WELCOME BACK MR. KEYNES!

A new fiscal stimulus to support growth MUST incorporate repairs of "collateral damage" of prolonged monetary easing and address longer term trends.

By Bart Le Blanc

- *Another glum view from the IMF on the state of the world economy and again a downward revision of the outlook for the world economy.*
- *It is time for new policies. The IMF breaks a lance for fiscal stimulus to complement the continuing monetary easing.*
- *It is important to keep in mind that monetary policy was never meant to be the dominant economic policy for such a long time.*
- *As seen, prolonged monetary easing has brought significant 'collateral damage' through the mispricing of risks, asset price inflation, new inequalities, undermining pension schemes and the business model of commercial banks.*
- *But monetary policy and fiscal policy are very different animals: implementing monetary policy is quicker (and dirtier) and unrestrained by strict fiscal limits but with known side effects!*
- *Fiscal policies are more targeted and responsive and fulfil broader policy goals (e.g. income effects) but take longer to implement and face strict prudential limits.*
- *Any new fiscal stimulus needs to support growth and repair some of the collateral damage done by QE.*
- *This requires a holistic approach on income policies, climate change action, demography/longevity, and the use of tech in health, environment and infrastructure, if not the policy is doomed to fail!*
- *Oh yeah, and in the side line: Brexit is so yesterday's story! There is no going back to pre-referendum age. The EU and the UK should focus on the future.*

1. "Global Manufacturing Downturn, Rising Trade Barriers"

The latest World Economic Outlook does not hide the IMF's current somber views on growth in the coming years. Its title (see above) says it all.

Since early last year, every quarterly IMF review has shown growth projections gradually scaled down by a cumulative 1% point to around 3% for the world GDP today.
That is a significant drop representing more than $80 billion expected output lost. The Chinese economy is expected to grow by around 6% (instead of 7). By far the biggest relative drop is expected to occur in the emerging economies (ex-China), where earlier growth expectations of some 5.5% have been scaled down to close to 4%.

Table 1.1. Overview of the *World Economic Outlook* Projections
(Percent change, unless noted otherwise)

		Projections		Difference from July 2019 WEO Update[1]		Difference from April 2019 WEO[1]	
	2018	2019	2020	2019	2020	2019	2020
World Output	**3.6**	**3.0**	**3.4**	**–0.2**	**–0.1**	**–0.3**	**–0.2**
Advanced Economies	**2.3**	**1.7**	**1.7**	**–0.2**	**0.0**	**–0.1**	**0.0**
United States	2.9	2.4	2.1	–0.2	0.2	0.1	0.2
Euro Area	1.9	1.2	1.4	–0.1	–0.2	–0.1	–0.1
Germany[2]	1.5	0.5	1.2	–0.2	–0.5	–0.3	–0.2
France	1.7	1.2	1.3	–0.1	–0.1	–0.1	–0.1
Italy	0.9	0.0	0.5	–0.1	–0.3	–0.1	–0.4
Spain	2.6	2.2	1.8	–0.1	–0.1	0.1	–0.1
Japan	0.8	0.9	0.5	0.0	0.1	–0.1	0.0
United Kingdom	1.4	1.2	1.4	–0.1	0.0	0.0	0.0
Canada	1.9	1.5	1.8	0.0	–0.1	0.0	–0.1
Other Advanced Economies[3]	2.6	1.6	2.0	–0.5	–0.4	–0.6	–0.5
Emerging Market and Developing Economies	**4.5**	**3.9**	**4.6**	**–0.2**	**–0.1**	**–0.5**	**–0.2**
Emerging and Developing Asia	6.4	5.9	6.0	–0.3	–0.2	–0.4	–0.3
China	6.6	6.1	5.8	–0.1	–0.2	–0.2	–0.3
India[4]	6.8	6.1	7.0	–0.9	–0.2	–1.2	–0.5
ASEAN-5[5]	5.2	4.8	4.9	–0.2	–0.2	–0.3	–0.3
Emerging and Developing Europe	3.1	1.8	2.5	0.6	0.4	0.6	0.2
Russia	2.3	1.1	1.9	–0.1	0.0	–0.5	0.2
Latin America and the Caribbean	1.0	0.2	1.8	–0.4	–0.5	–1.2	–0.6
Brazil	1.1	0.9	2.0	0.1	–0.4	–1.2	–0.5
Mexico	2.0	0.4	1.3	–0.5	–0.6	–1.2	–0.6
Middle East and Central Asia	1.9	0.9	2.9	–0.5	–0.3	–0.9	–0.4
Saudi Arabia	2.4	0.2	2.2	–1.7	–0.8	–1.6	0.1
Sub-Saharan Africa	3.2	3.2	3.6	–0.2	0.0	–0.3	–0.1
Nigeria	1.9	2.3	2.5	0.0	–0.1	0.2	0.0
South Africa	0.8	0.7	1.1	0.0	0.0	–0.5	–0.4
Memorandum							
European Union	2.2	1.5	1.6	–0.1	–0.2	–0.1	–0.1
Low-Income Developing Countries	5.0	5.0	5.1	0.1	0.0	0.0	0.0
Middle East and North Africa	1.1	0.1	2.7	–0.6	–0.4	–1.2	–0.5
World Growth Based on Market Exchange Rates	3.1	2.5	2.7	–0.2	–0.2	–0.2	–0.2

