How to fund the fiscal stimulus

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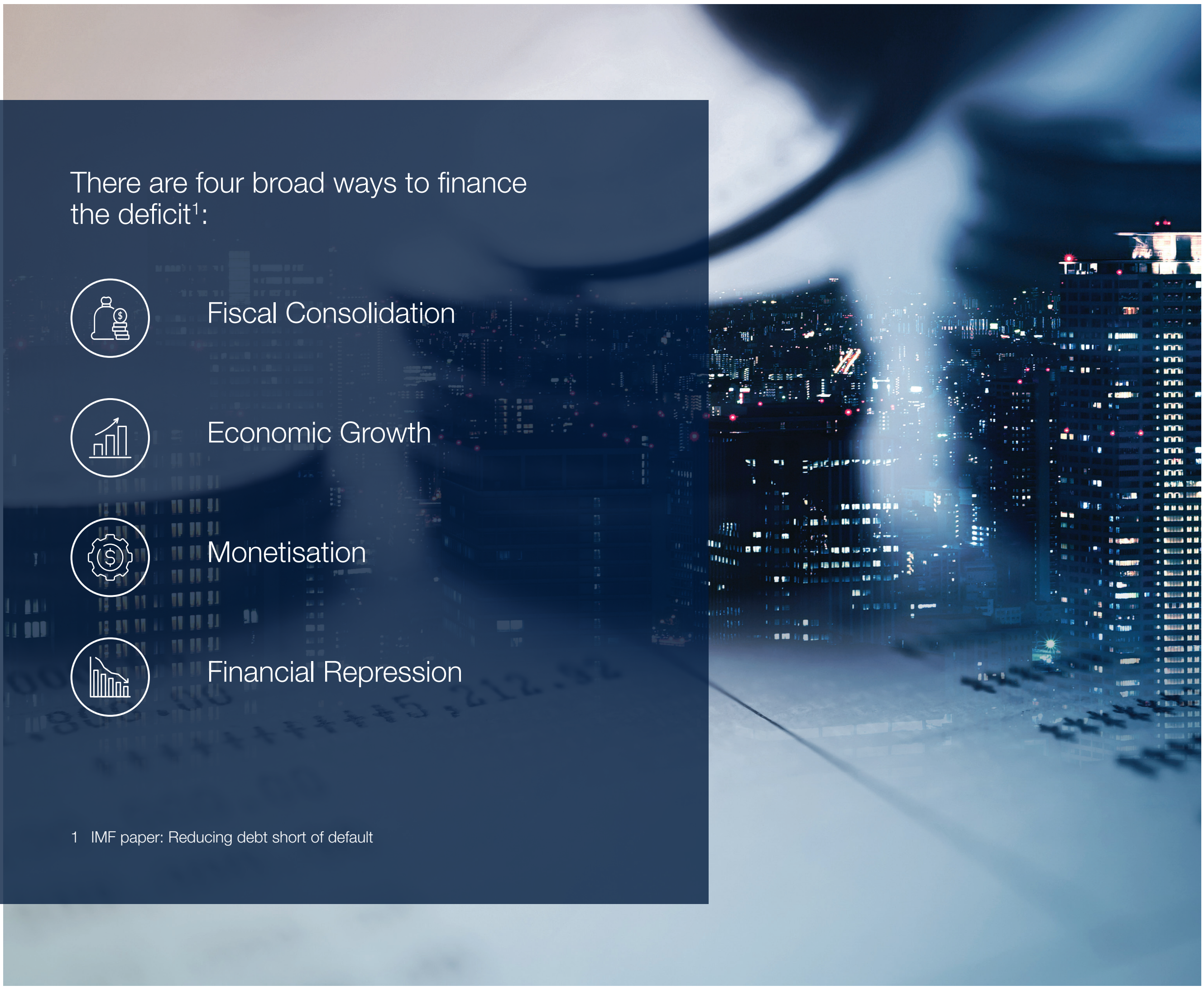
Financing the growing deficit

The record spending by governments worldwide to deal with the COVID-19 crisis has raised questions about how to finance the spending in the coming years. How the resulting government fiscal deficits are financed can impact returns on a wide variety of assets, not just government bonds.

