GLOBAL ECONOMICS FOCUS

How will policymakers fight the next downturn?

- Concerns that policymakers in developed countries do not have the tools to fight the next downturn are generally misplaced. There is plenty more they could do. The constraints will instead be reluctance to prolong the adverse side-effects from the use of unconventional monetary policy tools and unease about pushing government debt even higher.

- Normally, policy arsenals are depleted in a downturn and rebuilt in the subsequent recovery. The problem is that the rebuilding has not really happened this time. Interest rates have not risen at all in the euro-zone and Japan. Only the US has begun to reverse the balance sheet expansion seen under quantitative easing (QE). Government deficits have been nearly eliminated in some, but not all, countries, and virtually no inroads have been made into reversing the sharp rise in government debt.

- What’s more, policymakers have made little use of the past few years of recovery to prepare for the next downturn. The inflation-targeting frameworks that contributed to the global financial crisis have been left intact. Nothing has been done to formalise the ad hoc use of unconventional tools, such as QE. And little has been done to strengthen the architecture of the euro-zone with regards, for example, to a fiscal union.

- Despite all this, there are still many options open to policymakers. As far as monetary policy goes, interest rates could be reduced (further) below zero, QE could be expanded and monetary frameworks could be changed. It makes more sense for fiscal policy to do the heavy lifting, though, even with government debt at generally high levels. And we would expect a “helicopter drop” – a fiscal loosening financed by a permanent expansion of the money supply – to be given more serious consideration in the next downturn.

- Admittedly, the euro-zone’s monetary union restricts its room for manoeuvre more than most. But even it has options. For example, the euro-zone’s strict fiscal rules could be loosened. Or the German government could spend some money, cut taxes and undertake regulatory reforms to boost investment.

- However, there is a big question mark over whether policymakers will make adequate use of these tools – especially in a severe downturn which would take them further into the realms of unconventional policy. The main constraint on monetary policy will be unease about the adverse side-effects of the long-term use of unorthodox policies – for example, increasing inequality or causing asset price bubbles. Meanwhile, nervousness about the high levels of government debt could limit the use of fiscal policy to boost the economy. Even countries where government debt as a share of GDP has been falling – such as Germany – are unlikely to loosen the fiscal shackles.

- What’s more, recent behaviour by world leaders suggests that there will not be much collaboration at the global level to deal with a downturn. In fact, the reverse would be more likely, with countries resorting to beggar-thy-neighbour policies. In particular, a deep US downturn could spark President Trump to renew his protectionist agenda, prompting a downward spiral of retaliatory barriers to trade. This would echo the 1930s when the 1930 Smoot-Hawley Tariff Act exacerbated the Great Depression.

- Overall, then, policymakers are not powerless in the face of the next downturn. Indeed, we expect their tools to prove adequate to cope with a relatively modest slowdown. However, if there was a more severe downturn, we think that policymakers would be reluctant to undertake the more radical steps that would be required – with a relatively weak policy response raising the risk of a prolonged slump.

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How will policymakers fight the next downturn?

A global downturn appears to be getting underway, begging the question of what policymakers can do to respond if it gets worse. What policy tools do they have, and will these be adequate?

We are answering this question in many of our individual country services, but this Focus takes a more global perspective. In particular, we compare and contrast the options for different economies, consider the common concerns that countries might have and examine the scope for global cooperation.

Policy arsenals only partially restocked

The question of whether policymakers are prepared for the next downturn is only really an issue for developed economies. Interest rates in developing economies are generally high enough to mean there is plenty of scope to cut them. And most of the major emerging markets have ample fiscal firepower too, with government debt levels relatively low, budget deficits under control and reliance on funding from non-residents lower than in the past. (See Emerging Markets Economics Update, “Which EMs can afford to loosen fiscal policy?”, 6th December 2018.) So emerging markets as a whole look relatively well-tooled.

