| FTSE 100 ▲ | FTSE 250 ▲ | GBP/USD ▲ |
|---|---|---|
| 7627.99 **+0.14%** | 21775.24 **+0.27%** | $1.3013 **+0.17%** |
| (HTTPS://WWW.TELEGRAPH.CO.UK/MARKETS-HUB/INDEX/X1) | (HTTPS://WWW.TELEGRAPH.CO.UK/MARKETS-HUB/INDEX/X12) | (HTTPS://WWW.TELEGRAPH.CO.UK/MARKETS-HUB/CURRENCY/Y15) |
| **GBP/EUR ▲** | **BRENT OIL ▲** | **BITCOIN ▲** |
| €1.1696 **+0.25%** | $64.70 **+0.72%** | $8608.69 **+6.12%** |
| (HTTPS://WWW.TELEGRAPH.CO.UK/MARKETS-HUB/CURRENCY/Y9) | (HTTPS://WWW.TELEGRAPH.CO.UK/MARKETS-HUB/COMMODITY/C7) | (HTTPS://WWW.TELEGRAPH.CO.UK/MARKETS-HUB/CURRENCY/Y31) |



◆ Premium



# The monetary king is dead. Long live the fiscal king

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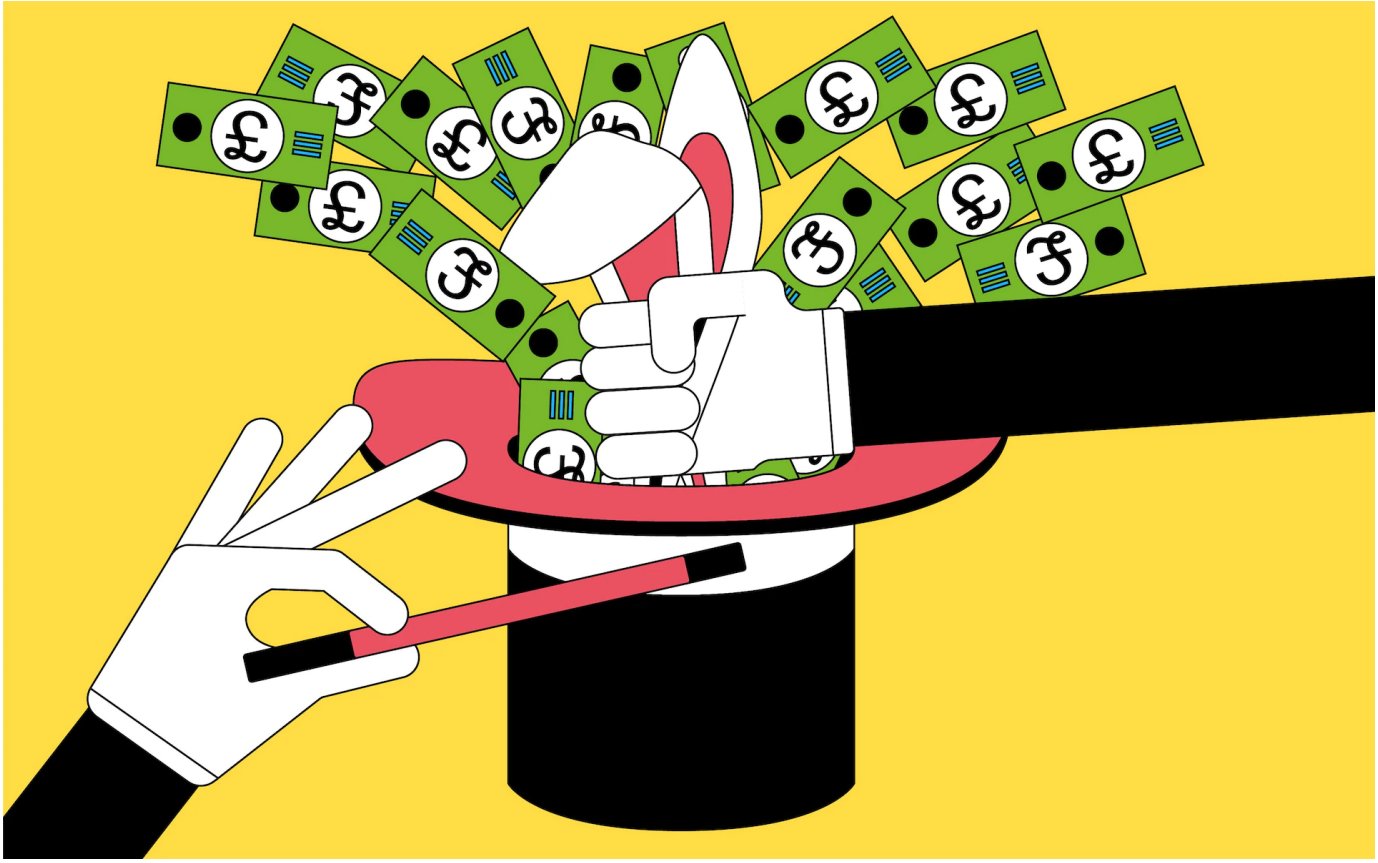
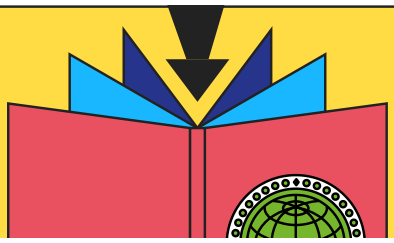


