

Dollars and Sense:

A Q&A on Fiscal and Monetary Policy

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October 19, 2020

Last week we had a series of meetings with some of our longest standing clients and learned about what's keeping them up at night. As a second wave of COVID-19 infections takes hold around the world, many questioned if there's any more firing power, following the bazooka of fiscal and monetary measures that occurred during the spring. In this report, we tackle this and other pressing client questions.

Question 1: How can unemployment and consumer spending both be so high?

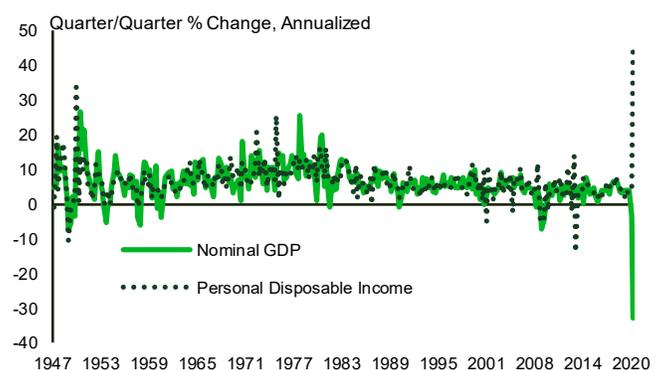
Unprecedented spending by the U.S. government to ease the pandemic burden on households was a supersized application of Keynesian Economics 101. When the economy contracts, the government fills the void. In the second quarter, a 33% annualized dive in nominal GDP and a 13% average unemployment rate, was met with a 44% jump in personal disposable income. This marked a complete departure from past experiences (Chart 1). Economic growth and income paths usually follow each other, with government automatic stabilizers only partially filling the gaps. The divergence this time came from a 75% increase in government transfer payments, equivalent to US\$2.4 trillion over the April to June period. This was the main factor allowing consumer spending to defy recession dynamics.

Question 2: Without government support, does the economy fall off a cliff?

The short answer is that the pulling back of government supports to historical norms causes spending to realign more closely to employment outcomes, with one caveat. The jolt in income over the spring allowed households to build up a larger war chest. This better starting position in savings helps initially cushion the blow, but not prevent financial strain on households over time, particularly those at the lower income distribution who are bearing the larger cost of job losses and have less savings than the rest of the population.

In July 2020, the U.S. allowed unemployment insurance top-offs and other pandemic measures to expire, while other countries not only extended, but enhanced government supports that were not measuring up. Data have revealed stronger spending and job patterns in such countries relative to the U.S. through the summer and early fall months. Our U.S. modelling demonstrates that a new fiscal package with a conservative estimate of only US\$400 billion in new spending would raise the level of GDP by 0.7% by the end of 2021. If this cycle had a typical relationship between GDP and employment, that difference would equate to approximately 600 thousand more Americans working by the end of 2021. But this is not a typical cycle. The speed of the recovery is dictated by the evolution of a virus and related government decisions to protect the population and

Chart 1: Government Support for Incomes Is Unprecedented



Source: BEA, TD Economics. Last data point Q2-2020.

health care capacity. So the near-term job multiplier is likely muted for every dollar of government spending. But there would be more bang-for-the-buck in the medium term via the protection of household finances. This would mitigate scaring and inequality, and thereby permit a faster rebound as virus risks recede.

Question 3: What's the bill adding up to?

Naturally, higher government support means higher debt. Since March, marketable debt in the U.S. has grown by over US\$3 trillion. The IMF has the Federal government's net debt-to-GDP ratio (net of cash and equivalents) reaching 107% by 2021 (Chart 2).¹ This is rare, but not the first time that debt levels have reached such high levels. In the 1940s, government spending to support the war effort caused the debt-to-GDP ratio to double from 42% to 106% over four years. Over the subsequent three decades, that ratio declined, with government spending as a share of real GDP dropping from a peak of 85% in 1944, to 26% in 1947. However, repeating this outcome is highly unlikely. The U.S., along with other countries, is likely to maintain a structurally higher debt ratio over the long run. Before the pandemic, spending as a share of GDP was already just 19%. With little fat to trim on non-discretionary spending, the options for a quick resolution are more limited.

Question 4: Who's paying for this? Me? My kids? My kids' kids?