In this Focus, then, we concentrate on developed markets. And here the picture is considerably less reassuring. After the global financial crisis, policymakers’ arsenals were well and truly depleted. Conventional tools had been exhausted – with interest rates cut to rock-bottom and fiscal deficits pushed to record levels – forcing policymakers into the world of unconventional policy tools, such as quantitative easing (QE).

Normally after a downturn, there would be a long period of growth during which policy would be tightened and normal settings restored – ready for it all to begin again. The problem is that this has not really happened this time. As far as interest rates go, the only countries to have “normalised” policy to any significant extent are the US, where official interest rates have risen to 2.25%-2.5%, and Canada, where they have reached 1.75%. (See Chart 1.) Meanwhile, the euro-zone and Japan have not raised rates at all. Indeed, in real terms, official rates are still negative in the UK, euro-zone, Canada and Japan.

Even in North America, interest rates have probably not risen by enough to have created sufficient scope to deal with the next downturn. After all, the fed funds rate has fallen by an average of 400bps (in both nominal and real terms) after past US recessions. (See US Economics Focus, “Does the Fed have the tools to fight the next recession?”, 22nd January.)

As for unconventional monetary policy, the US is the only country to have reversed any of the asset purchases that it undertook. And even then, only a small proportion of the overall programme has been unwound; its balance sheet has fallen from a peak of 25.1% of GDP in 2014 to 21.2% now. (See Chart 2.) Other unconventional measures, such as Japan’s cap on government bond yields, also remain in place.

At least most governments have brought their deficits down significantly. (See Chart 3.) But there is still quite a wide range; Germany has achieved a surplus whereas France’s deficit is still nearly 3% of GDP. And while the US reduced its deficit to 3.2% of GDP in 2015, President Trump’s stimulus has since pushed it back up to 5% of GDP.
Even those countries that have reduced their deficits have not (with the exception of Germany) reduced them by enough actually to repay a significant portion of the additional debt that was built up during the global financial crisis. (See Chart 4.)

Second, the fact that inflation has become “stuck” at low levels in countries such as Japan means that monetary policy has not tightened, even as the real economy has recovered. Inflation expectations remain stubbornly low in response to past low rates of inflation, yet without a rise in inflation expectations, inflation itself seems unlikely to rise.

And third, the fact the global financial crisis appears to have inflicted a significant permanent hit to potential output in the global economy means that government debt has taken a one-off step-up that won’t be quickly reversed. Previous sharp rises in government debt – such as that seen in the UK during the Napoleonic Wars in the 19th century – took many decades to reverse.

Less prepared than they could have been
Some argue that policymakers should nonetheless have tightened policy more aggressively in order to rebuild their ammunition. But this tightening may well have directly brought about the next downturn. Instead, we think that policymakers could have done some other things to create more room for manoeuvre when the next downturn arrives. In failing to do so, they have arguably missed a trick.

Admittedly, we can be fairly sure that they would respond more quickly and decisively to stress in the financial system than they did at the start of the global financial crisis. There would be no dithering while worrying about moral hazard. Liquidity would quickly be provided to financial institutions and regulatory counter-cyclical capital ratios relaxed.
However, policymakers have done little to develop their strategy for responding to a downturn in the real economy. For a start, the inflation-targeting frameworks that contributed to the global financial crisis have been left intact. There have been plenty of ideas for changes that would have made it easier to respond to future crises now that the zero bound on nominal interest rates is likely to be reached more often. Most obvious is raising the inflation target, to create more scope for nominal and real interest rates to be cut. But there are other more radical ideas – such as replacing cash with electronic money to make it easier to impose negative interest rates. However, central banks’ inflation targets and policy frameworks have been left unchanged.

Meanwhile, nothing has been done to formalise the use of unconventional monetary policy tools, such as QE. It is understandable that central banks essentially made things up as they went along after the financial crisis, when they unexpectedly exhausted conventional policy tools and were testing other tools to see what worked and what did not. But it is now widely understood that one consequence of the drop in neutral interest rates is that unconventional monetary policy will have to be used more often in the future. Yet central banks have done nothing to set up more formally what their steps would be if they exhausted conventional tools again.