The IMF points out that this slowdown is taking place in an overly generous monetary context. Regardless the verdict on these central bank policies (more about that later), it is clear that without the current monetary easing the economic outlook would have been far worse.

The major culprits of impending downturn are more political than economical. The continuing trade conflicts (US and China, US and EU, Brexit) have led to a slowing down of capital investment across the many sectors in many countries resulting in a negative impact on world trade.
In addition, specific structural changes to fight climate change such as new car manufacturing standards and realities (think: Extinction Rebellion), are affecting the markets for new and used cars and have a significant impact on the automotive industry (ouch Germany!). And this is only the beginning.

As the downward risks (e.g. trade, geo-politics, new environmental standards) are seen as elevated, the IMF warns that an abrupt shift in risk appetite may further expose the vulnerabilities in the financial system.

2. The BIG Bazooka

In the last 10 years the world's economic policies have been dominated by monetary policies. Interventions by the US Fed , the Bank of Japan and the ECB in 2008 and 2009 have added in some 15% of GDP to the available liquidity in the US and European economies and cumulatively up to 25/30% in the following years triggering unprecedented drops in interest rates even leading to negative rates in some countries such as Japan and Germany.

However, after 10 years of monetary easing central banks have unfortunately not (yet) found sufficient support for a way back to "normalised" monetary policies. But the tide seems to be turning against monetary policy as the only instrument in the economic policy tool kit for the last decade.
Even the IMF, the natural ally of central banks, gave the clearest signal in the latest WEO Foreword: *"Monetary policy cannot be the only game in town and should be coupled with fiscal support where fiscal space is available and where policy is not already too expansionary."*

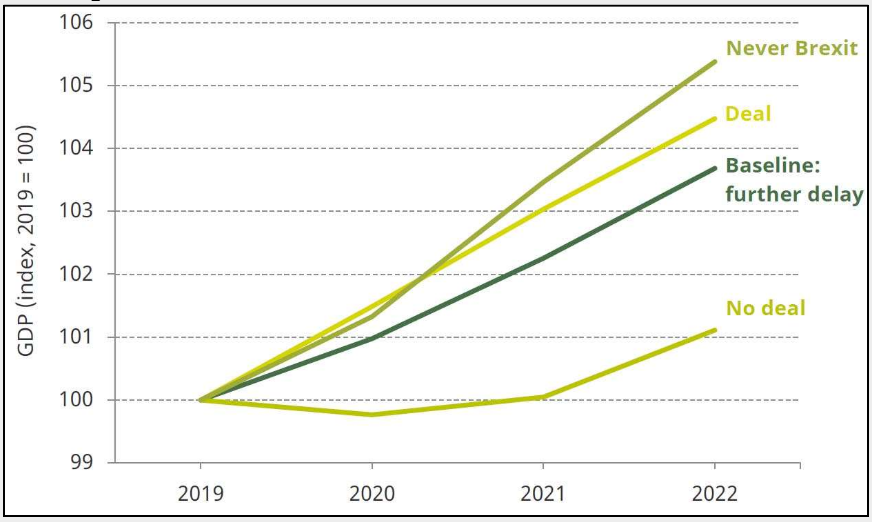
Brexit is yesterday's story

As a Dutchman living in the UK since the 1990s, I have had uncountable discussions and arguments over the outcome of the EU Referendum of June 2016. My view was and still is that Brexit is a supreme act of national self-harming.
Brian Bilstone, the so called "Poet Laureate of Twitter" captured it very well in a brief poem:

> *"Let's jump off this cliff – it'll be fun!*
> *A right laugh!" urged all the people*
> *(well, I mean just over half of those*
> *who had bothered to speak up at all).*
> *I peered down at the rocks;*
> *it was a long way to fall.*

The renowned Institute of Fiscal Studies produced recently an insightful graph on the economic effects of 4 different scenarios.