There is a long list of options on the table for addressing high government debt. Higher taxes (on capital gains, income, sales, and wealth) are a hot topic of conversation at our virtual cocktail parties. So too are future spending cuts. Neither path would be well received by everyone.

This is where central banks can help to ease the burden. Over the last few months, we witnessed just how much support they can provide. For the U.S. government, the Federal Reserve's quick actions not only eased financial market dislocation, but it made the cost of debt cheaper. It did this through a series of programs, coupled with cutting its policy rate to the zero lower bound and using forward guidance to push market expectations to be flat on the policy rate for the next decade. The average interest rate on U.S. government debt is now just 1.68%, while the average on newly issued debt is well below 1%. By keeping rates low, the average rate the government pays on all of its debt will decline over time.

There's one important caveat here. This narrative will hold for as long as interest rates stay low. If rates rise, it would make a compelling case to reduce debt burdens actively and more aggressively. Clearly, the most desirable path before aggressive taxes or spending cuts is to try to 'grow' out of it. If GDP growth is greater than the interest rate on debt, it is reasonable that the economy can in fact reduced the debt burden over time. As the economic recovery gains time, receding support payments are filled by tax payments.

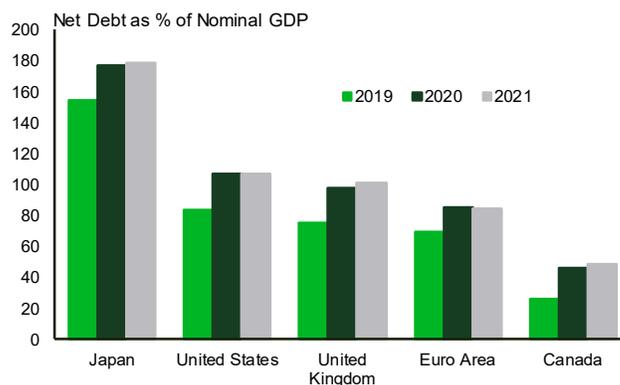
This is not expected to be the case in the U.S. The Congressional Budget Office (CBO) projects that the debt-to-GDP ratio will continue to increase over time. Once the pandemic impact is over, higher U.S. spending on social security and major health programs, combined with higher interest costs will push the debt-to-GDP level to 195% by the year 2050.² According to the CBO's figures, even if interest rates stay low, there will have to be spending and/or revenue adjustments in order to keep the debt-to-GDP ratio stable at the current pandemic level. This in part reflects the worse starting point of U.S. debt levels, highlighting the importance of fiscal responsibility ahead of crisis moments.

Question 5: What's your take on the central bank buying so much government debt?

In the near term, this is not an issue so long as there are actions undertaken to mitigate economic and financial risks, which is exactly what's occurring. Ultimately, central bank actions should remain scaled in accordance to those risks. This is why the Federal Reserve is encouraging the government to act.

In terms of the scale of what's occurring, since March, the Fed's balance sheet has grown by approximately US\$3 tril-

Chart 2: Debt Levels to Reach New Highs



Source: IMF Fiscal Monitor, TD Economics.

lion to US\$7 trillion today. The majority of the assets held are U.S. Treasuries that have increased by approximately US\$2 trillion over the last seven months. That means the Fed has funded about two-thirds of all new government issuance, causing its total holdings to be approximately 22% of all outstanding U.S. government securities (Chart 3). While this is already greater than the 20% peak of the Global Financial Crisis (GFC), it is not at levels seen among a number of peer regions.

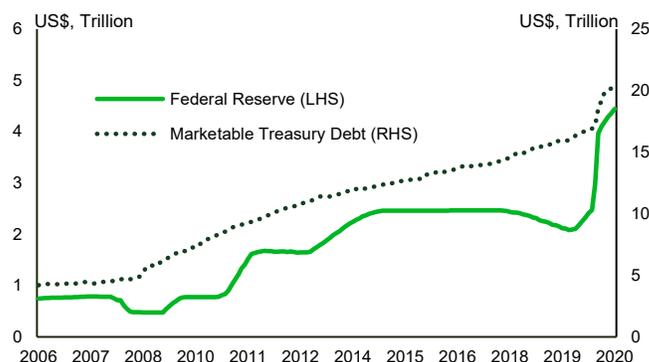
The asymmetric economic and financial risks is why the Fed is encouraging the government to spend further. Chair Powell has stated that if the government failed to reach a new stimulus deal, this would “lead to a weak recovery, creating unnecessary hardship for households and businesses”. A central bank that’s acting as a partial backstop is quite the motivation for a government, but the encouragement at this point remains in alignment to the Fed delivering on its economic mandate.

