Adding Fiscal Policy To Monetary Policy, QE and ZIRP.

Monetary policy has likely reached the limits of usefulness, not necessarily the limits of efficacy. The efficacy of monetary policy was questionable in the first place. Multiple QE programs and low interest rates have managed to inflate assets but not to spur the economy as much as was hoped.

Monetary policy is but one class of tools available to encourage growth, fiscal policy being the other. Without fiscal stimulus, monetary policy has to work doubly hard and faces leakage in terms of risk of asset price bubbles, unequal distribution of benefits, disinflation due to increased capacity, and downward pressure on interest rates. Fiscal policy will not mitigate all of these side effects but it could reverse some of the unequal distribution of benefits and put a floor under market interest rates.

Why has fiscal policy not been engaged so far?

- Many countries' national debt is high in relation to GDP, many on account of financial sector bailouts in the crisis of 2008.
- Austerity followed as economic orthodoxy. The Eurozone, for example, has strict guidelines on state budgets.
- Operating both monetary and fiscal easing carries high inflation risk as output is boosted to potential and could overshoot. By operating monetary policy first, excess capacity is allowed to build before fiscal policy is applied to raise capacity utilization.
- Fiscal policy is politically charged and requires strong government to obtain approvals.
- Cost of debt is another factor. Leading with monetary policy results in lower cost of debt for governments if they subsequently raise spending and seek to finance it

in the bond markets.

Are we likely to see a shift towards fiscal policy?

- Japan has periodically engaged in fiscal stimulus which has seen its national debt climb from 0.5X GDP in the 1980s to over 2.5X today. Just days ago, the Abe government announced a 28 trillion JPY fiscal package.
- Japan was able to do this as the Abe government, already with a super-majority in the lower house had recently won a super-majority in the upper house, was unchallenged in the Diet.
- BoJ’s QQE and negative interest rate policy had taken 10 year JGB yields from 1.66% in 2008 to -0.29% just a week ago. Cost of debt is very low.
- Japan needs reflationary policy to revive its economy. Recent data has shown Japan sliding back from the recovery from the first dose of Abenomics.

Does Europe need fiscal stimulus, and if it did, could it become a reality?

- The European economy is still on track with the recovery triggered since the LTRO operations of late 2011. PMI data point to the durability of this recovery.
- The risks to the recovery are Brexit, both directly and indirectly should it trigger more divisions, security, which could embolden nationalists and Eurosceptics seeking to close Europe and restrict freedom of movement, and a long list of local events, such as the impending Italian legislative referendum, which could escalate and spread into more, threatening the integrity of the union.
- Even if there was cause for fiscal stimulus, Europe has strict guidelines regarding budget deficits. While these limits have often been broken, they have not been intentionally breached as part of a deliberate spending campaign. Eurozone national debt to GDP is still

elevated having risen from a low 65% in 2007 to 92% in late 2014; it has receded to 90.7%, still a very high level.

- While monetary policy is coordinated by the ECB, the lack of fiscal union would mean that fiscal plans are domestic affairs. Coordination would be difficult and depend significantly on the strength of the individual member states' governments and their ability to approve such programs. Assuming each member state budgets towards their own situation, they would find monetary policy calibrated to the collective and not to their own circumstances.
- That said, the ECB too has followed a similar path as the BoJ in QE and negative interest rate policy resulting in conditions conducive to debt financing fiscal deficits.

What are the consequences of adding fiscal policy to monetary policy?

- Monetary policy has dual impact on inflation. On the one hand lower rates spur activity, or at least facilitate activity and in that respect spurs inflation. On the other hand, low interest rates encourage over investment and over capacity which have more durable deflationary pressure. Fiscal policy mitigates this by addressing directly the demand deficiency and is therefore inflationary.
- On its own, QE and NIRP lower interest rates across the term structure. The application of fiscal stimulus increases the demand for money and bids up yields across the term structure.
- Fiscal stimulus is likely to cause currency appreciation as interest rates rise. The impact on trade is less predictable given the number of distortionary trade pacts in force and the protectionist biases in the current environment. At this stage it is likely to be

neutral.

- Fiscal deficits are a prime example of kicking the can down the road as the expenditure will need to be financed and financed with long term debt. Given that most countries are running historically high debt to GDP ratios, the assumption of more debt could be destabilizing at some point. This could lead to sharper interest rates and weaker currencies.
- The crowding out of the private sector is a particular risk given that monetary policy has already exposed weak private investment and demand.
- The biggest risk is not one resulting directly from fiscal or monetary policy but the slippery slope that all analgesic solutions pose. We have witnessed how easy it is to embark on QE and rate cutting policies and how difficult it is to wean economies off such policies. The same will apply to fiscal policy. What it implies is that governments will continue to apply policies which provide short term relief but which may not treat the underlying cause of slow growth, and that the only way such policies are withdrawn is not when they are no longer needed, but when governments can no longer sustain them.