The Next Round in the Fight for Growth: Preparing for a Fiscal Push

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Globally, economic growth appears to be entrenched in a period of malaise in spite of the considerable efforts of central banks. Since the financial crisis, they have gone to great lengths to stimulate growth, moving from traditional policy measures to more innovative ones. Yet thus far, growth remains sub-par. While we’ve seen significant monetary policy action from central banks, what has been lacking is meaningful fiscal policy action from governments. Given that debt levels in many countries are already high, there has been reluctance to significantly increase spending, particularly in Germany and the U.S.

However, that may soon change. As economic growth and inflation remain sluggish, the natural question is: What’s the next stimulus tool in policymakers’ toolboxes? Potentially, it could be aggressive fiscal stimulus or, more exotically, helicopter money, which would combine monetary and fiscal policies. With helicopter money, the government provides aggressive fiscal stimulus that is funded by the central bank. The fiscal spending can take the form of infrastructure spending, tax cuts or direct payments to citizens, and the goal is to encourage spending, thereby stimulating growth and inflation.

If aggressive fiscal policy is not widely adopted, or is unsuccessful, the current lower-for-longer environment is likely to persist. If helicopter money were to be implemented, it is difficult to forecast the outcome for investors because it has only very rarely been used. Broadly, the potential for aggressive fiscal policy or helicopter money reinforces our longstanding view that there is a wide range of potential outcomes for both the economy and markets. Given this, the TD Wealth Asset Allocation Committee (“WAAC”, “we”) maintains its preference for a well-diversified portfolio of assets, including developed market sovereign and corporate bonds, high quality North American equities, plus allocations to cash and gold.
The expanding spectrum of monetary policy

Central banks acted swiftly to lend support as the financial crisis plunged global economies into recession. But with economic growth and inflation remaining stubbornly low in spite of traditional accommodative monetary policy, central banks moved along the spectrum from conventional measures to less conventional measures. Initially they began by lowering policy rates to extremely low levels (known as zero interest rate policy or ZIRP) to bring down short-term interest rates with the hope that this would increase investment and consumption and, in turn, employment. To augment the public’s confidence in monetary policy, they began issuing forward guidance that discussed the data they were using to make decisions and advised onlookers about future monetary policy plans.

But growth and inflation remained low and unemployment remained high, so a number of central banks, including the U.S. Federal Reserve (Fed), European Central Bank (ECB) and Bank of Japan (BoJ), launched massive asset purchase programs (quantitative easing, QE) through which they purchased bonds in order to depress interest rates along the yield curve. In the U.S., the Fed launched Operation Twist, through which it tried to bring down long-term yields even further by selling some of its shorter-term bonds and using the proceeds to buy longer-dated bonds. Yet economic growth and inflation remained modest, and in many locations, ZIRP transitioned to NIRP (negative interest rate policy) and numerous government bonds now provide negative yields (more than $10 trillion of developed market debt – almost 40% of the market – currently has negative yields¹). So, what does the future hold? Will we see a continuing transition to even more exotic policy measures?

Figure 1: Monetary Policy Innovation Spectrum

*Combined assets of the U.S. Federal Reserve, European Central Bank and Bank of Japan.
The next policy phase: aggressive fiscal stimulus

With monetary policies becoming increasingly impotent, the potential next phase in policy support may come from governments rather than central banks — in the form of aggressive fiscal stimulus. Because aggressive fiscal stimulus would focus directly on enhancing growth rather than on lowering interest rates (which many monetary policies have focused on), the theory is that the economy should more quickly reap the benefits. The aim would be to increase aggregate demand, inflation and nominal growth, which in turn should support job and wage expansion. The spending could be directed toward funding infrastructure development because there can be a multiplier effect if the funds are spent productively. The initial stimulus could give the economy a boost by creating new jobs and, if the projects are designed to support future growth (for example, new roads to reduce traffic and increase productivity), then the positive effects could be sustained over the long term.

We’ve already begun to see this unfold in Canada, where the Liberal party made aggressive infrastructure spending a centerpiece of its recent election campaign, and in Japan, where Prime Minister Abe recently announced his intention to launch a substantial stimulus package, one of the country’s largest since the financial crisis. Amid lackluster growth and listless inflation, it is possible the debate surrounding significant fiscal stimulus may intensify in Europe and the U.S. as well. In Europe, the combination of very slow growth and high levels of political stress in countries like Italy and France may push Germany to reconsider its longstanding preference for austerity. And in the U.S., if the Democrats win both the Presidency and the Senate, they may well push for more spending.

Helicopter money: Pennies from heaven?

There has been a great deal of speculation that policy may take an even more exotic turn and move beyond aggressive fiscal stimulus to unfunded fiscal stimulus (helicopter money), which is a combination of fiscal and monetary policy. Under a helicopter money scenario, the government and its central bank coordinate policies to provide funding for fiscal spending that is aimed specifically at spurring economic growth. The central bank creates helicopter money and the government spends it on fiscal stimulus projects.

What differentiates helicopter money from aggressive fiscal stimulus is the fact that helicopter money is unfunded — the central bank essentially produces the money from nothing. To create helicopter money, the central bank uses a program that’s very similar to QE. It purchases bonds issued by the government, but in this case, the bonds have a zero coupon and are perpetual (they never mature) — meaning there is no cost to the government because it doesn’t have to pay interest and it never has to repay the loan. Because helicopter money is financed this way, the government doesn’t need to increase taxes to pay for the stimulus programs. This makes it more likely that consumers will increase spending as they won’t need to save to offset associated tax increases. It may also serve to weaken the currency of the country implementing it, which might provide further support to the economy.