Real GDP growth in the UK under different Brexit scenarios (2019 = 100)



In one glimpse everyone can see that economically Brexit is going to hurt. But the delay scenario is also a bad option. Continuing uncertainty affects businesses and consumers and negatively impacts effective demand in the UK economy.
When writing this article, the way forward is still not clear, but my simple message is: stop analysing, reviewing, commenting, criticising. No new insides will be gained from that.
The fact is that a **new** European landscape is taking shape.
There is no going back to the pre-referendum years.
Parties on the UK and the EU side should start focussing on the future and focus on the guiding principles for the future partnership such as:

- The EU needs strong cooperation with the UK on many fronts, including climate change and security
- Immigration issues still require sustainable solutions
- Less "Brussels" and more national policy space
- Less internal market protection, more competition and less regulation
- Coordinated fiscal policy space at EU *and* national level

Collateral damage

Although economists have little doubt that the BIG Bazooka actions of central banks have reduced the extreme financial stress in the aftermath of the 2008/2009 crisis, and have been broadly successful in stabilising the world's financial conditions.
At the same time many also point at the "collateral damage" of the extremely low interest rates have resulted in over-inflated asset price, overblown valuation of liabilities creating new inequalities in income and wealth and the stress in the banking/life insurance/pension sectors. Who the victims of this collateral damage are depends very much on where institutions and people stand on the asset and liability ladder.
Let me briefly describe some of the issues.

- Overly generous and prolonged monetary easing has seriously distorted the pricing of risk in financial markets. A study by French economists Blot, Hubert and Labondance concludes: *"From a policy perspective, central banks should be aware that there is a risk for expansionary policy to inflate stock price bubbles. However, due to the asymmetric response of bubble components, monetary policy would not be the right tool to try to deflate them." (JEL December 2017).*
  In addition, the pricing of other risks such as term and illiquidity risk and credit risk has also been affected.

- Inflated asset prices create wealth for certain groups in society (e.g. portfolio investors and owners of property), while at the same time people with modest savings and a small asset base and low wages or small pensions will suffer. It thus creates new inequalities. A study of researchers of the Dutch central bank concluded: *"Taken together, our results imply that … aggressive monetary policy … may come with an unwanted side effect: higher income inequality." (How Does Unconventional Monetary Policy Affect Inequality DNB, May 2014).*Extracts from a soon to be published study by the French economist Thomas Piketty's (*Capital and Ideology*) confirm this on the basis of extensive data analysis and continues to prescribe a series of re-distributive policy measures which will undoubtedly resonate with many centre left groups in the US and in Europe.

- Apart from the impact on asset pricing, low rates have also brought devastation to the valuation of liabilities. Liabilities of pension funds and life insurance portfolios have skyrocketed as they need to be discounted against ever lower (and sometimes even negative rates). In countries like the Netherlands (a country with a strong capital-based pension system) with very strict financial valuation regulation, this has taken pension funds in negative funding ratio territory, potentially leading to cuts in current and future pension for large groups.

- The expected relaunch from the current morose inflation levels has not really happened; inflation has not increased. Investments have not boomed. In a recent Bank of England Staff Working Paper (February 2018), Philip Bun and others have concluded that the availability of cheap credit, has made corporates looking at ways to reduce borrowing costs through refinancing, rather than using credit for financing corporate investment. According to this study productivity in the UK may even have suffered.

- Zero or negative interest rates destroy the basic business model of banks. Banks traditionally earned their keep from a positive margin between their funding costs and the interest rate they charge their customers for lending, in addition to their systematic transformation function (lending longer and funding shorter). Flat or even inverse yield curves put enormous further pressure on the banks and poses an existential question on the sustainability of their business models.