Governments could also have prepared for the next downturn by planning projects that could be rolled out rapidly to increase the effectiveness of fiscal policy. One of the arguments against a big boost to government investment in the last downturn was that the time-lags involved in major infrastructure spending meant that it would not boost the economy quickly enough. That could be avoided next time by preparing shovel-ready projects. Governments could also have increased the built-in automatic stabilisers (such as unemployment benefit) which mechanically boost spending and cut taxes in a downturn. This would mean that fiscal support in a downturn would be less dependent on discretionary fiscal stimulus.

And finally, not much has been done to strengthen the architecture and institutions of the euro-zone ahead of another downturn. For example, there has still been little progress towards establishing a fiscal union that would help the region to withstand asymmetric shocks by providing fiscal relief to the worst hit member states. In particular, there are still no common euro-zone bonds. Progress on completing the banking union has been slow too.

Central banks not out of options though

On the bright side, none of this means that policymakers are now powerless in the face of a slowing global economy. There are still many options open to them. Although these are generally second-best to using conventional policy, it is wrong to say that policymakers are totally out of options.

As far as monetary policy goes, interest rates could be taken (further) into negative territory. Even those countries that have experimented with negative interest rates have done so timidly, including Japan (-0.1%), the euro-zone (-0.4%), Sweden (-0.5%), Denmark (-0.6%) and Switzerland (-0.7%). Admittedly, there is a limit to how low interest rates could go; we previously suggested that they could drop to around -2% before they outweighed the costs of storing cash physically. (See Global Economics Focus, “Are negative interest rates effective?”, 23rd October 2015.) But even if the limit were -2%, that would still give the US Fed the scope it would need to cut nominal interest rates by the total of 400bps needed on average during a recession.

Meanwhile, QE could be expanded. There is little room for government bond yields to fall further in Japan and the euro-zone, but there is scope to push them down in North America and the UK. (See Chart 5.) Of course, yields might fall anyway in a downturn. But more QE could still work in other ways – for example, by raising inflation expectations.

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Source: Thomson Reuters

Admittedly, Japan already holds almost 50% of government debt, while the ECB is not a million miles away in some countries from its self-imposed
limit of 33% of outstanding debt. But just because programmes are already large does not mean they cannot be made even larger, with the ECB increasing its limit. (See European Economics Focus, “How will the ECB respond to a recession?”, 11th February.)

Indeed, central banks are a long way off buying the entire stock of government bonds. (See Chart 6.)

Even if they did get close to that point, there are plenty of other assets that they could buy – for example, the stock of global equities is larger than that of government bonds. (See Chart 7.)

Other options for central banks include extending forward guidance and setting limits on government bond yields. Monetary policy frameworks could be changed to a price level or nominal GDP target to try to boost inflation expectations, although it might be hard for central banks in these circumstances to credibly commit to high inflation.

Japan’s failure to lift inflation much above zero suggests that even the bold use of unconventional policy tools might not work. However, we explain in Box 1 why Japan’s example is not as dispiriting as it might seem. There are a number of lessons that other countries could take from Japan’s experience to help them to avoid ending up in its position.

**Box 1: Lessons from Japan**

The first lesson that other developed economies should take from Japan’s experience is the need to act quickly. Once very low inflation takes root, it is very hard to shift. And the slower policymakers are to act, the more likely it is that external shocks will come along to make things harder (the 1997/98 Asian crisis in Japan’s case, as well as the global financial crisis). It took Japan five years to cut the policy rate from 6% in 1990 to 0.5% in 1995.

