Fiscal dominance writ large

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Fiscal dominance writ large

Fiscal policy has become less predictable, and so more impactful, relative to monetary policy - this is a regime shift, not a one off.

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NOV 16

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A key pillar of my macroeconomic framework is that there was a regime shift between 2019-2021, in which the US (and likely the global economy) exited the post-GFC liquidity trap. One derivative of that framework is my view that current policy rates are neutral - not restrictive**.**

A key trigger for the regime shift was a watershed shift in Western European and US government attitudes to deficit spending - after a decade of repeated efforts at fiscal consolidation. This week saw two more data points indicating that the current regime is one in which government spending has an outsized influence on markets - relative to both the past decade and to monetary policy.

The first was the market reaction to news reports that Chancellor Reeves is no-longer expected to raise income tax, and both gilts and sterling duly had a horrible day of it. The day before, I had been on a panel at '#RISK Europe 2025', and the moderator asked if bond markets had "too much influence" over the upcoming budget. My answer was that if you want bond markets to have less influence, then you need to borrow less, and Friday was a pretty clear demonstration of that truism.

In contrast, there was less market reaction to the announcement by President Trump that he wants to use US tariff revenues to fund $2000 cheques for "low income" households. If that were to happen, the spending (potentially 0.4-0.6% of GDP, based on 50-80mn low income households) would be meaningful - not only in a macro-economic sense, but because, as I have mentioned before, it would represent a step towards appropriating tax and spending powers away from congress.

In this report I discuss the post-GFC liquidity trap and its end in 2020. I also show that the absorption of US government spending (who benefits) has shifted since the GFC - more US government spending now ends up with households, meaning it has a bigger push on both consumption (and meme-stock trading) relative to the past.

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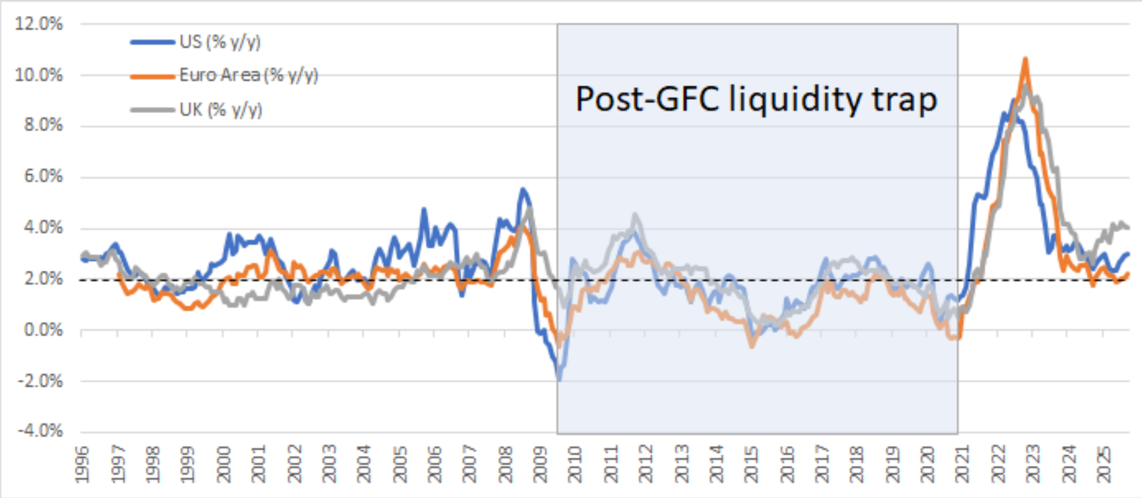
2009-2019: Life in the liquidity trap

