25 January 2021

LEADING THOUGHTS

The Best Way to Get a Car Out of a Ditch

And how investors should judge the next round of government spending.

Your car is stuck at the side of the road, so you gun the engine.

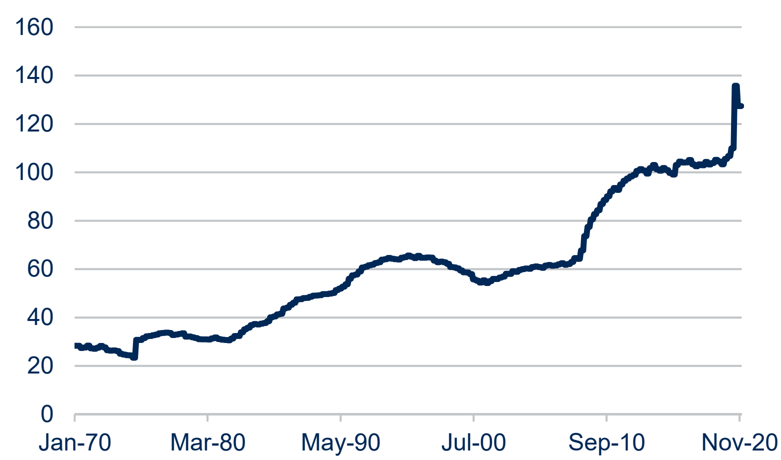
Metaphors are often as misleading as they are helpful, but imagining President Joe Biden—or any world leader—at the wheel may help visualize this moment in economic policymaking. He's got to get moving again and he knows there's no tow truck big enough to help. He also knows that stepping on the gas risks either an uncontrollable lurch that collides with speeding traffic or spinning wheels that sink the car deeper into mud.

As the new administration seeks to add another $1.9 trillion to America's debt, with more spending to follow later this year, investors raise some natural questions. Will this blast of money ultimately jolt the economy into an inflationary catastrophe? Or does it produce a generation of corporate zombies and years of sagging productivity?

The best answers coming into view are "no" on both counts. If inflation begins to rise someday, it will likely return just as slowly as it has melted away over the last several decades. Meanwhile, the new debts will take care of themselves as long as the spending keeps growth higher than interest rates.

The debt debate usually triggers a lot of muddy thinking. While America's debt stock has risen above 100% of GDP through the latest crisis and looks to be headed higher, service costs have actually fallen with interest rates. Meanwhile, default risk is virtually zero since a country that issues debt in its own currency can always print more.

FEDERAL DEBT AS A PERCENT OF GDP



Source: Bloomberg. As of January 21, 2021.

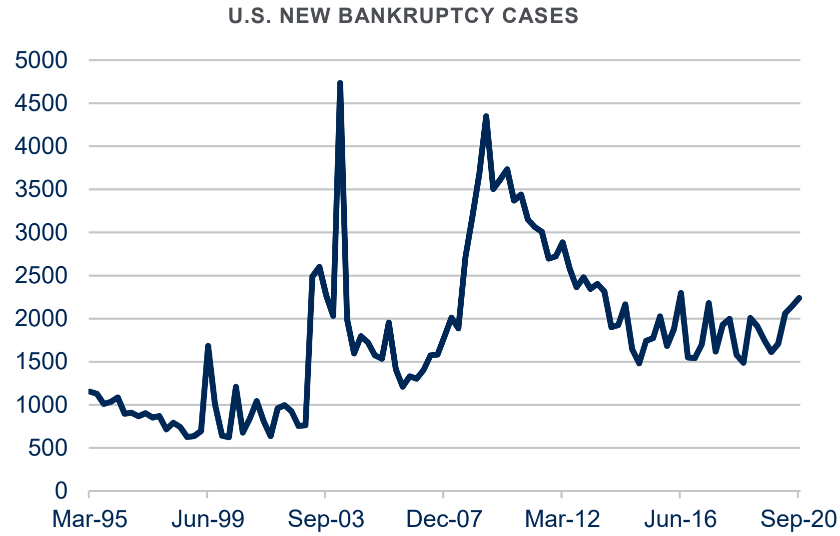
Source: Bloomberg. As of January 22, 2021.

The harder question to answer involves inflation, which has been falling even as America's deficits and debts soar. Some economists argue globalization and China's disruption of the world's labor markets helped keep wages in check; others point to an ageing population that has boosted savings, keeping rates low. Poor infrastructure and inequality may contribute as well.