The second is not to let worries about high levels of government debt scupper things. In 1997, just as inflation was finally picking up noticeably, the Japanese government lifted the sales tax to try to reduce government debt. (See the first circled period in Chart 8.) This tightening of fiscal policy contributed to the subsequent recession. And the more recent tightening in fiscal policy is one reason why QQE has not been that successful since its launch in 2014. (See the second circled period.)

The final lesson is not to let unease about unconventional policy get in the way of giving it a go. No-one could deny that Japan has been bold; it first started QE way back in 2000, its balance sheet expansion exceeds that of other countries and it has tried many new things. But it hasn’t cut interest rates far below zero due to (unjustified) concerns about the effects on bank profits. And fear of losing control of inflation stands in the way of a QE-financed fiscal boost.

That said, as we discuss elsewhere in this Focus, there is no guarantee that other countries would avoid these pitfalls either. For example, the concerns that have stopped Japan from going further on unconventional policy could be shared by other countries too.
Admittedly, Japan itself is much nearer the end of the road in terms of monetary policy options. However, even if it is more constrained on monetary policy than other countries, fiscal policy could still play a role, especially if done in conjunction with monetary policy through the “nuclear” option of a helicopter drop (which we discuss a bit later).

Fiscal policy to do the heavy lifting

Indeed, we think that in most countries, it would make sense for fiscal policy to do the heavy lifting in the face of a severe downturn.

But what about the high levels of government debt? These can’t be ignored completely. We disagree with those who point to the ease with which Japan carries its high level of public debt as evidence that other countries could easily raise their debt towards Japan’s levels. Japan has been able to endure its high debt due to a unique combination of conditions, namely ample domestic savings, a strong external position and ultra-loose monetary policy. (See Japan Economics Update, “Japan’s high public debt not a reassuring example for others”, 27th Nov. 2018.) Nonetheless, financial markets have generally been tolerant of looser fiscal policy if the aim is to support an economy during a downturn, and they believe that governments will bring borrowing back under control when economies recover. Although academic research on the effects of high government debt levels on GDP growth is mixed, the received wisdom in the past that advanced economies suffer negative effects if the debt to GDP ratio climbs above 90% is now seen as too simplistic. In fact, some recent research even suggests that expansionary fiscal policies adopted when economies are weak not only stimulate GDP, but also reduce debt to GDP ratios. (See “Fiscal stimulus and fiscal sustainability”, Auerbach and Gorodnichenko, 2017). Accordingly, faced with a downturn, we think that governments would have scope to raise their deficits to support their economies if they wanted.

A fiscal loosening would be easiest for those countries which can print their own money (e.g. the US). And although euro-zone countries would be restricted by the constraints of the monetary union, whose fiscal rules place a limit on deficits, the rules could be relaxed in a downturn. And some countries – most notably Germany – have a strong enough fiscal position to mean that they could loosen policy while still meeting these rules anyway.

However, a substantial fiscal loosening would not be a viable solution for the most highly indebted euro-zone countries. Greece’s gross government debt to GDP ratio is 188% of GDP, smaller only than Japan’s. (See Chart 9.) And Italy’s debt to GDP ratio has risen from 100% of GDP in 2007 to 131% now. Imagine if another downturn pushed Italy’s debt up by a similar amount again, to 160% of GDP. It is hard to imagine financial markets tolerating this. After all, Italy’s low rate of potential GDP growth means that it is unlikely ever to reduce this debt ratio again through stronger real economic growth. And with monetary policy controlled by the ECB, Italy obviously cannot print its own money to finance the government’s finances.

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Of course, this also begs the question of whether the most indebted country, Japan, has room for a fiscal expansion. After all, Japan cannot bank on the conditions that have allowed it to support its high debt level lasting indefinitely. Nonetheless, Japan is still rather different from Italy or Greece, not least in its ability to print its own money. So although financial markets might not tolerate a sustained loosening in Japan’s fiscal policy, we think that they would show the same tolerance to a temporary one as they would to other countries.