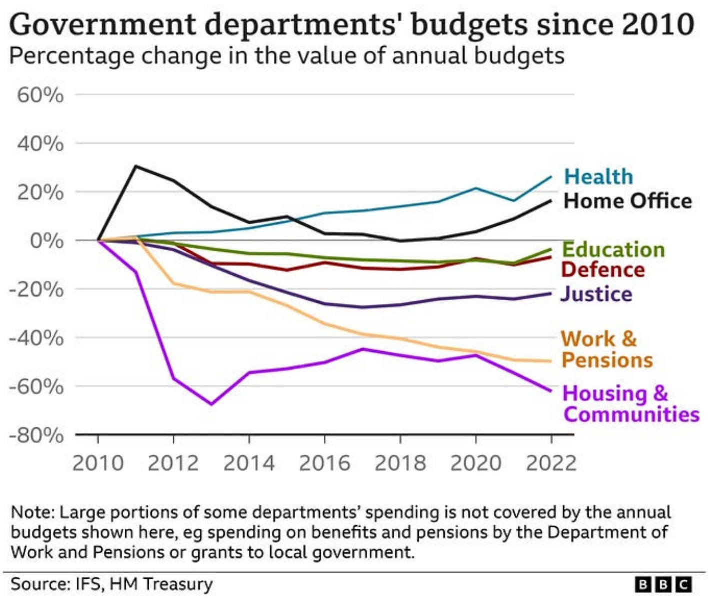
In macroeconomics, a liquidity trap is when monetary policy easing (cutting central bank rates) ceases to have measurable effects on the economy[1]. There are many similar ways of framing this such as "reaching the effective lower bound" or "pushing on a string". The key feature is that central banks see little to no pick up in either activity or inflation as they ease policy - even when they deploy non-standard policy tools, such as asset purchases (Quantitative Easing).

This, in a nutshell, was the post-GFC period of 2009-2019. Central banks kept policy rates well below previous estimates of "neutral" but faced persistent inflation undershoots or even periods of deflation.[2]



I am not economically trained[3], so I spent a lot of the 2010s learning from the NYT column of Dr Paul Krugman, who convinced me that the world was in a liquidity trap and what was required was either even-more extreme central bank easing (!) or, taking a more Keynesian approach, significant government spending. Personally, I was always more convinced of the latter.

However, throughout the post-GFC period, most governments repeatedly attempted to enforce austerity in response to the sharp rise in debt loads and the (wrong) lessons from the Euro Area crisis. Macroeconomically this was exactly the wrong policy, as the cost of borrowing was at historic lows and economies needed a demand boost.

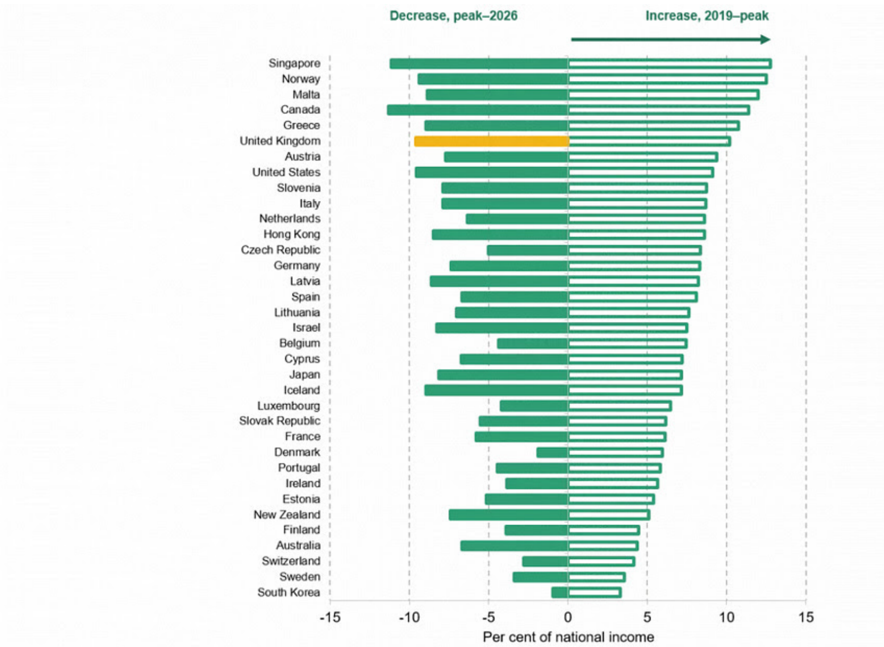


Indeed, if you are particularly masochistic you can hear me arguing that government spending was the correct policy response to negative rates in November 2019 on this podcast.

