FUNDAMENTALS

Time for coordinated policy to revive growth?

With global growth remaining subdued and increasing signs that monetary policy is reaching its limits, the calls for fiscal easing and more policy coordination are growing louder.

In this edition of Fundamentals, LGIM Economist Magdalena Polan takes a look through the lessons of history and presents the case for greater coordination between monetary and fiscal policy.

THE PERCEPTION OF MONETARY POLICY BEING AT ITS LIMITS IS GROWING…

Global growth has remained sub-par. Inflation and inflation expectations, meanwhile, have been hovering near historical lows (especially in the developed economies) and well below targets set by central banks. This is despite exceptional and prolonged easing by the major central banks, highlighting the limits to monetary policy's ability to revive growth and stoke inflation following the global financial crisis.

There are a few reasons why the prolonged easing has not been more successful. These include a fall of the 'neutral' rate below zero (so below most policy rates), lower investment and risk appetite, and higher precautionary savings making rate cuts less effective. Tight fiscal policy is likely to have contributed too, given its negative impact on growth and expectations (see **Figure 1**). As shown by recent studies, fiscal austerity has a more negative impact on the economy when growth is already weak (as fiscal multipliers are higher); tightening fiscal policy soon after the recession, therefore, likely prolonged the slowdown, especially in the euro area.

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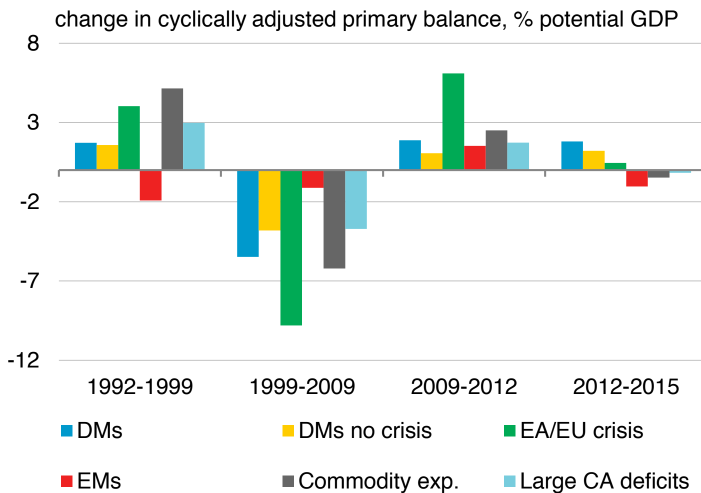
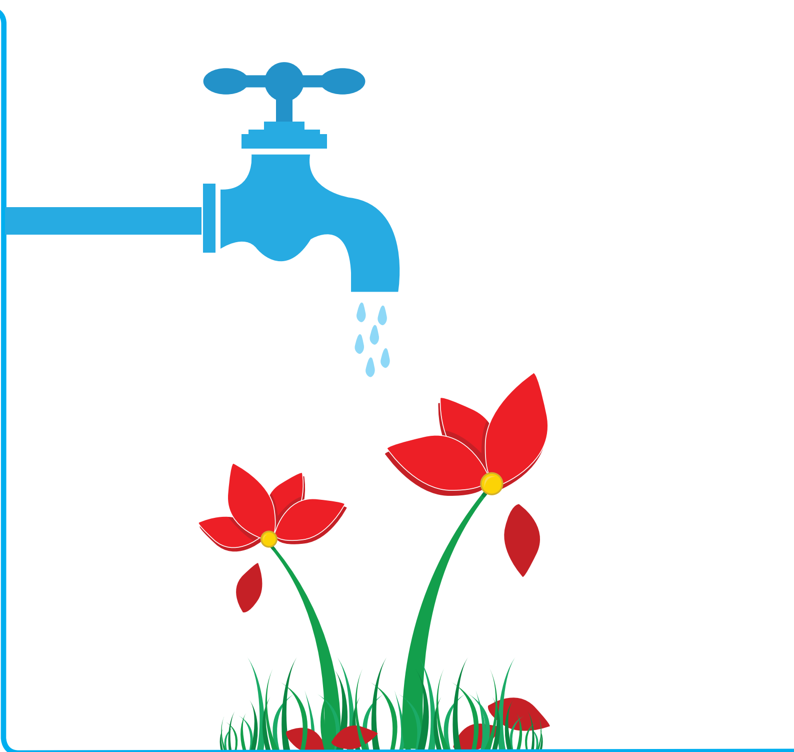
INVESTMENT MANAGEMENT

Figure 1. Tighter fiscal policy may have reduced the effectiveness of monetary easing



Source: IMF, LGIM

Note: Changes in the cyclically adjusted primary balance across various country groupings, GDP weighted. The cyclically adjusted primary balance captures the underlying fiscal stance, corrected for changes in GDP (mostly effects of automatic stabilisers).



