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IS THE UK ABOUT TO SWITCH TO FISCAL STIMULUS?

KEY POINTS

- On November 23, UK Chancellor of the Exchequer Philip Hammond will reveal the government's post-Brexit economic plans amid speculation that a major switch to fiscal policy in developed markets may be on the way.
- The UK already has a substantial shopping list of infrastructure projects that require funding, including a new planned runway at Heathrow Airport, the next phase of the UK's high-speed rail system, and a major house building program. In the U.S., President-elect Donald Trump has signaled his intention to rebuild the country's infrastructure.
- In a period of very low interest rates, there is a clear opportunity for developed world countries to borrow cheaply in order to fund major infrastructure projects.
- However, questions remain over how effectively the fiscal multiplier will work in economies where unemployment is relatively low and borrowing is already high. A sudden, aggressive increase in public borrowing would also likely result in steeper yield curves, higher inflation, and interest rate rises.

On November 23, UK Chancellor of the Exchequer Philip Hammond will provide the clearest indication so far of the Conservative Party government's post-Brexit economic plans in the annual Autumn Statement. The statement will be followed closely by the markets amid speculation that the UK government may be about to embark upon a major shift from monetary to fiscal stimulus—a move that may signal the beginning of a global refocusing of policy toward fiscal measures.

Anticipation of a revival of fiscal policy in developed markets has been building for some time. In March, European Central Bank (ECB) President Mario Draghi told journalists at a press conference that monetary policy has its limits, insisting that structural reforms will be needed to reinvigorate the eurozone's economy. Then in early August, Japanese Prime Minister Shinzo Abe's cabinet approved ¥13.5 trillion (USD $132 billion) in fiscal measures, accompanied by speculation (denied by the Bank of Japan) that the country's monetary stimulus program may be scaled back.

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In the U.S., President-elect Donald Trump has promised major cuts in both corporation tax and income tax, as well as an increase in infrastructure spending. “I’ve spent my entire life in business looking at the untapped potential in projects and people around the world. That is what I now want to do for our country,” Trump said just before he was elected president. “We’re going to rebuild our infrastructure, which will become second to none. We will put millions of our people to work as we rebuild it.”

THE END OF MONETARY STIMULUS?

Speculation about the likely post-Brexit plans of the UK government remains intense. At last month’s Conservative Party conference, Prime Minister Theresa May said that there have been undesirable side effects from the ultralow interest rates of the past few years. “People with assets have got richer,” she said. “People without them have suffered. People with mortgages have found their debts cheaper. People with savings have found themselves poorer. A change has got to come. And we are going to deliver it.”

May was distancing herself from the policies of former Chancellor of the Exchequer George Osborne. Osborne believed the Bank of England (BoE) should be responsible for generating demand through quantitative easing (QE) and interest rates and that fiscal spending should be tightly controlled to repair the damage to the economy caused by the financial crisis. In her speech, May hinted that her government may favor tighter monetary policy with less fiscal austerity.

But how far might the government go? The day after May’s speech, new Chancellor Philip Hammond provided few clues in his own speech to conference. He said he was ready to take “whatever steps are necessary to protect the economy from turbulence” and hinted that this could include tax cuts to stimulate economic activity. “Fiscal policy may have a role to play,” he said, although he stopped short of outlining the extent of any fiscal spending or detailing any specific projects it may be used for.

Hammond has, however, previously expressed his willingness to borrow “when the cost of money is cheap,” an indication that the UK government is prepared to accept an increase in the budget deficit in order to spend more on infrastructure and public services. As bond yields are at near-record lows, the timing would seem to be right for the government to embark on a major spending program.

SHOVELS AT THE READY

The UK already has a substantial shopping list of infrastructure projects that require funding. These include a planned new runway at Heathrow Airport, the new Hinkley Point C nuclear power plant, the next phase of the UK’s high-speed rail system, and the renewal of Trident, the country’s nuclear deterrent. Plans have already been announced to build tens of thousands of new homes at twice the normal speed to tackle the UK’s housing shortage. Work on the latter, the closest of the above to being a “shovels ready” type of project, could begin very quickly.

The political opportunity for the Conservative Party government is huge. Under the leadership of Jeremy Corbyn, the opposition Labor Party is beset by internal conflict and is arguably weaker than it has been in decades. Having pushed an aggressive austerity program since 2010, the Conservative Party has an opportunity to reposition itself as a pro-investment party, potentially attracting disaffected Labor Party voters and strengthening its position ahead of the 2020 general election. As a visible means of support for the economy during a likely period of instability following the Brexit vote, such “UK plc” projects could be very popular among the public.

At the same time, it is important for the UK government to retain its fiscal credibility over the next few years as it manages the process of leaving the European Union. Foreign investors compose around 25% of the gilt market, and their confidence will need to be maintained. It is unlikely, therefore, that the government will merely announce it will borrow a further £25 billion on top of the money it already owes. Instead, it is more likely to choose alternative forms of funding. One option on the table, which press reports suggest the government is seriously considering, is to raise billions of pounds by issuing new “infrastructure bonds.” Another possibility would be for the government to issue a credit note to the BoE, which would then directly create the money over time to invest

in projects as the need arises. However, directly tapping the central bank for money in this way would be an unorthodox move and is therefore less likely than a new bond issuance.

A STEP INTO THE UNKNOWN

There are few precedents for the kind of fiscal stimulus that some believe the UK government is about to embark upon. And the effectiveness of such a move in the current environment is far from certain. When Franklin D. Roosevelt announced his New Deal in the 1930s, he did so during a period of mass unemployment and no Social Security. The major infrastructure projects that followed delivered four years of economic expansion that constituted the biggest cyclical boom in U.S. history. However, in a situation such as the one the UK currently finds itself in, with unemployment at a relatively low 5%, an enormous welfare state, and an already-high debt-to-gross domestic product ratio, it is unclear whether the fiscal multiplier will work as efficiently—if misdirected, it could be very inefficient. As such, projects where there are clear benefits, such as housing and transport, are more likely to be chosen than procurement projects, which tend to be inefficient.

The potential inflationary impact of a fiscal boost to the UK economy is also unclear. One view is that monetary stimulus has so far only succeeded in holding off deflation rather than causing inflation, so it would be possible for the UK government to embark on fiscal stimulus without having much of an inflationary impact. Again, however, attempting to do this in a period of relatively low unemployment—when, moreover, not everybody wants to be a builder—is a very different proposition to doing so when unemployment is 15%–20% and people are desperate for work. A major building project in the UK would likely result in bottlenecks and would require a significant influx of foreign workers to achieve—and given the government's stated intention to introduce immigration controls, this could impact the building industry at a time when unemployment is already relatively low.

THE LONELINESS OF THE FIRST MOVER

The persistence of low/negative yields at the shorter end of the curve has led many investors—particularly large institutional investors—to allocate heavily to longer-dated bonds, where some yield can still be found. This has paid off as low inflation, low interest rates, very accommodative monetary policies, demand for safety, and falling short-term savings rates have combined to strengthen the long end of the curve. However, a sudden, aggressive increase in public borrowing would likely result in steeper yield curves, reducing the value of longer-dated bonds.

The impact of this would be unlikely to be confined to the UK. Major bond markets have typically been highly correlated, flattening and steepening at the same time, so it is reasonable to assume that a steepening in the UK yield curve could lead to the same happening in other markets—especially if other countries follow the UK and introduce fiscal stimulus packages of their own. Any measures announced by the UK government will therefore be closely monitored by the markets to determine their effectiveness. In this sense at least, it remains to be seen whether the UK experiences a "first mover's advantage" or a "first mover's disadvantage."

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