One can conclude that the socio-economic effects of prolonged monetary easing policies were unintentionally negative ("collateral damage") and that rightly questions have been in many countries. It is not surprising that more and more people now state that monetary policy cannot be "the only game in town".

3. Almost a century of Keynesian economics.

The main fundamentals of economic policy are not very different across the world regardless the nature of national economic systems and beliefs. They are complex and multi layered and vary in emphasis but with all the differences in political views, they contain similar key elements such as:

- sustainable economic growth while respecting the natural environment;
- broad based employment with proper remuneration and workers rights;
- balanced distribution of income and wealth;
- stable and limited price inflation;
- balanced external position/balance of payments;
- continuing development of welfare.

As said before, the last decade of economic policy has been dominated by loose monetary policy. We should however not forget that this was in many countries accompanied by austerity driven fiscal policy. Evaluating the policy impact against the above-mentioned policy objectives, one must conclude a mixed result.

Apart from the restoration of financial stability, the results in many other areas are not positive: no real progress on sustainable development and climate change action (note the US withdrawal from the Paris Treaty), lagging levels of remuneration of wage earners in real terms and slowing of productivity growth, widened gap in the distribution of income and wealth and new inequalities, worsened balances of payment in some countries and welfare levels suffered.

After a decade of almost exclusive monetary policy dominance it is important to revisit the basics of fiscal policy. When the father of fiscal policy, John Maynard Keynes, published his General Theory of Employment, Interest and Money in 1936, the world was recovering from one of the deepest recessions in modern age.
Economic growth had been negative for years and the financial system had collapsed and lied in tatters. Keynes' approach to understanding the causes of the economic depression was very different from the traditional neo-classical supply-side economists. They believed in the self-restoring capacities of the market economy and focussed on improving the conditions for supply of goods and services hoping for markets to do the rest.
Keynes focussed on effective demand as the key to employment and growth. Government has a central role to play in demand "management" through taxation and allocation of budgetary resources and through automatic stabilising public systems such as social security.

In commenting on Keynes' theory Mark Spencer of Brock University recently stated: "*He (Keynes) deplored the situation where a few individuals or companies stored massive wealth while vast numbers experienced poverty and insecurity (his alarm bells ring today!) and sought to promote initiatives where governments could intervene with social projects to keep money fluctuating.*"
Keynes's theory was economic theory *and* economic policy at the same time.

The Keynesian economic policy approach has been tested many times during the last century. After the oil price shocks in the 1970s and 80s when inflation skyrocketed and growth disappeared, many western governments launched public spending programmes to compensate for falling consumption and investment demand.
The recently announced post-Brexit UK government's plans for additional infrastructure spending and tax reform plans prove that Keynes had never really left the economic policy stage.

4. Comparing fiscal and monetary policy

Although both fiscal and monetary policy are very much central government/central bank driven, they differ in many aspects.
In the following table I have tried to summarise some key aspects of fiscal policy and monetary policy in terms of goals, decision making, financing and overall impact assessment.

	Fiscal Policy	**Monetary Policy**
Objectives	*To promote through government action (budgetary resources, taxation, regulation):* - *Sustainable growth* - *Climate change action* - *Broadly shared employment* - *Balanced income and* - *wealth distribution* - *Stable financial development* - *incl. inflation control* - *Balanced external position* - *Contribute to welfare*	*To regulate the country's or monetary zone's money supply to ensure:* - *Price stability* - *Full employment* - *Balanced economic growth* *(based on published objectives of the FED, ECB, Bank of Japan, People's Bank of China)*
Decision making	*Through political/democratic majority rule in open and transparent process* - *Political consensus on multiple objectives* - *Societal debate (e.g. trade unions, employers)* - *Implementation through legislative process*	*Through discretionary, independent central bank process* - *Consensus within central bank procedures (FED Chair plus Federal Open Market Committee FOMC, ECB President plus Governing Council, BoJ Governor plus Policy Board etc)* - *Implementation immediate*
Funding	- *Taxation: direct or indirect, progression steepness* - *User charges (e.g. tolls, prescription charges)* - *Public sector borrowing* - *All instruments limited by strict ratios for deficits, debt levels, taxation, etc.*	- *Increase/decrease of money supply through interest rate setting, open market interventions, reserve requirements, etc.* - *No formal limits*
Impact	- *Discretionary demand by additional resources (direct through public spending or indirect through lower taxes and higher consumer/corporate spending and investment)* - *Tax relief allows consumers and corporate investment to raise demand* - *Procedural time lags* - *Additional borrowing pushes up capital market rates* - *Inflation may be pulled up by increased demand (Pull inflation)*	- *Indirect via lower interest rates* - *Corporate investment cheaper but need business reason* - *Economic time lags* - *Certain asset class prices (stocks, property) inflate creating new inequalities* - *Savings rates drop* - *Liabilities of pension schemes increase* - *Inflation may be pushed up if policy successful (Push inflation)*

