

# The Limits of Monetary Policy? The Price of Fiscal Policy.

Since the ECB announced a rate cut of 0.1% taking the deposit facility rate to -0.50% and a resumption of bond purchases at a rate of 20 billion EUR per month, the 10 year bund yield has predictably moved from -0.71% to -0.45%, a 0.26% rise, substantial when yields are that low.

The ECB's move was not as big as the market had hoped for, and yet, it is not clear what the market could have hoped for. Negative rates had not worked for Europe since the ECB cut rates below zero in 2014 and then reduced it further in 2016.

If QE had significant impact on Eurozone growth, it took 2 years to take work, and its effectiveness quickly faded. It seemed from the data that ever increasing amounts of bond purchases would be required to maintain growth, not even accelerate it. Eurozone QE began in early 2015 and Eurozone economic activity sagged in 2016 before picking up in 2017. As QE slowed in 2018, manufacturing has slowed significantly from early 2018 to date (September 2019).

Some of Europe's problems are specific. While China and the US girded for trade war, Europe has remained trade focused. Its economy is highly reliant on trade with imports and exports representing over 80% of GDP. China's metric is just over 35% while the America's is just over 26%.

The EUR has tracked economic growth closely ceteris paribus. The weakness in 2014 was probably due to dollar strength as the US tapered its QE. The impact of European QE supported the economy and the EUR for a while, before growth carried the EUR higher throughout 2017 and Q1 2018. Since then it has been weak.

The Fed meets 18 September and is widely expected to cut rates by 25 basis points. The futures market implies that the probability of a rate cut is 98%. The Fed is in a difficult position. It has already once caved to market and Presidential demands for a rate cut and it may cave once again. The jobs market is tight and earnings are stable. If there are signs of weakness, they lie in PMIs which represent the sentiment amongst purchasing managers, surely dented by the President's trade war. President Trump wants two things, among others; a trade war with China and rate cuts from his Fed. He is likely to get the second as a consequence of the first.

But other things are evolving. Despite such strong odds for a rate cut, the 10 year treasury yield has risen 44 basis points to 1.9% in the space of two weeks. Inflation has perked up, core CPI rising from 2% in May to 2.4% in August. Disruptions to Saudi oil supply has caused a 10% overnight surge in oil prices. If supply cannot be restored quickly or Yemen makes further successful attacks on Saudi petroleum assets, inflation could be headed higher. But these are mere exogenous shocks to inflation.

Republican Presidencies usually coincide with rising budget deficits and the national debt. The Trump Presidency has seen the deficit rise from 3.1% of GDP to 4.4% of GDP. There seems to be a greater acceptance that fiscal policy will be engaged to address the next downturn. Even in Europe where the Maastricht conditions provide formal guidelines on government debt to be broken, the sentiment towards fiscal rectitude seems to have relaxed. If there is a significant secular change to attitudes it is surely towards engaging fiscal policy. And if the world turns on the fiscal taps, the probability of steeper term structures, and rising inflation, is higher.

Bond markets may not be prepared for this. So far, the narrative is that duration is the safe harbour from credit and equity risk. this will be tested if inflation rises and if a

trend towards steepening term structures begins.

If inflation and higher long term rates is the price we have to pay for growth, it will be important what our deficits go to finance. There are two main paths, trickle down economics or wealth transfers through more progressive taxation. If the behaviour of humans over centuries is a guide, we must expect self interest to dominate and trickle down economics to be the chosen route. The fiscal accommodation will work but its effectiveness will be blunted. That means that the price we pay for growth will be very high. If a more progressive tax and spend policy is pursued to effect wealth transfer from rich to poor, the redistribution alone will boost growth, and the deficits will add to it. The price we pay for growth will be lower. But because it will be borne more by the rich and influential, the likelihood of this is lower.

What might change the calculus above is if societal change occurs alongside.