Theoretically, central banks never run out of ammunition CREDIT: THE TELEGRAPH

# The Investors' Handbook 2020



***In this series, as Davos looms, the Telegraph examines the big topics keeping investors awake at night in 2020. Here, Ambrose Evans-Pritchard expounds the era of extreme fiscal stimulus set to dominate the next chapter of our slow-growth world.***

The policy classes of the rich democracies know that central banks in their current form are near exhaustion, but they retain a touching faith in fiscal stimulus. The new orthodoxy is that spending à l'outrance can step into the breach without insidious consequences.

What is more enticing than the notion that highly-indebted G7 states can defeat secular stagnation – or the "long-dragging conditions of semi-slump", as Keynes described the 1930s (https://www.telegraph.co.uk/business/2016/08/04/we-are-all-keynesians-now-so-lets-get-fiscal/) – by borrowing unlimited sums in perpetuity at near-zero cost? The only proviso being that the money is spent wisely on investment, with a rate of return higher than the rate of interest. This writer has made exactly such arguments in the past.

Pessimists shake their heads. The new post-austerity doctrine – sweeping Britain's born-again Tories, America's Republicans, and even the arch-disciplinarians of the International Monetary Fund itself – skips over hidden dangers. The stoics warn that our world may be moving from one policy trap into another, this time threatening to asphyxiate liberal democracy itself. What if there is no Deus Ex Machina forever poised to save us?

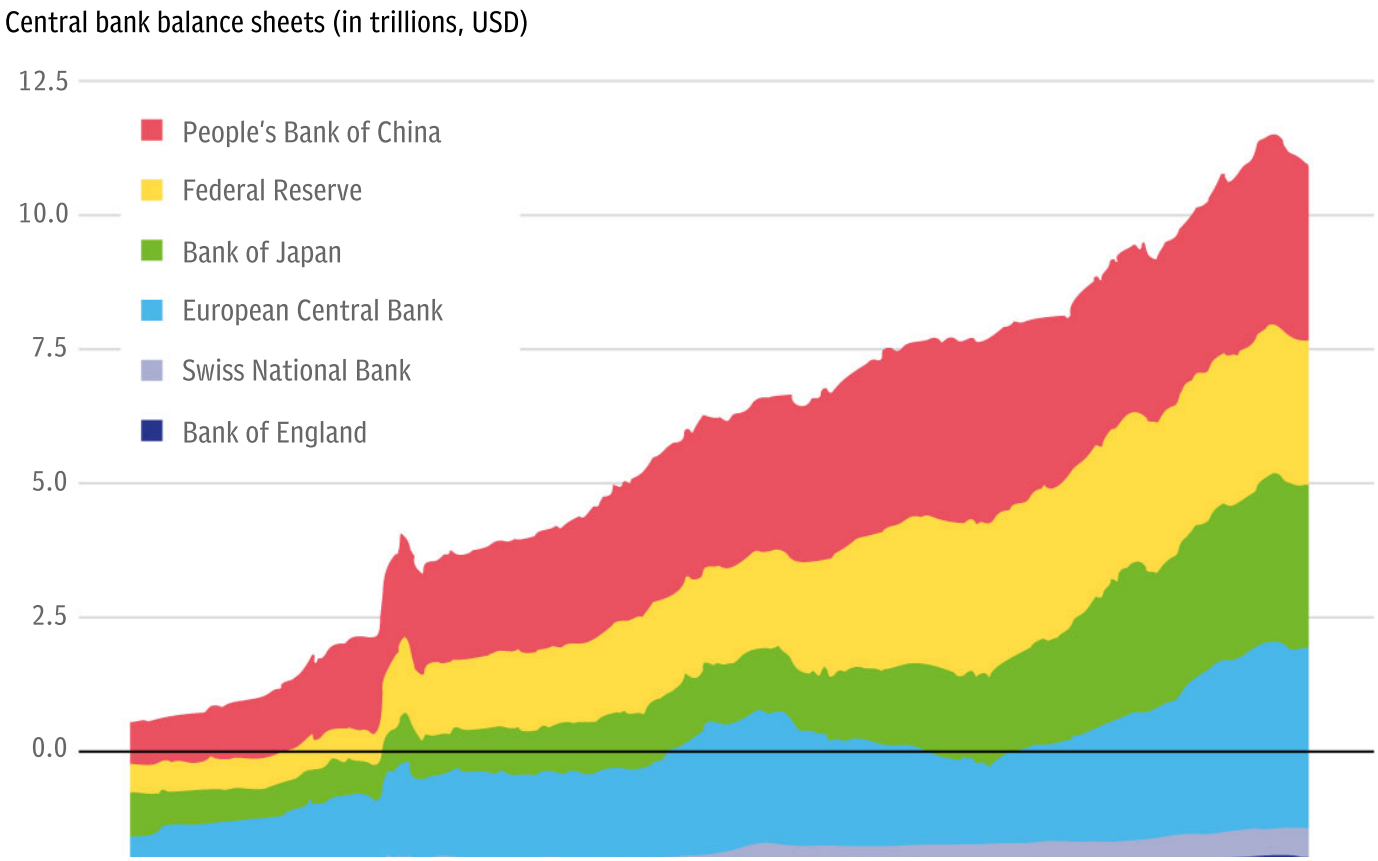
Keynesians, Monetarists, hard-money "Austrians", and intertemporal Wicksellians – least known, but most unsettling – disagree vehemently about the causes of the Great Recession and the low-growth malaise that has followed. They disagree just as vehemently about the solution.