This comparison teaches us that monetary policy is quicker (and dirtier) and unrestrained by strict prudential limits. However, there are questions as to its effectiveness. It is also known that reversing the monetary policy course is very difficult and analysis does show that any reversal has little impact in turning around the initial outcome. It is however clear that the policy can indirectly breed unwelcome results in terms of new inequalities.

Fiscal policies are better targeted and more effective in their results and fulfil broader policy goals (e.g. income effects). They are based on broad political consensus and should enjoy popular support. They take however longer to implement and face constraints from strict disciplinary rules (e.g. the EU's Deficit/GDP ratio of maximum of 3% and Debt/GDP of 60%) which creates limitations, depending on a country's financial health

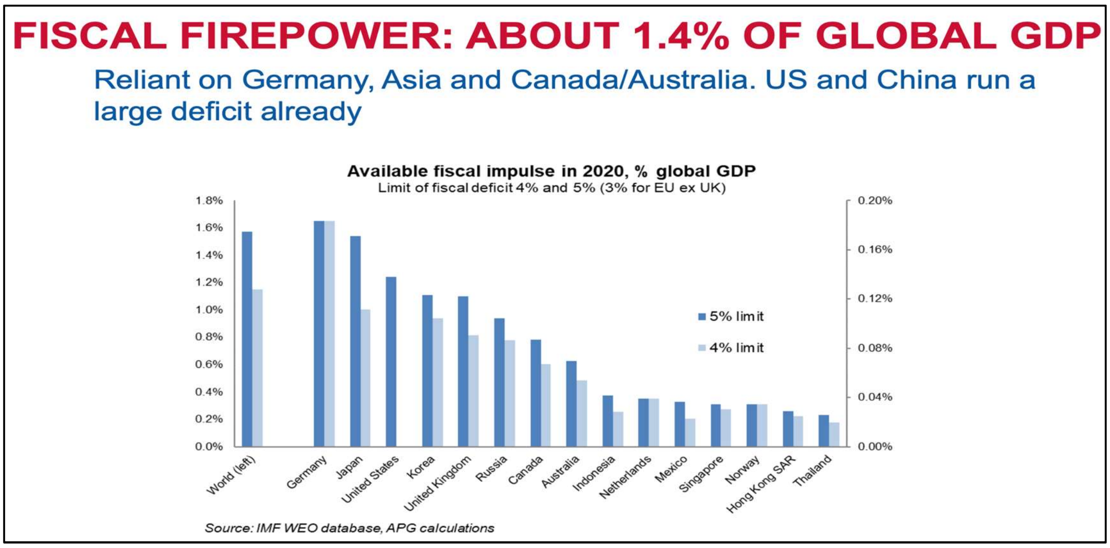
Is there room for new fiscal stimulus?

In the immediate aftermath of the financial crisis many governments were faced with growing public deficits and increasing public debt. Dropping tax revenue and sharply rising unemployment expenditure combined with lower GDP levels led to ratios of debt to GDP and public spending to GDP being tested in many countries.

After the financial crisis many countries in Europe introduced significant austerity programmes with budget cuts and tax increases in order to rebalance public finance. After many years of implementing these policies, the health of public finance seems to have been restored and the time seems ripe for a review of fiscal policy towards a more generous and expansive approach. The UK conservative party has called for the "end to austerity" especially in view of the possible impact of Brexit on the UK economy. And very recently Paolo Gentiloni, the former prime minster of Italy and now the new EU commissioner for economic and financial affairs stated: "*the risks of a prolonged period of low growth must not be overlooked*" and supporting new economic growth "*cannot be left to monetary policy alone" (article in Il Sole 24 Ore of 20 October 2019).*

A recent study by pension investor APG Asset Management illustrates that after years of austerity policies in many advanced economies the fiscal balances have significantly improved with countries like Germany and the Netherlands running fiscal surpluses.