2020-2022: Massive fiscal spending works

The COVID pandemic has titanic social and economic repercussions that will reverberate for decades. One element was the shift in attitudes to fiscal spending. After a decade of failed austerity, governments lost their fear of fiscal spending and deficits exploded. Spectacularly.

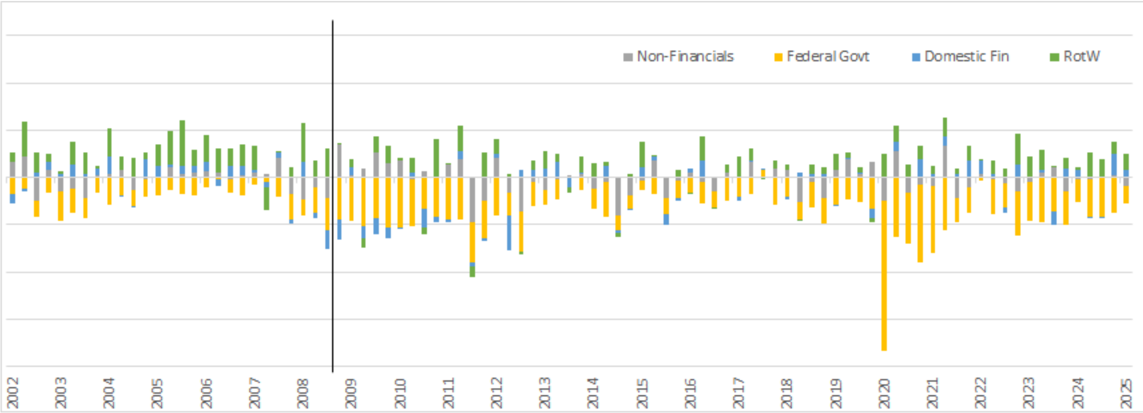
Most governments saw a trough-to-peak expansion in government spending of 7-9% of GDP. Those deficits would have previously only been seen during wars.



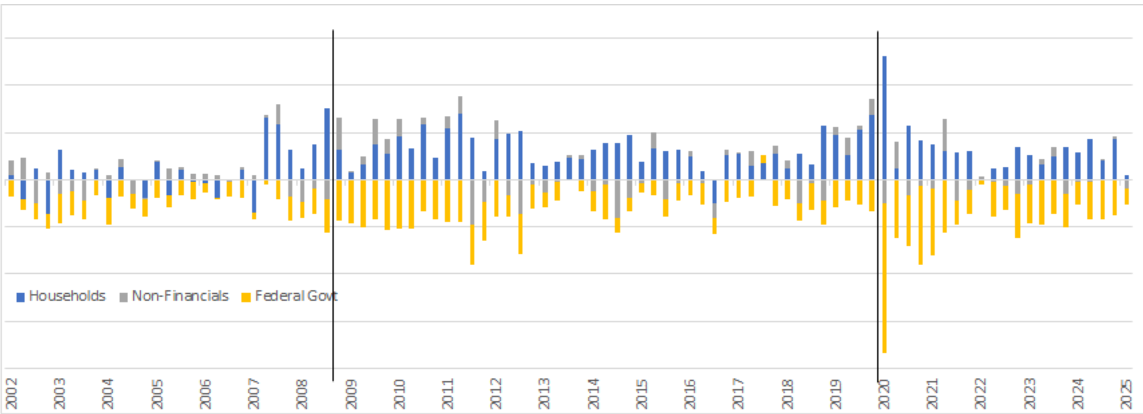
The combination of fiscal expansion with pandemic constraints on the supply side of the economy violently kicked economies out of the liquidity trap - though it took the inflationary surge in 2022 for this to be widely recognised.

