we need a policy framework that maintains the 'time consistency' and 'nominal anchoring' of independent central banks, but also gives more freedom to use fiscal policy when it is needed most – particularly now bond yields are so depressed and the lower bound on interest rates is likely to bite in every major downturn. Two recent ideas stand out. One proposal, by Ben Bernanke, is for the Treasury to set up a special account at the Fed. The Fed could then credit the account with the funds the Treasury needs to spend in order for the Fed to meet its inflation target. The government (through the legislative process) would still decide exactly how to spend the money. A similar idea, by Eric Lonergan at M&G, would see the Bank of England channel the funds to government investment. In both cases, central bank would retain the ability to raise interest rates if inflation got too high, while the government would decide how to allocate the cash. This would blur the lines between fiscal and monetary policy, but it is surely preferable to the recklessness of MMT.

Bottom line

The long-term 'supercycle' in macro policy seems to be starting over, with fiscal policy set to dominate monetary policy. This has important implications for financial markets:

- Facing an eventual challenge to their independence, central banks will try everything to prevent another recession happening anytime soon. Investors should expect policymakers to make every effort not to 'overtighten'. In fact, their tolerance for inflation is probably higher than markets have been assuming. Inflation would have to break significantly higher (>3% on an underlying basis?) to force a policy response;
- In contrast, if we are reliant on fiscal policy to end the next recession, the downturn could be deeper than a 'normal recession'. It always take longer to agree a major public spending programme, even if the consensus is already shifting in this direction. This problem could be particularly acute in Europe. While the next recession probably won't be as bad as 2008-09, it is likely to be significantly worse than the Dotcom downturn, where central banks reacted quickly to inflate house prices and boost private credit;
- Investors cannot ignore the debate about MMT and helicopter money, particularly as it challenges existing policy regimes. Should these proposals gain traction, we would expect them to raise long-term yields (especially the term premium). Diluting central bank independence and dislodging inflation expectations is also the surest way to return to the era or higher and more volatile inflation, even if this doesn't seem imminent.

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