Even within the current very strict deficit frameworks, there seems to be ample room for fiscal stimulus particularly in the EU, Japan and many emerging economies plus Canada and Australia (clearly not in the US and China which have large and growing deficits).



Source: APG Asset Management 2019

The graph shows that the available headroom for stimulus programmes in the EU and Japan, Canada and Australia and a number of emerging economies might amount to some 1-1.5 % of World GDP.
That is indeed significant Fire Power! It better be used wisely.

5. The Tinbergen approach: support growth and address the major issues of today.

I will never forget attending - as a young economics student - a lecture by Nobel prize winner Jan Tinbergen. In his characteristic sober and low-key way, he explained the principles of economic policy setting. One message is stored in my memory: to achieve multiple economic policy objectives, one must apply different and complementary policy instruments, pay close attention to the coordination of policy implementation, and monitor the outcomes.

In the spirit of Tinbergen, we will need to look for complementing the current monetary policy (impossible to abruptly halting this) with new fiscal policy initiatives.
When devising these fiscal stimulus measures it is imperative not to focus too much on the immediate or short-term impact.

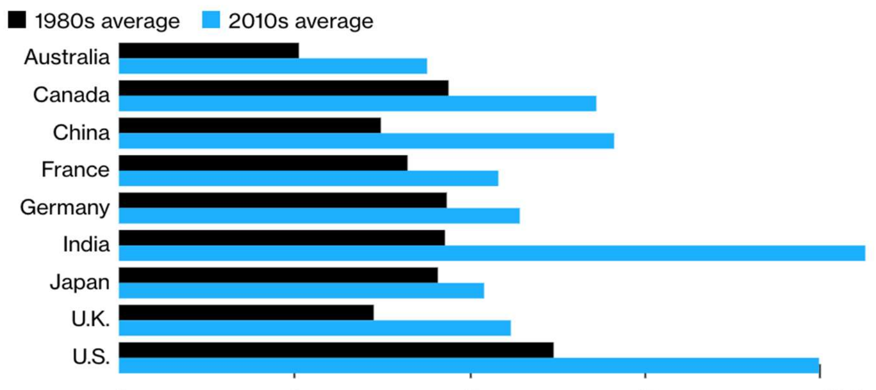
It is essential that the new fiscal policies integrate explicitly some of the trends that will shape the future of socio-economic framework such as:

- Inequality
- Climate change
- Demography/Longevity
- Health-Tech, Energy Tech, Infra Tech

They all bring with them issues which are important for the way new fiscal stimulus needs to be shaped as highlighted below.

Address inequality issues.

Much has been said about growing inequality, many of them fuelled by the asset price effect of monetary easing. The development of the so-called Gini coefficient (*measure of inequality in income 0 = complete equality, 1= complete inequality*) over recent years has shown a significant growth in income inequality in the US from 0.35 to around 0.40 (comparable levels in the EU are around 0.30 and stable).
This development is also Illustrated by the graph below.