To address this, we can split economies between those agents (households, corporates) who have a savings surplus and those with a savings deficit. The government sits in the middle and typically levies taxes to fund its expenditure. These taxes can be raised via traditional measures, including income, corporate and consumption taxes. Since the demands on government spending are many, it typically runs a deficit, financed by those with a savings surplus.



There are four broad ways to finance the deficit[1]:

- Fiscal Consolidation
- Economic Growth
- Monetisation
- Financial Repression

1 IMF paper: Reducing debt short of default

FISCAL CONSOLIDATION: AUSTERITY

Governments pursue fiscal consolidation to bring a high budget deficit back under control. This is often referred to as austerity and is achieved by either reducing the level of government spending or raising taxes. Pursuing austerity in a counter-cyclical fashion, that is reducing the deficit during times of above-trend economic growth, is generally viewed as prudent and less painful than doing it during periods of economic hardship. However, as the example of European austerity between 2013 and 2019 showed, when pursued during periods of below-trend economic growth, the impact can lower growth potential even further.

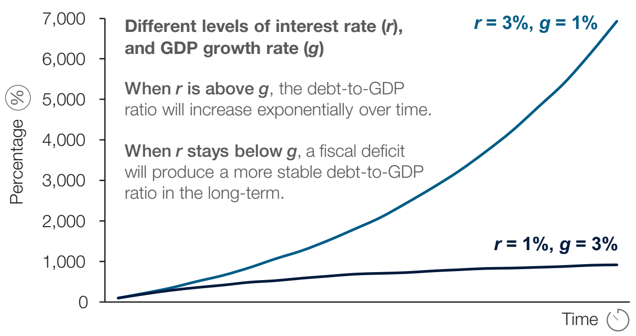
> **Austerity tends to favour households and corporates with excess savings.**

GROWTH: ECONOMIC REFORMS

Economies stuck in low growth with high levels of domestic debt can pursue economic reforms to boost growth and keep inflation in check. Reforms can reduce barriers to entry and promote competition, which lowers the costs of goods and services. As inflation expectations decline, interest rates can fall, reducing the government's interest expenses. Higher economic growth should also boost tax revenues, which can reduce the budget deficit and the debt-to-GDP ratio over time.

> **Economic reforms also tend to be favourable to households and corporates with excess savings.**

Fig. 1 Interest rates above the economic growth rate will drive an exponential increase in debt to GDP over time



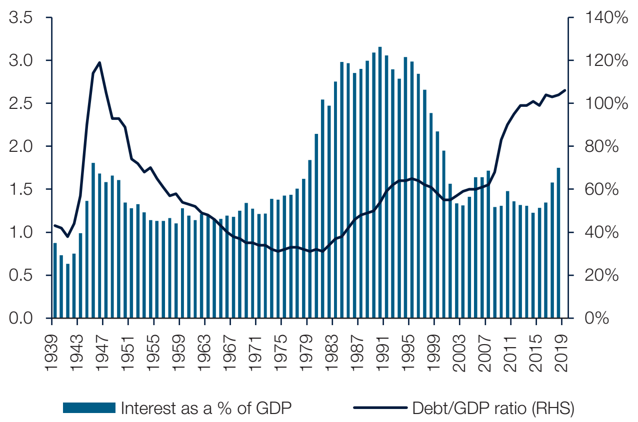
Source: BCA, Standard Chartered

FINANCIAL REPRESSION: INTEREST RATES BELOW THE ECONOMIC GROWTH RATE

Financial repression involves keeping interest rates artificially below the rate of economic growth in an economy, to try and achieve a faster pace of growth, even at the risk of higher inflation (to increase the denominator of the debt-to-GDP ratio). Households and corporates with high levels of cash see the real value of their savings decline, pushing investors to search for higher income and/or returns in riskier assets.