But I think it is underappreciated that not only did deficits open up, as governments spent more, but that more of that money ended up with households - both directly and "indirectly". A significant complaint, both from social justice warriors but also economists, was that too much post-GFC government spending was not only wrongly sized, but also wrongly orientated - with the perception that much of it went to the financial sector for bailouts. In reality, while money did go into banks initially, most of that money ended up making its way to the household sectors indirectly[4].

The US is a particularly striking, and relevant, example here. Pre-GFC the US government tended to, like most Western European nations, run a modest budget deficit at the federal level. Further, most of this deficit was absorbed by the overseas sector - which is to say that US spending used to leak out, via the import of goods and services. Indeed, this was quite well understood by EM investors.



But post-GFC, and in particular post-COVID, this has changed dramatically. As a first-order check, it’s not hard to understand that more US government spending was being directed towards households, through tax cuts (TCJA) or stimulus cheques. But this can be misleading where trying to understand who that spending ultimately benefits. A better way is to look at sectoral balances - which sectors run a surplus to offset the federal government’s deficit[5].



Post-GFC, households absorbed a greater share of US fiscal spending. Indeed, during and shortly after COVID households absorbed the majority of US fiscal - this explains much of the unexpected strength of the US economy post 2020, and also the unexpected strength of the retail-bid for stocks and other investments. US fiscal is not only supporting consumption directly, with cheques to low-income households, but when that money is spent it is not *being* retained by businesses - it's making its way back to households - not *the same households,* but households nonetheless.

This might sound surprising given the massive earnings growth of US hyperscalers, but it is important to remember that those earnings are being more than spent via their massive capex commitments as well as shareholder returns. This is why they have started to ramp up their debt issuance.

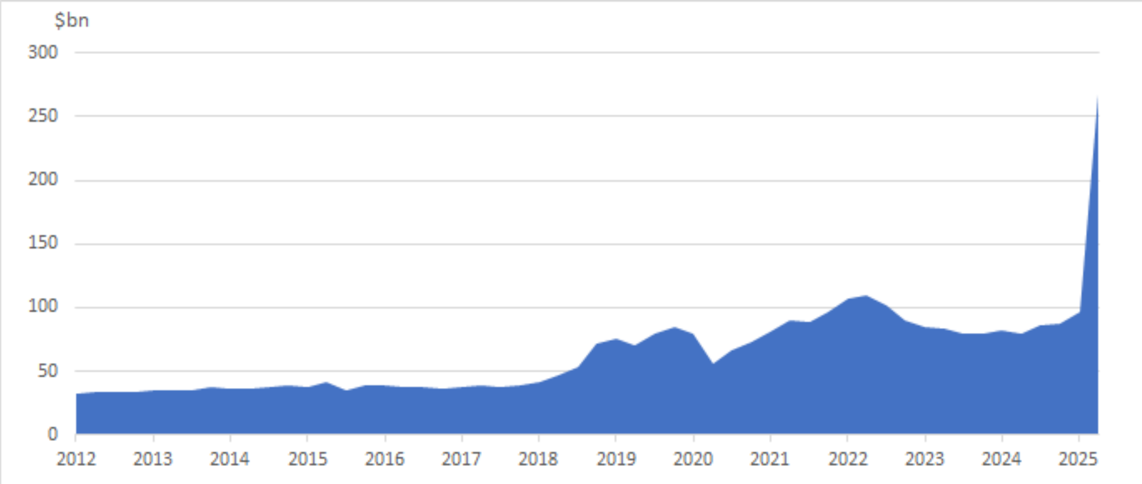
Activity fiscal policy at the White House

Pre-GFC, fiscal was largely dull. Western European economies were doing relatively well, government spending was stable with both low debt and low deficits. Monetary policy was the active part of the macroeconomic policy tool kit. And for most of 2009-2019 there were repeated attempts to return to this orthodoxy via austerity and QE: but they were unlikely to succeed because economies were in a liquidity trap.