Question 6: Isn’t that MMT?

Ah, this leads nicely into a discussion of Modern Monetary Theory (MMT). This is the idea that the government can spend all it wants because the central bank is able to buy the debt. Yes, the central bank is buying government debt, but this is not yet crossing the threshold of MMT. A key component of MMT is missing – that the central bank loses independence in taking up government debt. We’d argue that the Fed and other central banks are buying debt through QE to keep interest rates low and are still intending to reduce the size of their government debt holdings once the economic recovery is established. That is very different than giving up the reins of central bank independence.

What is happening now is more aligned to debt monetization (assuming that some of the purchases are permanent). The central bank is buying the government’s debt to inject funds and support the financial system, with the goal of returning employment and inflation back to its mandate objectives. It is not the same outcomes as being a funding conduit to give the government the option to indiscriminately spend tax payer money. But, we have to acknowledge that there is undoubtedly a risk here. The fact that the central bank is stepping in can create moral hazard. Should the government spend too much, causing rising debts to result in unsustainably higher interest rates, there is a feedback loop where the central bank’s hand could be forced to step in to support government debt as a means towards financial and economic stability. That pressure would blur the lines on

Chart 3: Fed Ownership of Government Debt Continues to Rise



Source: FRB, U.S. Treasury Department, TD Economics. Last data point September 2020.

central bank independence and also the line between central bank support and MMT.

Question 7: What’s the limit on higher government debt?

A long time ago, people would use the debt-to-GDP ratio and say that if the level gets above a certain threshold, the government would need austerity to address the fiscal situation. We know now that there is no specific level. It depends on the level of interest rates, the economic trajectory, the credibility of the central bank, and the confidence from investors in the government’s ability and willingness to service and manage the debt. This is why a country like the U.S. can maintain a debt-to-GDP ratio above 100%, whereas a country such as Turkey saw investor flight when its debt ratio was less than 40%.

That said, there is a self-reinforcing mechanism for fiscal discipline – inflation. Economic history is littered with examples of governments that spent too much. From the Weimar Republic post-WWI, to Zimbabwe a little more than a decade ago, we know that uncontrolled government spending combined with unrestrained money printing leads to inflation. Those are extreme examples. What we are looking at now is a time period of low inflation due to a demand shock and an economic void that is being addressed by government spending. These efforts are intended to get the economy back to full capacity but not replace consumers and businesses as the economic growth engine. Among other factors, the central bank will be guided by inflationary pressures in pulling back monetary support. However, at this moment in time, the massive hit to aggregate demand and highly uncertain future (determined by a virus) means that the threat of economy wide inflation is very low.