Even those governments that could not loosen fiscal policy would not be powerless. For example, they could change spending and tax levels to try to boost the economy, while keeping the overall budget balance unchanged. Spending could be shifted to areas thought to have bigger “multiplier” effects on the economy. Or the Government could keep the tax-take unchanged and change its composition e.g.
cut taxes for low-income households, paid for by higher taxes on high income ones with a low marginal propensity to consume. If the government thought that consumers would save any tax cut, it could instead give them a time-limited voucher to spend, as Japan did in 2009.

Meanwhile, there are other things that governments could do – such as relaxing regulatory restrictions to encourage spending, increasing the spending of regulated utilities, easing employment laws, easing planning restrictions and making it easier for people to set up new businesses.

**The case for a helicopter drop would strengthen**

We also think that the next downturn will see more serious consideration given to the “nuclear” option of a so-called helicopter drop, i.e. a fiscal expansion financed by printing money.¹ Japan would seem to be a particularly good candidate for one. (See Japan Economics Focus, “What could policymakers do next if QQE doesn’t work?”, 16th April 2015.

In some ways, a helicopter drop would not be that different to what has already been happening. Under QE, central banks have been buying government bonds, pushing down bond yields and therefore facilitating fiscal loosenings by governments. What supposedly makes a helicopter drop different is that it involves a permanent expansion of the money supply. But QE has been going on for so long in some countries (most notably Japan) that it could hardly be called temporary anymore. And there is a question mark over whether a helicopter drop could ever be truly permanent anyway. After all, there are other ways for policymakers to withdraw the stimulus from the economy – for example, by issuing more government bonds than are needed to finance borrowing in order to draw money out of the private sector, or by the central bank selling sterilisation bills.

**Nonetheless, a true helicopter drop would still have some key advantages over the recent bouts of QE.**

First, it would allow governments to increase their spending without adding to government debt. This might make them more willing to loosen policy. It would also avoid the theoretical problem of “Ricardian equivalence”, whereby a fiscal loosening financed by a rise in government debt does not prompt households to spend more because they anticipate a future rise in taxes. **Second, a helicopter drop would deliver the printed money straight to people.** This would avoid QE getting caught up in the workings of the financial system, as well as allay worries about the distributional effects. **And third, to the extent that the boost to the money supply was perceived as permanent (even if it did not end up being so), it would boost inflation expectations.**

So a helicopter drop might well be successful in pulling economies out of a deep downturn. **The problem is what would happen once that had been achieved.** Once governments come to rely on money printing, they have historically found it incredibly hard to stop. Just think of all the past times that helicopter money has been used – Weimar Germany, Japan in the 1930s, and more recently Argentina, Venezuela and Zimbabwe. Indeed, governments’ inability to keep inflation in check is the whole reason why independent central banks were established in the first place. **Accordingly, there is a risk that the experiment would end in high inflation, and possibly hyperinflation.**

However, this is not an insurmountable obstacle. **One possible solution would be to ensure that the independent central bank remained in control of the policy throughout.** Lord Turner, the former head of the Financial Services Authority calls this “helicopter on a leash”. Both he and former Fed chairman Ben Bernanke have suggested creating a new regime in which the central bank would decide how much fiscal funding to permit, calculating the maximum amount of monetary base that the central bank was willing to create and leave it to the Government to decide how much actually to spend within this limit.

¹ Note that the new strand of economics called “Modern Monetary Theory” – which suggests that governments set a full employment target and get the central bank to print money to finance the deficits needed to achieve this – is a variant of a helicopter drop. (See Global Economics Update, “Modern Monetary Theory creates more problems than it solves,” 31st January 2019.) So too is “People’s QE”, which advocates giving printed money straight to the people, potentially via public investment banks. Some (such as UK Labour party leader Jeremy Corbyn) have suggested that this would be done under the government’s direction, while some economists have suggested a version of People’s QE in which the central bank would have sole charge. (See UK Economics Weekly, “Should we worry about “Corbynomics?””, 4th September 2015.)
But will policymakers have the nerve to do all this? So claims that policymakers are short of ammunition look misplaced. Some countries (namely the US, UK and Canada) have a bit more room for manoeuvre than others. (See Table 1.) But even policymakers in Japan and the euro-zone are not powerless. So the key question is not so much whether policymakers have tools, but rather whether they would have the appetite to make adequate use of them. And that is a much bigger if.