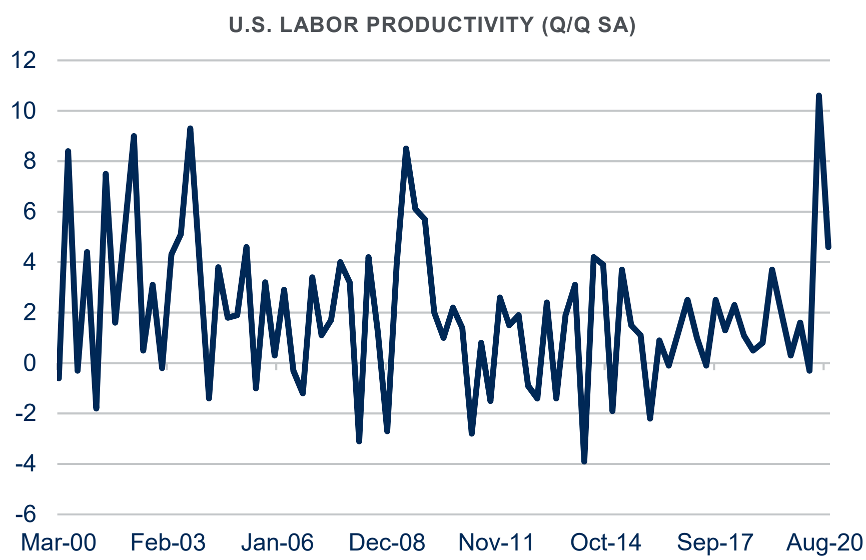
Nothing is permanent. Someday, inflation may actually return as the older population's spending starts to outpace the savings of relatively fewer younger workers, which Charles Goodhart and Manoj Pradhan argued in a provocative book last year. Indeed, new tariffs and trade wars may further throttle the benefits of globalization. But if these were the forces most responsible for driving costs down over decades, it's hard to imagine a sudden or unexpected reversal, especially as relentless technological innovation continues to drive down production costs.

"Most important about the ramp up in government spending will be ensuring a focus on projects that boost the economy's long-term growth potential, especially in infrastructure and education."

If an inflationary lurch looks unlikely, what about the spinning wheels and the mud? Sending out overly generous checks may discourage some from going back to work, but the rising legions of the long-term unemployed signal a greater concern. The longer someone is jobless, the harder it is to find a new job. More difficult to answer is the impact of cheap money on business productivity and the firms that remain afloat solely because their interest payments are so low. But these theoretical concerns do not seem to match the data so far as bankruptcies in the age of cheap money have not fallen and productivity is actually starting to edge up.



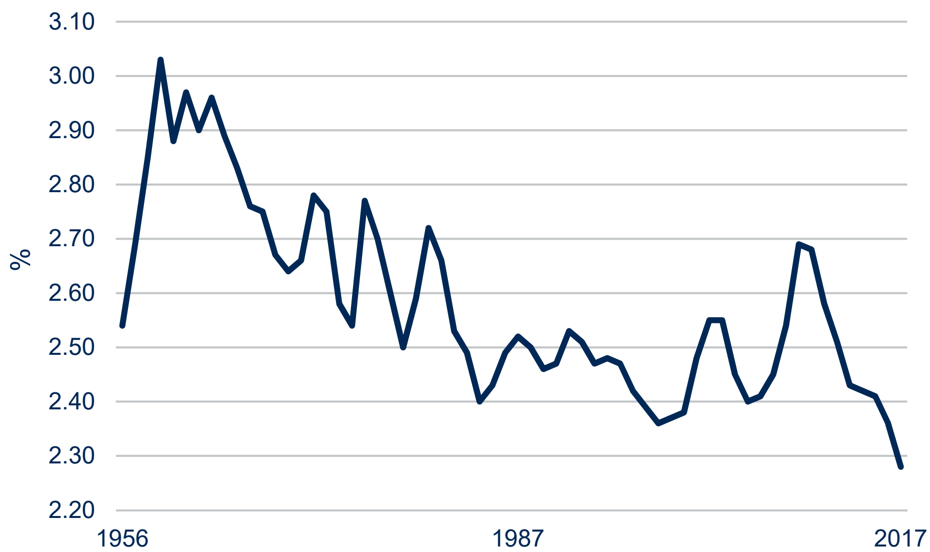
Source: Bloomberg. As of January 21, 2021.



Source: Bloomberg. As of January 21, 2021.

Most important about the ramp up in government spending will be ensuring a focus on projects that boost the economy's long-term growth potential, especially in infrastructure and education. Of course, the spending needs to be accompanied by difficult policy choices that streamline the project approval process and tackle the complex social issues that shape teaching and learning. Climate policy will need to strike a balance between the costs and the economic opportunities. Immigration reform is about as controversial a topic in America today, but sustainable growth requires an expanding labor force.

PUBLIC SPENDING ON INFRASTRUCTURE AS A SHARE OF GDP (PERCENT)



Source: Congressional Budget Office, using data from the Office of Management and Budget, the Census Bureau, and the Bureau of Economic Analysis. As of December 31, 2017.

Ensuring the money is spent well and debts remain sustainable is at the heart of a fresh paper by former Treasury Secretary Robert Rubin, former Budget Director Peter Orszag and Nobel Laureate Joseph Stiglitz. Instead of relying on arbitrary debt or deficit targets, this unlikely trio suggests extending debt maturities to reduce vulnerability to an eventual rise in rates. They also argue for more robust "automatic stabilizers" to boost spending, for example, on infrastructure in a downturn when it's needed most, and adjust through the recovery.

There are no easy or automatic solutions to the problems facing the Biden administration as it charts the next four years of recovery, and the economic debates on what makes good policy are shifting almost as fast as the realignment in political debates. What is clear, however, is that the car can't stay in the ditch and there's no tow on the way.

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**As of September 30, 2020*
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