Addressing weak output growth

Governments are torn between fiscal austerity and stimulating economic growth. Since credit driven growth ceased in 2008 private sector economic growth has been muted. Consumption has been hampered by the need to restore household balance sheets. Such restoration is likely to overshoot as the lessons of 2008 linger, so savings rates are likely to be higher than expected. Corporate investment is likely to be less robust as well as managers risk management is highly autocorrelated and corporates are likely to retain a high buffer of cash on their balance sheets. This leaves exports as the driver of growth. Not every country can be a net exporter.

Governments had been quick to pick up the slack left by private consumption and investment. This fiscal stimulus has left sovereign balance sheets stressed. A balanced budget approach to stimulus is not effective since it is only a reallocation of resources which may or may not be better than the status quo. Also, in the US, it is important to measure the net stimulus taking into account Federal and State policies.

The efficacy of fiscal stimulus is in the details. Should government cut taxes effectively outsourcing its fiscal stimulus to the private sector or should it directly engage in productive activities? The psychology of the consumer will likely drive them to save any additional disposable income they receive. Policy may be better served by government directly engaging in economic activity. It should do this in the form of building infrastructure and capacity for the future productivity of the country. There is the risk that government is a poor allocator of resources and that resource allocation is suboptimal. However, in the face of a private sector that is unwilling to deploy new resources, government is the best available solution.

The problem faced by most governments is paying for the fiscal stimulus. Governments with weak balance sheets may not be able to fund their fiscal plans. Their ability to fund their ongoing liabilities and operations may require them to operate a policy of fiscal restraint or austerity.

Economic policy is not one dimensional. While a government operates fiscal policy, its monetary authorities or central banks operate monetary policy, in the form of market intervention or determination of interest rates. In the acute liquidity crisis of 2008, central banks the world over increased the leverage on their balance sheets in an effort to prevent the failure of the financial system. They continued to print money in 2009 in an effort to compensate for the sharp decline in the velocity of money in circulation. This strategy works by inflating the nominal output of the economy but is unable to ensure that the nominal output increase is evenly distributed across all segments of the economy, and can thus be highly inflationary in certain sectors or industries, and is also unable to ensure that real output will increase, i.e. can lead directly to inflation. This strategy has worked to a certain extent and failed in others. In capacity constrained markets it has created inflation while in non capacity constrained markets it has increased real output. In particular it has caused asset price inflation in financial assets, which have now become acutely sensitive to monetary policy.

Monetary policy has its limitations. In developed markets, interest rates are already close to zero. In the absence of inflation, it is not possible to induce negative real interest rates. Fiscal stimulus needs to be brought to bear. The current issue is how to fund that stimulus. Since the beginning of May, Europe has focused on the ability of Greece to repay its debts. Similar concerns arose about Portugal and Spain. The likely outcome will be that developed market central banks will have to purchase sovereign debt thus inflating money supply substantially and accelerating the debasement of fiat currency. This is highly inflationary. High debt to GDP countries will likely favour this type of inflationary policy since they have few options and this option is least worst.

Inflation, however, is measured with a CPI or RPI. The mechanical and defined specification of a price index can hide or degrade information. Owner’s imputed rent features significantly in most inflation measures, yet is never paid, and thus has little income effect. It is likely that inflation may be underestimated for some time while eroding real incomes and purchasing power. Inflation can occur not only in goods markets, service markets, but in the market for future claims on goods and services, in other words, the asset markets.

The future direction of asset markets whether equities, credit, commodities or real estate is likely to be highly sensitive to economic policy. While global growth remains fragile and uncertainty is high, economic policy will have a high impact on prices. Only when certainty returns to the global economy will idiosyncratic risk return to markets.