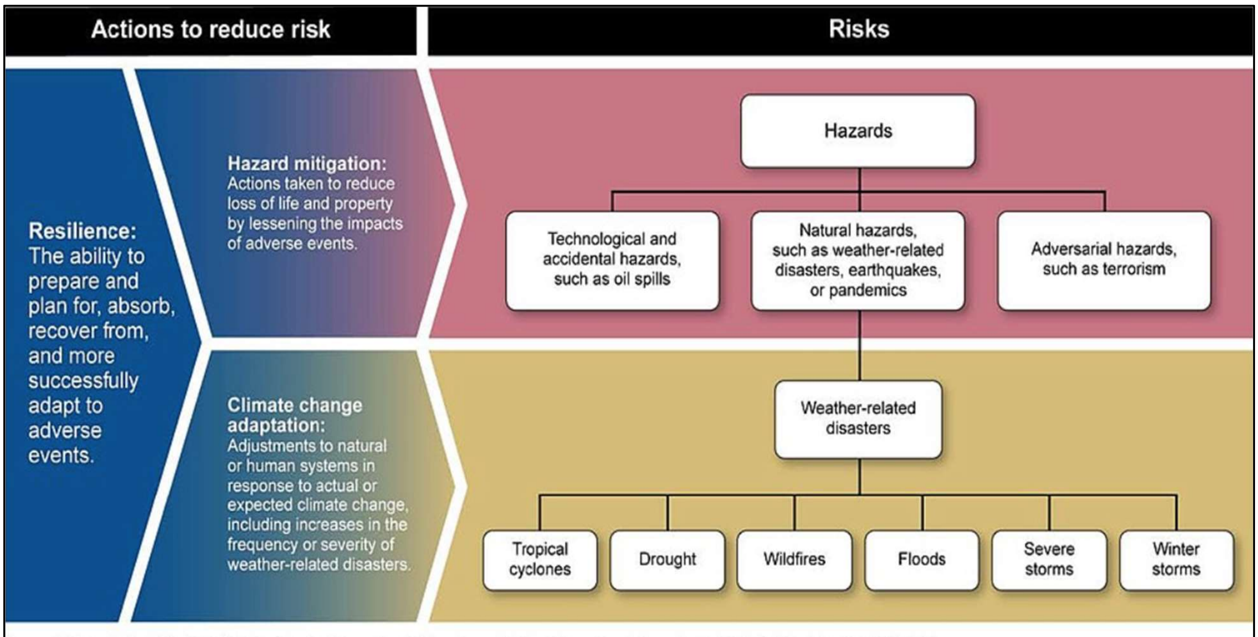
Source: World Wealth and Income Database (WID)
Note: Piketty was among the founders of the WID, which draws on research by more than 100 economists globally

Income distribution has always been a core element of economic policy. The various fiscal policy tools be it taxation or government spending or regulation, would unavoidably touch on income distribution issues.
It is politically very important that new fiscal stimulus measures do not ignore the increased inequality following from the monetary easing policies over the last decade.

This will require a fierce political debate in many countries and politicians cannot hide any longer for the urgent need for a fundamental discussion on progressive taxation.
Any new fiscal stimulus will require a response to inequality issues that have been avoided for too long.

Fight Climate change.

For economic and fiscal policies to reflect the growing need to tackle climate change means to put CO2 reduction in the centre of all policies, whether they are budgetary or tax or general legislative policies.
Such approach affects almost all areas of government action, from building regulations and energy transition measures to tax policies aimed at green taxes and public infrastructure development with strong sustainability drivers (see schedule below).



Source: GAO analysis of Presidential Policy Directive 8, previous GAO work, and National Oceanic and Atmospheric Administration data. | GAO-16-454

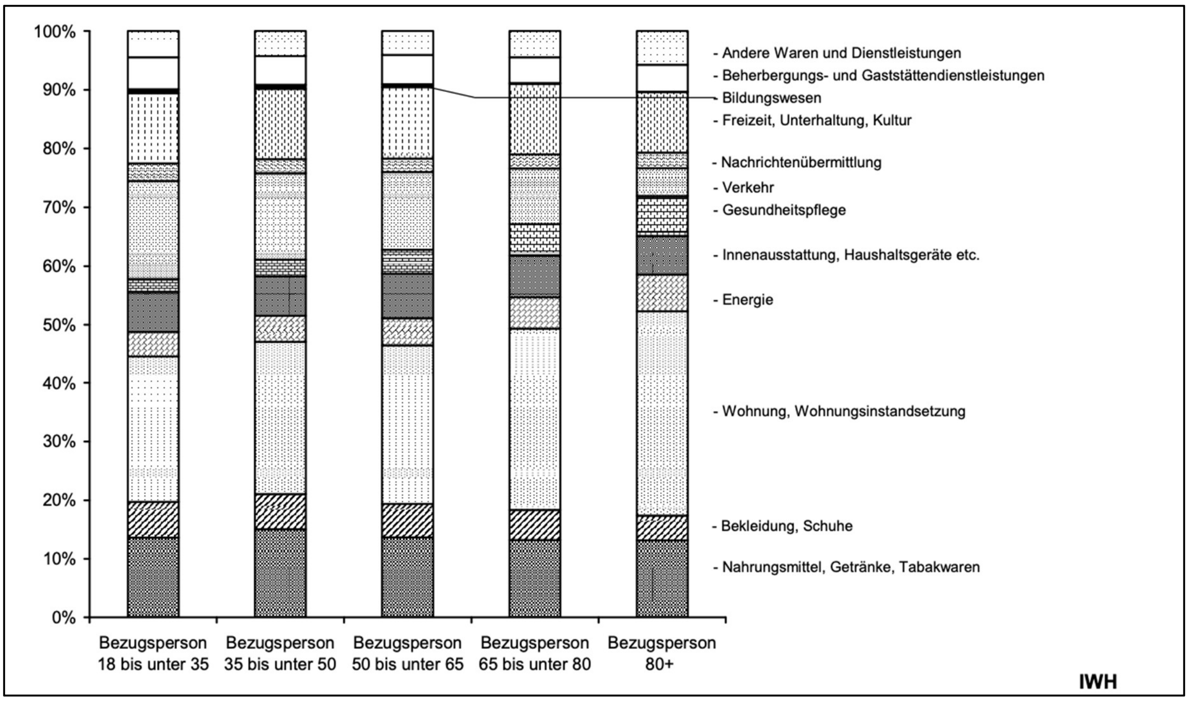
We need however be aware that the introduction of “green taxes” although sensible in its origin, is fraught with problems.
Income effects of such indirect taxes are frequently biased against lower income and rural groups, as the 2018/19 Yellow Vests movement in France has proven. A recent EU study on the impact of environmental taxation concludes the following:
“*replacing a portion of income tax with green taxes is one of the best options for environmental fiscal reforms. However … environmental taxes have the potential to affect the poorest members of society most, as they spend a greater proportion of their income on energy than wealthier members.” (Energy Economics 2014).*