The main constraint on monetary policy would be unease about the adverse side-effects of the long-term use of unorthodox policies. Of course, this did not stop central banks from pursuing unconventional policy after the financial crisis. But they might become more nervous if a severe downturn took them even further into the untested realms of unconventional policy.

First, there would be concerns about the impact on financial stability. Extra QE could inflate asset price bubbles, causing bigger problems further ahead. Cutting interest rates significantly below zero could also cause problems. Negative rates are supposed to increase the incentive for banks to use their reserves to lend money at a higher rate. But there is also a risk that the direct negative impact on bank profitability of low net interest income reduces banks’ ability to accumulate capital via retained earnings and so not only leads to weaker lending growth as banks raise lending rates to stay profitable, but also raises viability concerns for weakly capitalised banks. Indeed, this concern has stopped Japan from taking its interest rates below their level of -0.1%.

Second, worries about its distributional impact might stand in the way of more unconventional policy stimulus. There is already discontent about the impact that the long period of low interest rates has had on savers and pensions (via lower annuity rates). This could stop policymakers from cutting interest rates further, or banks from imposing negative deposit rates or charging customers to hold accounts. Similarly, the boost that QE has given to asset prices is viewed as having disproportionately benefited the rich. Indeed, many argue that these concerns contributed to the UK’s vote to leave the EU and the election of President Trump. Note, too, that Japan’s massive fiscal stimulus of the 1930s, financed by printing money, sparked social unrest at the fact that the large conglomerates, or zaibatsu, were the biggest winners from stimulus.

Third, central banks might be worried about the impact that a further period of very low interest rates would have on their economies’ productive potential. In particular, it might further sustain so-called “zombie” firms (poorly-performing companies which, without the benefit of low interest rates, would have gone to the wall), denting productivity growth. Fourth, if central banks were to start buying large amounts of risky assets such as equities, they would be vulnerable to making big financial losses.

And fifth, central banks’ unease with the blurring of the line between monetary and fiscal policy might stop them taking more radical steps. QE has already blurred the boundary between the two, but a helicopter drop would muddy the distinction even more. And while a helicopter drop, or variant, could work if implemented sensibly, the risk that governments would continue with it in the good times could stop it from being used in the first place.

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Green = Not tried at all yet. Amber = Tried and could do more. Red = Tried, but now at the limit.
Japan and the euro-zone have the most limited policy options and are best suited to trying a central bank financed fiscal expansion in a severe downturn. Yet both countries’ historical experiences are likely to stand in the way. Germany’s money printing in the 1920s caused the Weimar Republic’s hyperinflation. Meanwhile, Japan’s debt monetisation of the 1930s did help it to escape the Great Depression and Prime Minister Takahashi sought to tighten policy once inflation returned. But he was assassinated by militarists keen to use unconstrained monetary finance to support imperial expansion and hyperinflation resulted.

We also think that governments would be reluctant to use fiscal policy as much as they should in the face of a sharp downturn. With debt levels generally high, governments are likely to be feel constrained in what they can do, either because of the perceived threat of an adverse market reaction or if they thought that pushing debt up further would be unpopular with their voters.

Remember, after all, that, even during the global financial crisis, there was a heated debate about whether fiscal policy should be loosened to support the economy or tightened to improve the fiscal situation. Although those advocating a fiscal loosening won out, the stimulus arguably should have been bolder and longer. By 2010, countries such as the UK were already implementing austerity programmes which contributed to their slow recovery from the crisis. And note that all but a handful of Republicans voted against the 2009 Recovery Act, arguing that it was wasteful spending. Meanwhile, as we pointed out in Box 1, worries about Japan’s high government debt have been behind the periodic tightenings of fiscal policy that have hampered the effectiveness of monetary policy.