The fiscal spending can take the form of payments to citizens (either directly or through a tax rebate), financing for infrastructure projects, or it can be a combination of both. Providing payments to the public can ignite economic growth by helping to spur consumption. (We noted the potential benefits of infrastructure spending earlier.)
It’s important to note that helicopter money is not without risks. The public may not spend the extra money domestically; instead using it for offshore investments or saving it (although this risk may be tempered by the potential for increasing inflation expectations and lower real yields, both of which act as disincentives to saving). In addition, inflation is notoriously difficult to control. If officials don’t provide enough stimulus to amplify growth and inflation, the central bank could lose credibility, and if they provide too much stimulus, they could end up with hyperinflation, which would erode savings, cause significant harm to the economy and damage the central bank’s credibility. Even if they manage to strike a good balance and provide just enough stimulus to reach their inflation target, there are still risks and potential downsides, for example:

- higher inflation will be detrimental to those on fixed incomes, such as the elderly, and those with significant cash and fixed income holdings,
- asset bubbles may form,
- wage growth may lag price growth,
- the distribution of the new money may be viewed as inequitable and lead to social unrest, and
- the lure of easy money may cause the government to become less fiscally responsible.

**Japan: Taxiing toward takeoff?**

While we think it is unlikely that policymakers in North America or Europe will use helicopter money in the next 12-18 months, it is possible that Japan will, given its decades-long struggle against deflation. In Japan, the government’s three arrows — fiscal stimulus, monetary easing and structural reforms — do not appear to have been effective: trade is poor, industrial production is weak and economic growth and inflation are stagnant. This makes it a prime candidate, and there is precedent as Japan has employed helicopter money before, using it to stimulate its economy in the 1930s.

While Japan has implemented substantial stimulus programs since the financial crisis, previously they have been largely focused on lowering interest rates and/or the yen; helicopter money would instead focus on fiscal expansion aimed at achieving growth and inflation targets.* If Japan were to move forward with helicopter money, it is possible that other countries might follow or, just as important for investors, the market may speculate that others will follow.

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*It’s worth noting that while helicopter money may well provide a boost to Japanese inflation, the economy and the stock market, it will not solve Japan’s underlying problem, which is that its population and workforce are shrinking. Regardless of monetary policy, healthcare costs associated with the aging population will continue to increase, and the declining population will weigh on economic output.

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**Why is it called helicopter money?**

Economist Milton Friedman first used a helicopter analogy to explain unfunded stimulus. He likened it to having central bankers circle a community in a helicopter and drop money down for citizens to pick up and spend. The theory is that their increased spending will spark inflation and economic growth. More recently, former Fed Chairman Ben Bernanke popularized the phrase when he used it in a 2002 speech.
What does this mean for investors?

If aggressive fiscal stimulus or helicopter money were to be implemented, and if the market believed they were likely to be successful, deflationary forces could recede and growth and inflation expectations could move higher. This scenario is potentially very positive for gold prices because real interest rates would likely stay very depressed as inflation moved higher and central banks worked to keep interest rates low (for example, through continued QE).

The impact on equities would clearly depend on the success of the stimulus in boosting growth. Higher consumer demand or significantly higher spending on infrastructure could provide a tailwind to some corporate earnings. Furthermore, improved economic and earnings growth in an environment of low interest rates could support valuations at existing or even higher levels. On the other hand, if the fiscal stimulus failed to boost growth, the fear that policymakers were out of ammunition might depress equity markets.

**Figure 2: Sovereign Bond Yields**

<table>
<thead>
<tr>
<th>Country</th>
<th>Policy Rate</th>
<th>2-year</th>
<th>5-year</th>
<th>10-year</th>
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<tr>
<td>United States</td>
<td>0.38</td>
<td>0.86</td>
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<tr>
<td>Canada</td>
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<td>0.70</td>
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<tr>
<td>Japan</td>
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<td>2.00</td>
<td>2.06</td>
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</tr>
<tr>
<td>New Zealand</td>
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<td>2.29</td>
<td>2.91</td>
</tr>
<tr>
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<td>-0.03</td>
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</table>

Source: Bloomberg Finance L.P., TD Asset Management Data as of March 31, 2016

For fixed income investors, aggressive fiscal stimulus and/or helicopter money would likely create a challenging environment. Currently, nominal yields are very low and even negative in a number of regions as investors have priced in a protracted period of weak growth and deflationary pressures. If fiscal stimulus was successful in raising growth and inflation expectations, it is reasonable to think that rates would increase somewhat, pressuring bond prices. However, given that central banks will likely continue to aggressively buy government bonds, it is unlikely that rates would rise significantly. If fiscal stimulus failed to stimulate growth, it is possible that yields could fall even further, particularly in North America, where yields remain high from a global perspective.
Our view

As policymakers move further along the stimulus spectrum, and potentially into largely uncharted territory, a number of questions remain unanswered: Will aggressive fiscal stimulus be implemented in Europe or the U.S.? Will helicopter money be implemented in Japan? If so, in what size? Will it succeed? If it does, will it prompt other regions to employ it and will that dilute its effectiveness? Broadly, uncertainty is prevalent. In an uncertain environment, we believe investors can benefit from tuning out some of the short-term noise, taking a long-term view of their investments and holding a well-diversified portfolio of high quality assets. In particular, we believe investors can benefit from embedding three key elements into their portfolios:

• an emphasis on risk management that ensures risk taking is being properly compensated;

• a high level of diversification to help mitigate the impact of market movements; and

• a focus on quality companies with strong balance sheets, high returns on capital and consistent cash flows that are positioned to prosper in a difficult environment.

This disciplined approach should help investors navigate the challenging environment they face today.

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As at July 15, 2016. Source: Bloomberg Finance L.P.

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