> **This route tends to favour household and corporate borrowers and those with exposure to financial assets.**

Fig. 2 US interest costs have declined, despite a rising debt-to-GDP ratio



Source: The Collaborative Fund, Standard Chartered

MONETISATION: MODERN MONETARY THEORY (MMT)

MMT is a form of money creation that starts from the view that the government has a unique role to create money via spending it and that a government borrowing in its own currency cannot be forced to default as it can create money.

> **MMT tends to favour household and corporate borrowers and those with exposure to financial assets.**

Fig. 3 **How to fund the stimulus – an overview**

FISCAL CONSOLIDATION

Deficit Financing Policies	Brief Description	Pros	Cons	Successful Examples	Less Successful Examples
Future fiscal austerity (greater public saving)	Pursuit of deficit reduction policies by increasing taxes or controlling government spending	This approach avoids ballooning of the public debt	Can compound economic weakness if growth is below trend	USA (1993-2001)	Euro area (2013-2018)
Future fiscal austerity (greater public saving)	A pre-emptive signal; taxes are increased to bring deficit under control	Reduced government deficit	May reduce household and corporate willingness to spend or invest	Singapore (1994) Taiwan (2018)	Japan (1997) Greece (2013)

MONETISATION

Deficit Financing Policies	Brief Description	Pros	Cons	Successful Examples	Less Successful Examples
Debt monetisation	Central banks print money to facilitate the government's ability to pay its debts	Ability to pay the bills in the short term	Inflation very likely, potentially hyper-inflation	–	Zimbabwe (2007)
Quantitative easing or controlling the cost of debt servicing	Central banks' purchases of government and corporate bonds from the markets with the goal of raising money supply, lowering bond yields and raising investments	Can offset deflationary risks. Creates buyer of last resort for bonds	Risk of future inflation and moral hazard	USA (2008)	Japan (2011)
Defaulting/ revoking the debt	Governments can unilaterally decide to default on debt owed to bond holders	Reduction in outstanding debt that may be at unsustainable levels	Can make future debt issuance more expensive	Germany (1930)	Argentina (2020 + 8 other defaults)
Debt forgiveness	Lenders can forgive loans made to a government	Reduction in outstanding debt that may be at unsustainable levels	If debt burden is unsustainable, government will need to live within its means	Africa / Jubilee debt forgiveness (2000)	Ghana (2015)
Government issued consols (perpetual bonds)	Deficits funded by perpetual bonds that have no requirement to repay the principal	No requirement to repay debt	This is a more expensive form of finance in the short term compared to traditional bonds	Austria (100 year bonds). Consols in US and UK	Argentina (100 year bonds)
Modern Monetary Theory (MMT)	Form of money creation that unburdens governments from requirement to repay the liability (cash is a government liability). Three criteria for successful MMT: 1) poor economic outlook and failure of alternative policy options 2) decline in trend growth forecasts 3) confidence in policy makers	Where an economic output gap exists, MMT could be successful	MMT could prove to be inflationary if there is a loss of confidence. Strict conditions of applicability. Untested	Only partial examples	Only partial examples

FINANCIAL REPRESSION

Deficit Financing Policies	Brief Description	Pros	Cons	Successful Examples	Less Successful Examples
Interest rates below economic growth rate	Delivering nominal economic growth above the government's funding cost ensures that the debt burden in real terms declines over time	Funding of increased debt burden is sustainable	Highly dependent on quality of government's investments. If achieved by artificially keeping interest rates below the rate of growth, it is a form of financial repression	China (post-1989)	India (post-1991)

GROWTH

Deficit Financing Policies	Brief Description	Pros	Cons	Successful Examples	Less Successful Examples
Economic reform	Reducing the obstacles to growth in an economy; higher growth leads to reduced debt-GDP ratio	Positive effect on growth in the short term and potentially long term if sustained	Potential job losses as reformed sectors restructure and substitute capital for labour	UK (1980) Germany (2000)	–

Source: Standard Chartered

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