"There are many suspects but, as in Agatha Christie's *And Then There Were None*, who committed the crime is unclear," says Olivier Blanchard, the IMF's former chief economist and High Priest of the fiscal congregation.

His prize lecture to the American Economic Association last year electrified the fraternity with a now famous one-liner: "put bluntly, public debt may have no fiscal cost".

There must be good reasons to do borrowing. Spending must be targeted. But yes, governments should not be "paralysed" by a misplaced phobia of debt.

## Central banks are nearly maxed out




We are going to hear a lot more of the counter-arguments in 2020. One lascerating indictment is coming in a book by currency theorist Bernard Connolly, shy guru of the London and New York hedge funds: *You Always Hurt the One You Love: Central Banks, Academic Economists, and the Murder of Capitalism*.

Connolly says the global economy is not in 1930s "Keynesian conditions" where fiscal stimulus becomes imperative. It is in a "Japanised" realm of full-employment, near deflation, and low growth all at the same time, a state of affairs that confounds today's canonical model – known as the New Neoclassical Synthesis.

The last thing the developed world needs now is a disinterment of Franklin Roosevelt's New Deal, virtuously clothed in green, that perpetuates imbalances by other means. "Governments will take a bigger and bigger share of output," says Connolly. "They will become the owners of the national capital stock and you will end up with socialist societies."

Theoretically, central banks never run out of ammunition. Danny Blanchflower, a Bank of England rate-setter during the Lehman crisis, says jaws dropped when staff first briefed the Monetary Policy Committee that they could in principle buy "absolutely anything" under quantitative easing.

"The Treasury could issue a £100bn infrastructure bond on Friday, and the Bank of England could buy it on Monday," he says. "What happens if a car company goes bust in the next crisis? Could the Bank just buy it? Could it buy a steel works?

"Yes it could, but should it? Bank officials are not accountable. At least those in charge of fiscal policy are elected."

## Long-term government bond yields for Germany


This is the warning of *Unelected Power: The Quest For Legitimacy in Central Banking*, a cri de coeur by Sir Paul Tucker, the Bank's ex-chief of financial stability. The money-

men are acting as "overmighty citizens" on the boundaries of legitimacy.

They have acquired "quasi-fiscal powers". They "legislate" by regulatory fiat. They pick winners and losers on a grand scale. They have become the "third great pillar of unelected power" alongside the judiciary, without judicial restraint.

Yet ultimately central banks are constrained by legal mandates and the Zeitgeist, and this may seriously tie the hands of the US Federal Reserve in the next slump. "The Fed is really limited in what it can buy," says Blanchflower.

It is prohibited from purchasing any asset other than US Treasuries or guaranteed mortgage bonds. It already brushed its 70pc limit on any one issue in the last crisis. At the same time the Fed has just five interest rate cuts left to play with. It required 20 cuts just for starters last time.