This means that any green taxation proposal as part of a stimulus plan will need to be accompanied by progressive direct tax measures to compensate lower- and middle-income groups.

Integrate demographic trends/Longevity

The demographic development in many parts of the world trends towards increased longevity and a smaller active worker-base, particularly in Japan and Europe, and in the near future also in China (consequence of one-child policy).
This will have serious implications for the future of society.

With a rising average age, the make-up of private and public consumption will fundamentally change. This change will not affect so much the overall value of consumption but will leave its marks on what people consume and change traditional categories of spending on goods and services.
A German study into spending per age group concluded that the level of spending on clothing and transportation drops when reaching 65+, while health and care spending more than doubles and housing costs and energy bills increase significantly (see below).



Any fiscal policy programme needs thus to incorporate responses to this shift in consumer spending particularly where is touches on the provision of public services. For example, further political decision on the provision of health care and the funding thereof is unavoidable. In most advanced economies health care is mainly funded through the public sector (even in the US almost half of national health care spending is government funded). Another example relates to future pension rights of younger workers and the pension entitlements of retired people.

Any forward-looking economic policy plan needs to address these wider issues of demography/longevity.
Ignoring these would sanction inequality issues for vulnerable groups.

Apply tech in public services

As a layperson in the field of new technologies and the use of Big Data, I can only generally appreciate the impact technological development has on many parts of daily life. New tech will affect many segments of public services such as healthcare, energy transition, communications and transport infrastructure, etc.

Examples in healthcare show their positive contribution to a more efficient and effective care provision. Artificial Intelligence is already a great support in the diagnostic field and virtual consultations alleviate the pressures of health professionals. Nano-medicine opens ways to individualise medical treatment and thus increase its success rate. 3D printing can manufacture artificial bones and protheses and even organs. Robot assisted surgery enhanced precision and control, it reduces infections and is minimally invasive.

It may all sound a bit sci-fi but make no mistake: it is here already!
Applications of new technologies and AI is other sectors of public services are equally mindboggling. This is particularly the case in health were the impact of demographic trends will put significant additional pressures on the provision of treatment and care.

It is therefore imperative that any new fiscal stimulus takes these developments into account as they can make public services more efficient and more effective.

6. Conclusion

This article started with a gloomy economic assessment for the near term. There is however reason to be optimistic and feel positively challenged.

A new holistic economic and fiscal policy approach will bring without any doubt a better balance than the past decade of monetary easing and austerity policies. Income distribution, climate change, demographic trends/longevity and the use of new technologies/Big Data will need to be an integral part of a new economic policy framework.
It is high time that politicians come out of your hiding places and start *making* real economic policy in the spirit of Jan Tinbergen.

Bart Le Blanc, October 2019.