Interest Rates & Foreign Exchange Rates													
	Spot Rate	2020				2021				2022			
		Oct-16	Q1	Q2	Q3	Q4F	Q1F	Q2F	Q3F	Q4F	Q1F	Q2F	Q3F
Interest Rates													
Fed Funds Target Rate	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25
3-mth T-Bill Rate	0.09	0.11	0.16	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10
2-yr Govt. Bond Yield	0.14	0.23	0.16	0.13	0.20	0.20	0.20	0.20	0.20	0.20	0.25	0.30	0.35
5-yr Govt. Bond Yield	0.32	0.37	0.29	0.28	0.30	0.40	0.50	0.60	0.75	0.90	0.95	1.05	1.15
10-yr Govt. Bond Yield	0.75	0.70	0.66	0.69	0.80	0.95	1.10	1.25	1.40	1.55	1.60	1.65	1.70
30-yr Govt. Bond Yield	1.53	1.35	1.41	1.46	1.60	1.75	1.85	1.95	2.05	2.10	2.15	2.20	2.25
10-yr-2-yr Govt Spread	0.60	0.47	0.50	0.56	0.60	0.75	0.90	1.05	1.20	1.35	1.35	1.35	1.35
Exchange rate to U.S. dollar													
Chinese Yuan	CNY per USD	6.70	7.08	7.07	6.79	6.80	6.80	6.80	6.80	6.80	6.80	6.80	6.80
Japanese yen	JPY per USD	105	108	108	106	105	105	104	104	103	103	103	102
Euro	USD per EUR	1.17	1.10	1.12	1.17	1.19	1.20	1.21	1.23	1.24	1.25	1.25	1.25
U.K. pound	USD per GBP	1.29	1.25	1.24	1.29	1.31	1.33	1.34	1.36	1.37	1.38	1.40	1.40
Swiss franc	CHF per USD	0.92	0.96	0.95	0.92	0.90	0.91	0.92	0.93	0.94	0.95	0.96	0.97
Canadian dollar	CAD per USD	1.32	1.41	1.36	1.33	1.30	1.29	1.28	1.29	1.30	1.30	1.30	1.30
Australian dollar	USD per AUD	0.71	0.61	0.69	0.72	0.73	0.74	0.74	0.73	0.72	0.73	0.73	0.73
NZ dollar	USD per NZD	0.66	0.60	0.65	0.66	0.67	0.68	0.68	0.67	0.67	0.67	0.67	0.67
Exchange rate to Euro													
U.S. dollar	USD per EUR	1.17	1.10	1.12	1.17	1.19	1.20	1.21	1.23	1.24	1.25	1.25	1.25
Japanese yen	JPY per EUR	123	118	121	124	125	126	126	127	128	129	128	128
U.K. pound	GBP per EUR	0.91	0.89	0.91	0.91	0.91	0.90	0.90	0.90	0.90	0.90	0.89	0.89
Swiss franc	CHF per EUR	1.07	1.06	1.06	1.08	1.07	1.09	1.11	1.14	1.16	1.18	1.19	1.21
Canadian dollar	CAD per EUR	1.55	1.56	1.53	1.56	1.55	1.55	1.55	1.58	1.61	1.63	1.63	1.63
Australian dollar	AUD per EUR	1.66	1.79	1.63	1.64	1.64	1.63	1.65	1.68	1.72	1.71	1.71	1.71
NZ dollar	NZD per EUR	1.77	1.85	1.74	1.77	1.77	1.77	1.78	1.82	1.86	1.87	1.87	1.87
Exchange rate to Japanese yen													
U.S. dollar	JPY per USD	105	108	108	106	105	105	104	104	103	103	103	102
Euro	JPY per EUR	123	118	121	124	125	126	126	127	128	129	128	128
U.K. pound	JPY per GBP	136	134	133	136	138	139	140	140	141	143	144	144
Swiss franc	JPY per CHF	115.2	111.7	113.8	114.9	116.7	115.0	113.3	111.6	110.2	108.9	107.6	106.2
Canadian dollar	JPY per CAD	79.9	76.1	79.2	79.2	80.8	81.0	81.3	80.2	79.4	79.2	79.0	78.8
Australian dollar	JPY per AUD	74.6	66.0	74.3	75.6	76.2	76.9	76.5	75.4	74.5	75.2	75.0	74.8
NZ dollar	JPY per NZD	69.6	64.1	69.5	69.8	70.4	71.1	70.8	69.8	68.9	69.0	68.8	68.7

F: Forecast by TD Economics, October 2020; Forecasts are end-of-period.
Source: Federal Reserve, Bloomberg.

Commodity Price Outlook															
	Price Oct-16	52-Week High	52-Week Low	2020				2021				2022			
				Q1	Q2	Q3	Q4F	Q1F	Q2F	Q3F	Q4F	Q1F	Q2F	Q3F	Q4F
Crude Oil (WTI, \$US/bbl)	41	63	-38	46	28	41	41	42	44	48	49	50	51	52	53
Natural Gas (\$US/MMBtu)	2.16	2.87	1.33	1.91	1.71	1.99	2.60	2.90	2.75	2.70	3.10	3.15	2.80	2.90	3.16
Gold (\$US/troy oz.)	1899	2064	1454	1582	1708	1909	1950	1930	1910	1890	1850	1825	1800	1775	1750
Silver (US\$/troy oz.)	24.13	29.13	11.98	16.90	16.38	24.34	25.00	24.50	24.00	23.50	23.00	22.75	22.50	22.25	22.00
Copper (cents/lb)	306	311	210	255	243	296	298	297	304	306	310	311	312	312	313
Nickel (US\$/lb)	7.00	7.65	4.94	5.76	5.53	6.45	6.81	6.87	6.87	6.92	6.92	6.95	6.99	7.02	7.06
Aluminum (Cents/lb)	84	84	66	77	68	77	78	75	75	74	74	73	73	73	73
Wheat (\$US/bu)	6.86	7.29	5.75	6.60	6.46	6.36	6.81	6.83	6.84	6.84	6.84	6.82	6.80	6.77	6.75