...LEADING TO CALLS FOR FISCAL EASING AND MORE POLICY COORDINATION

This has led to calls for relaxing fiscal policy to support growth directly and to increase the effectiveness of monetary policy. And indeed, both economic theory and empirical evidence suggest that a fiscal boost and closer policy coordination would be more effective in combination. A number of countries, especially among the advanced economies, have already followed these calls and started to ease their fiscal stance, or plan to do so soon.

In contrast to monetary policy, the effects of which are inherently uncertain and indirect (policymakers hope to affect consumption and investments by changing the price of money), fiscal easing could support economic output directly in short term by increasing demand. Here, higher government spending, and especially investment, may be more effective as it is likely to increase total demand. With general tax cuts or higher transfers, the governments run the risk that consumers may well save the extra income, especially if they consider fiscal easing to be temporary.

WELL-PLACED PUBLIC INVESTMENTS CAN BRING BENEFITS...

Fiscal policy also has the ability to lift potential growth in the medium term. This can be achieved by investments in areas that may be limiting growth, such as transport, housing, or areas that could generate savings, such as clean energy sources and energy efficiency. Projects do not require lengthy preparation and approval – improving the energy efficiency of houses, more residential construction, increasing investments in broadband connections, or just better maintenance of existing infrastructure.

Research from the IMF suggests that well-placed infrastructure investments are particularly good at lifting growth in near and longer-term. What is more, they also mobilise private investments. Tax policy can also support growth in the longer term, as can fiscal easing that absorbs the costs of structural reforms, such as those in the labour market.

...BUT FISCAL EXPANSION STILL CARRIES RISKS

Well-planned fiscal easing should carry fewer risks than in 'normal' times. In particular, with interest rates low and rather uncorrelated to debt levels (see **Figure 2**), the risk of crowding out private investment is lower, especially if central banks maintain easy policy. Also, higher spending now does not automatically have to increase the so-called 'Ricardian equivalence' risk, whereby consumers fear that higher spending will mean higher taxation later, and may restrain their spending now. If well-placed investments lift potential growth, servicing and repaying extra public debt (which would be cheap anyway, given ultra-low rates) do not necessarily imply higher tax burdens in the future.

Nevertheless, risks remain. The same IMF study showed that public investments have the biggest impact on growth in countries with high 'investment efficiency', suggesting that countries with weaker institutions and more complicated business procedures, may benefit less from higher infrastructure spending. There is also a risk that projects may fall victim to politics or graft.

Furthermore, coordinated fiscal and monetary expansion carries the risk of diminishing credibility of inflation targeting or raising concerns about the monetising of public debt. This may ultimately discourage policymakers from easing through 'helicopter money'.

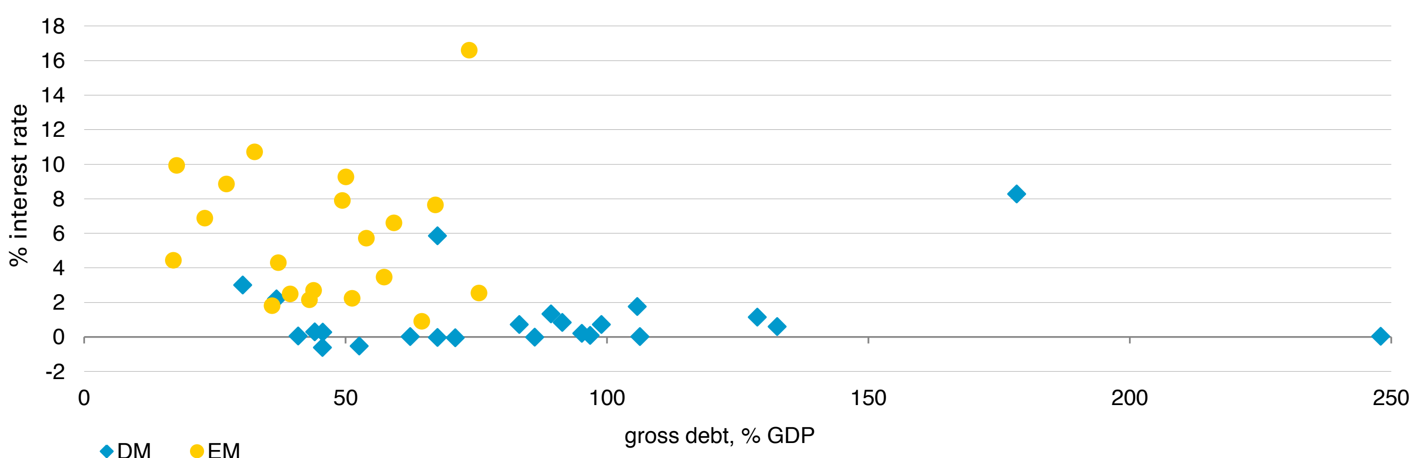
MORE SPACE TO EASE IN ADVANCED AND CRISIS-FREE ECONOMIES