"I am seriously worried about the Fed's policy space if the next recession is deep and nasty," says David Wilcox, the Fed's chief economist until mid-2018 and now at the Peterson Institute. "The Fed could do a whole boatload of [quantitative easing] and might just scoot by with enough counter-cyclical punch if it is an average recession, but it would be in deep trouble if it is any worse, like artillery that has spent its shells before the job is done.

"The European Central Bank is clearly in much worse shape, and so is the Bank of Japan." That is small comfort.

The ECB may already have hit the "reversal rate" at minus 0.5pc where intended stimulus does more harm than good, eroding the net interest margin of banks and causing households to save even more.



The Fed won't go below zero for fear of damage to the US money market industry but that creates a different problem: it cannot so easily pull down the long end of the yield curve to rescue the debt markets in a crisis.

The US Dodd-Frank Act passed by a puritanical Congress after the last crash restricts what Fed can do in extremis. It may no longer rescue a single bank (there must be at least five). Nor may it issue blanket guarantees of bank debt and money market funds, or again conjure up $1.5 trillion of instant loans to prevent the collapse of the

commercial paper and asset-backed securities market. Woe betide us if such restraint is ever tested.

Fiscal policy will have to step into the breach across the developed world when trouble hits but first we may all have to look into the abyss. “Discretionary fiscal policy is likely to come too late,” says Blanchard. “Obsolete fiscal rules may stand in the way (ie, the EU’s Stability Pack and debt brakes).”

Albert Edwards from Société Générale says the coming deflationary bust will be so frightening that central banks will in the end be forced to do helicopter money – creating money for direct spending.

“The response will politely be called ‘fiscal and monetary cooperation’ or ‘QE for the people’ and in a way it is better than just spraying money at asset markets,” he says. “But once politicians get hold of this tool, they will never give it up.”

Neo-Keynesian spending through sclerotic channels will dominate the next chapter of our slow-growth world

Edwards noted acidly that Takahashi Korekiyo – Japan’s Mr QE in the 1930s – was assassinated when he tried to turn off the spigot. “Populism will take off to another level and we’ll look back and think of Corbyn and Trump as moderates,” says Edwards. “We’ll get off-the-wall MMT (Modern Monetary Theory) and they’ll monetise away the deficits,” he says.

For Wicksellian economists, a switch to extreme fiscal stimulus is to double down on the errors of the last quarter century. The implicit critique of the Bank for International Settlements is that central banks have been stealing prosperity from the future by letting asset bubbles run while always intervening to prevent a bust.

This has blocked the Schumpeterian process of creative destruction and kept "zombie companies" alive. Hence dire productivity growth. (https://www.telegraph.co.uk/business/2020/01/08/pay-rises-threat-decade-long-productivity-slump-shows-no-sign/)

It has also caused the "natural" rate of interest to drop further with each cycle, until it cannot go lower. This ends in a debt trap when central banks no longer dare to deflate the bubble. The nervy instant return to QE in September shows that this trap has already closed.

**Latest columns | Ambrose Evans-Pritchard**

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Connolly says we are beyond the point where a monetary purge of past excesses is possible. The political trauma of a "Hayekian liquidation" would be unbearable. But nor does fiscal stimulus give us a get-out-of-jail-free card.

"The only way the world can escape this is a bonfire of the diktats: get rid of barriers, reduce market rigging, and end crony capitalism with a more aggressive competition policy," says Connolly. "You have to increase the rate of return on investment. It is not FDR's New Deal we need but Teddy Roosevelt's Square Deal." Bring back the 'trust busters' of the pre-World War One era.

"The argument that governments should invest now because rates are so low is false," says Connolly. "The test is not whether the return is higher than the cost but whether it is higher than the 'household time-preference'. If it is below, you are going to put consumption on a downward trajectory and pre-programme the next recession."

This is the iron logic of the Euler Equation. You cannot fool time forever. "Euler can be turned off if you don't care about asset bubbles, and if you mislead people by making them feel richer than they are," says Connolly, one of the rare economists who foresaw the full drama of 2008, when he was AIG's global strategist.

"That is what we have had over the last three years. It's a continuation of the Ponzi scheme and it will collapse when people get scared. You'll have a Minsky Moment."

Yet Wicksellians are a lonely voice. Teddy Roosevelt's war on cartels, vested interest, and rentier capitalism is scarcely in sight. Free trade and free markets are receding.

Neo-Keynesian spending through sclerotic channels will dominate the next chapter of our slow-growth world: for good or ill.

**In part 2 of The Investors' Handbook 2020, Ambrose Evans-Pritchard takes a heterodox look at climate change, arguing that it should be seen as an economic opportunity and not an economic threat.**

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