Admittedly, there are some developed countries which are not constrained by their fiscal situation. Germany is the obvious example. Its gross government debt as a share of GDP fell from a peak of 81% in 2010 to 60% last year. Indeed, Germany’s “twin” budget and current account surpluses would make it the obvious place to look for a country to help the world endure a downturn. A domestic expansion would increase spending on imports and help other countries. Nor would this be purely altruistic; it would obviously be in Germany’s interests to prevent another euro-zone crisis. In practice, however, it is unlikely that Germany would use the fiscal scope it has. The change of government last year has led to a slight fiscal loosening, but the debt ratio is still forecast to fall further. We don’t see that stance changing. (See European Economics Update, “German stimulus no game changer for euro-zone”, 7th February.)

Canada is another country that could spend more – and might also be rather more willing to spend than Germany. That said, this will depend in part on the outcome of the federal elections that will take place in October; the Conservatives and Liberals are currently close in the polls and a Conservative win would make a significant loosening less likely. In any case, a Canadian fiscal loosening would have smaller implications for the rest of the world than a German one. Canada accounts for 1.4% of world GDP, compared to Germany’s 3.2%, and Canada has a current account deficit. (See Chart 10.)

Global co-operation seems unlikely
So there is a big question mark over whether policymakers would actually choose to use the tools at their disposal. What’s more, recent behaviour by world leaders suggests that there would not be much collaboration at the global level to deal with a sharp downturn.

Multilateralism is under strain, in large part down to one President Donald Trump. As well as instigating the global trade war, President Trump has announced the withdrawal of the US from a number of international bodies in recent years (from the Paris climate accord to the UN Human Rights Council) and has warned it might withdraw from many others (from NATO to the World Trade Organisation). This
does not bode well for a co-ordinated response at the global level to the next downturn.

Admittedly, the benefits of this “co-operation” can be exaggerated. For example, the G20 agreed in 2009 that all those who could afford it should borrow and spend to support the global economy. But countries would have done this out of self-interest anyway. Similarly, the promises not to throw up tariff barriers would have been made partly out of fears that such barriers would just lead to retaliatory measures. Nonetheless, there might still have been a boost to confidence from global leaders appearing to take co-ordinated action – so the current fractious state of international relations might still undermine confidence.

More worryingly, countries might resort to beggar-thy-neighbour policies. In particular, it is obviously possible that a deep US downturn could spark President Trump to renew his protectionist agenda, prompting a downward spiral of retaliatory barriers to trade. This would echo the 1930s when the 1930 Smoot-Hawley Tariff Act exacerbated the Great Depression.

In addition, there is a risk that another economic slowdown would facilitate the election of populist governments that worsen the downturn. For example, the election of euro-sceptics in Italy could renew the euro-zone crisis, while an anti-business Corbyn-led Labour party is waiting in the wings in the UK. Admittedly, such governments might be more likely to support a fiscal stimulus that would boost the economy. But if financial markets questioned the commitment of these governments to bring the government deficit back down when economies had returned to health, then any benefit could be more than offset by an adverse reaction in the bond markets. Note, too, that the election of populist governments would make financial sector bailouts less likely.

Conclusions

Overall, then, policymakers are not powerless in the face of the next downturn. Indeed, we expect their tools to prove adequate to cope with a relatively modest slowdown.

However, if there were a more severe downturn, policymakers might prove reluctant to undertake the more radical steps that would be required. Accordingly, we think that the policy response would be relatively weak, at least initially, with policymakers perhaps only taking more drastic action once the economy had weakened significantly. All of this raises the risk of the next downturn turning into a prolonged slump.
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