The pandemic forced governments to spend in truly mind-blowing amounts which took us out of the liquidity trap - but we have not returned to policy orthodoxy. Instead, we have moved to a regime in which fiscal decisions dominate the discourse, while monetary policy is either paralyzed or forced to react to fiscal. This is seen explicitly in the UK with the conversation on Bank of England QT, but also in the Euro area and US with central banks pausing at higher rates, for longer, because inflation is responding more forcefully to the fiscal looseness than monetary policy "tightness" (this was dramatically the case in 2022/23).

The current White House is actively leaning into this change in macro policy. The shift of policy leverage, away from the central bank and towards the treasury, is something they are actively encouraging. And with tariffs, they have taken this one step further. Normally in the US, fiscal spending would be the domain of congress, but via tariffs the White House has given itself a direct lever on the US economy which it can use to pump-prime the economy with limited oversight.

It is in no-way a coincidence that Mr President was on Twitter announcing the potential $2000 stimulus cheque as soon as the US government shut-down ended, and there were some signs of the equity market wilting. This is, instead, the new policy “orthodoxy” in the US.



It’s the fiscal, stupid

Either by good fortune or good analysis, my forecast was correct: two years of massive fiscal spending saw economies exiting the liquidity trap - something 10 years of loose monetary policy did not achieve. This framework also served me well in 2022, guiding me towards a sharper hiking cycle, a higher terminal rate, and a longer pause at the top of the cycle - and it underpins my view that central banks will struggle to cut significantly without re-stoking inflation, particularly in the US and UK.

But the investment implications stretch further - in the US in particular. The extra-congressional spending powers that the White House are dabbling in by leveraging tariffs are, quite literally, extraordinary. In and of themselves, tariffs represented a substantial fiscal tightening - but this tightening was offset by the One Big Beautiful Bill. Vice-versa, tariff revenues were cited as offsetting the fiscal loosening in the OBBB - one reason why bond markets were relatively sanguine over the summer[6].

If Trump follows through on his commitment to spend those revenues, then that is de-facto fiscal loosening. And it will go to low-income households that have the highest propensity to consume (or possibly to gamble on meme stocks) - but even after it is spent, that money is likely to cycle back to (different) households based on sectoral flows following the COVID stimulus cheques.

As such, my starting position is that the nascent pull-back in US stocks will be short-lived and will eventually give way to some form of "Santa rally". The lack of US data makes the Fed hard to read, but another cut is not off the cards and we have already been told that there is a desire for more fiscal easing from the White House.

Further out, I expect more volatility to come from fiscal announcements, while central banks remain constrained by their belief that rates are restrictive even as inflation continues to drift slightly higher.

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1 For an overview of how monetary policy operates by setting the price of central bank reserves, see my article on explaining the inexplicable.

2 One ex colleague charmingly labelled this "missing-flation".

3 I'm actually a chemist by training.

4 The bigger issue was QE, which creates massive amounts of central bank reserves that can only go into the banking system - i.e. they cannot percolate out into the broader economy. This led to massive asset price inflation, which was much more socially distorting than government bailouts of banks which primarily rescued depositors (i.e. households).

5 As shown here and relating to Footnote 4, it is worth noting that almost none of the US government deficit ultimately ended up being absorbed by the financial system - even if bailouts were directed that way, the money eventually flowed through to other sectors.

6 Along with the technical effects of the debt ceiling, government shut-down, and over-issuance of bills by the treasury.

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