Despite the potential boost to growth coming from increased public investment, not all countries have the necessary 'fiscal space'. Many advanced economies and more developed emerging markets (especially those that have not suffered from the crisis in the euro area or have built ample reserves) have debt levels that sit comfortably below the levels deemed as unsustainable, as measured by rating agencies or the IMF. With record low costs of funding, these governments could ease without endangering their debt sustainability. Higher growth should also help finance the cost of future debt repayments.

But countries that suffered from the crisis, especially those in the European periphery and in emerging markets still adjusting to lower commodity prices or weaker global trade, have seen a relatively fast increase in debt in recent years (see **Figure 3**). These countries have less space to increase debt without triggering sustainability concerns, even if markets and investors are more understanding of the potential benefits. But they may still benefit from the spill-over of increased investment demand elsewhere. In addition, many emerging markets still have space to ease monetary policy.

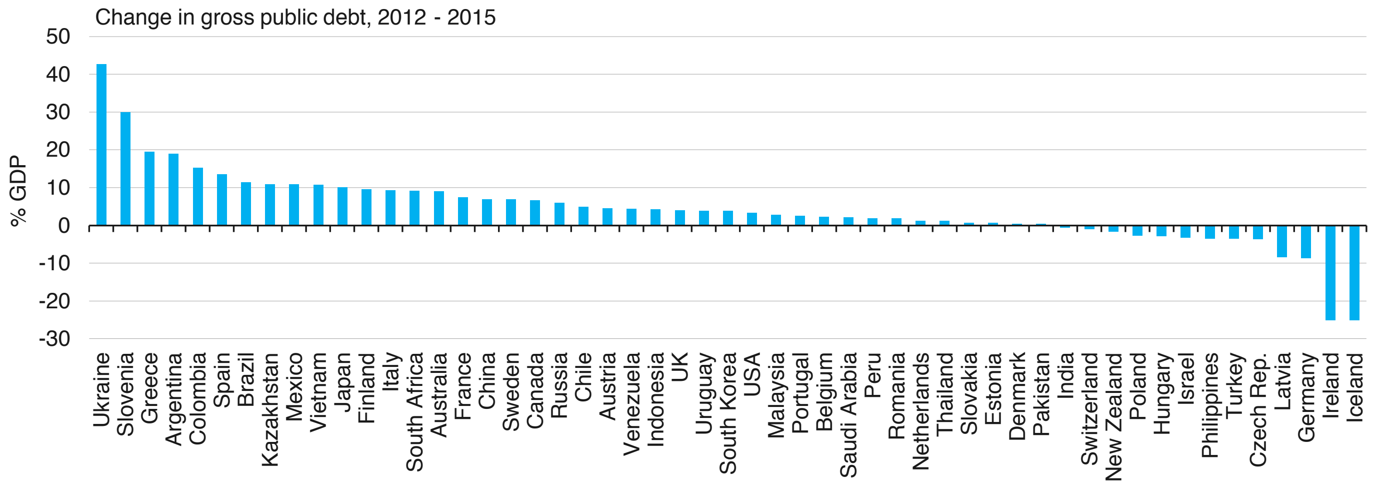
Political preferences also matter. A preference for lower state engagement, lower deficits, or formal rules (such as those in the EU), also limit the scope for expansion. Some countries are concerned by the looming costs of population ageing; but investing now to improve productivity or limit future costs of climate change may help to overcome these impending fiscal challenges.

Figure 2. Low funding costs in advanced economies support the case for increased government investment



Source: IMF, LGIM

Figure 3. Some European and emerging market countries have limited scope for fiscal expansion



Source: IMF, LGIM

MARKET IMPLICATIONS

Certain assets are more leveraged to increased public spending, especially on infrastructure. Construction and material stocks, for example, as well as broader manufacturing and energy stocks, could all benefit from higher spending. Exporters of materials and intermediary goods in the emerging markets are also likely beneficiaries.

The impact of changes in taxation or support for structural reforms would depend on specific policy choices (for example, the technology sector could benefit from incentives to invest in new sources of energy or communication). On the macro side, stronger growth and higher productivity growth could benefit the currencies of the countries with successful investment policies; expectations of the eventual increase in inflation and rates would also be likely to affect fixed income markets.

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