F: Forecast by TD Economics, October 2020; Forecasts are period averages; E: Estimate.
Source: Bloomberg, USDA (Haver).

International Interest Rates Outlook													
	Spot Rate Oct-16	2020				2021				2022			
		Q1	Q2	Q3	Q4F	Q1F	Q2F	Q3F	Q4F	Q1F	Q2F	Q3F	Q4F
Germany													
ECB Deposit Rate	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50
3-mth T-Bill Rate	-0.68	-0.71	-0.56	-0.62	-0.60	-0.60	-0.60	-0.60	-0.60	-0.60	-0.60	-0.60	-0.60
2-yr Govt. Bond Yield	-0.78	-0.70	-0.70	-0.70	-0.70	-0.65	-0.60	-0.55	-0.49	-0.46	-0.42	-0.36	-0.28
5-yr Govt. Bond Yield	-0.80	-0.66	-0.70	-0.71	-0.65	-0.60	-0.55	-0.50	-0.44	-0.41	-0.37	-0.31	-0.23
10-yr Govt. Bond Yield	-0.62	-0.47	-0.46	-0.52	-0.50	-0.45	-0.40	-0.35	-0.29	-0.26	-0.22	-0.16	-0.08
30-yr Govt. Bond Yield	-0.20	0.02	0.00	-0.10	-0.15	-0.10	-0.05	0.00	0.06	0.09	0.13	0.19	0.27
10-yr-2-yr Govt Spread	0.15	0.23	0.24	0.18	0.20	0.20	0.20	0.20	0.20	0.20	0.20	0.20	0.20
United Kingdom													
Bank Rate	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10
3-mth T-Bill Rate	0.02	0.18	0.01	0.00	0.05	0.05	0.05	0.05	0.05	0.05	0.05	0.05	0.15
2-yr Govt. Bond Yield	-0.06	0.12	-0.08	-0.03	0.05	0.15	0.20	0.25	0.30	0.40	0.50	0.60	0.75
5-yr Govt. Bond Yield	-0.08	0.21	-0.05	-0.06	0.05	0.25	0.30	0.35	0.40	0.50	0.60	0.70	0.85
10-yr Govt. Bond Yield	0.18	0.35	0.17	0.23	0.20	0.40	0.45	0.50	0.55	0.65	0.75	0.85	1.00
30-yr Govt. Bond Yield	0.73	0.82	0.64	0.78	0.75	0.95	1.00	1.05	1.10	1.15	1.20	1.25	1.35
10-yr-2-yr Govt Spread	0.24	0.23	0.25	0.26	0.15	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25

F: Forecast by TD Economics, October 2020; Forecasts are end-of-period.
Source: Bloomberg.

Global Stock Markets					
	Price Oct-16	30-Day % Chg.	YTD % Chg.	52-Week High	52-Week Low
S&P 500	3,484	2.4	7.8	3,581	2,237
S&P/TSX Composite	16,439	0.0	-3.7	17,944	11,228
DAX	12,909	-2.3	-2.6	13,789	8,442
FTSE 100	5,920	-3.0	-21.5	7,675	4,994
Nikkei	23,411	-0.2	-1.0	24,084	16,553
MSCI AC World Index*	582	1.1	3.0	594	384

*Weighted equity index including both developed and emerging markets.
Source: Bloomberg, TD Economics.

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Endnotes

- 1 <https://www.imf.org/en/Publications/FM/Issues/2020/09/30/october-2020-fiscal-monitor#Full%20Report%20and%20Executive%20Summary>
- 2 https://www.cbo.gov/publication/56598#_idTextAnchor007