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Fiscal Boost Needed to Make EU, UK and Japan Great Again

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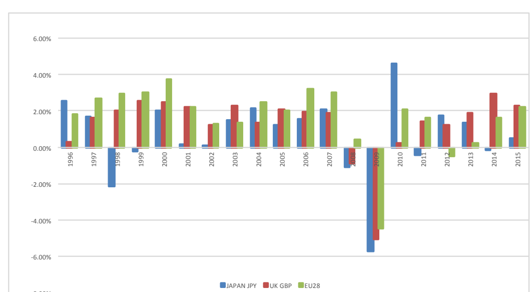
Developed economies suffer from secular stagnation

All of the economies in the developed world have been suffering from diminished economic growth, a rising tide of adverse sentiment toward international trade, and a growing willingness to accept politicians favoring nationalistic economic policies. Last month's issue of my CAMRI Global Perspectives portrayed the biggest developed economy, the US, as a similarly distressed economy because recent economic growth has been well below all historic expansion standards. The common global theme echoing among all the developed economies is that they have slipped into the curse of secular stagnation.

Economic growth in the other three developed economies has averaged 2%, or less over the past 19 years. For example, economic growth in Japan has been the most affected by secular stagnation as their economy expanded on average by just 0.5% per annum over the past two decades. Economic growth in the EU (less the UK) has been slightly faster than in Japan, 1.46%. However, in the years since the 'great recession', economic growth has been negligible: just 0.28% per annum. In the UK economic activity has been more buoyant, but less than average annual growth over their post WW2 history. Economic growth averaged 2% per annum over the past two decades, which may have contributed to their decision for exiting the EU.

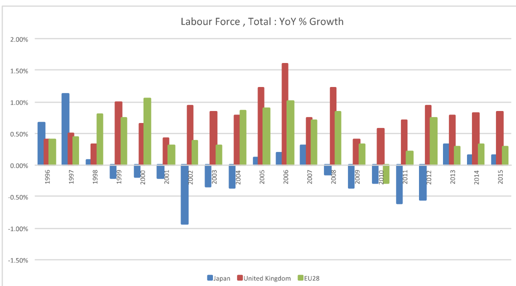
GDP growth Diminished in last decade



Labor force growth has diminished

One common theme present in all of the developed economies that are suffering from secular stagnation is the long-term slowdown in the growth of their labor forces. Theoretically, this reduction in labor force growth has been one of the major factors contributing to the stagnation thesis. Many elements have contributed to the decline in the growth of the labor force such as restrictive immigration policies, aging populations, and declining birth rates. Since long-term growth is typically construed to be a combination of labor force growth and multifactor productivity growth, secular growth in these economies will continue to diminish.

Labor force Growth diminished substantially



As observed in the above chart, labor force growth in Japan has been negative on average over the past 20 years and this accounts for a large share of the cause for Japan's minuscule growth. The European Union's labor force growth has also been a key contributor to their unsatisfactory growth rate. Labor force growth in the EU 28 has averaged just 0.5% in the past 20 years. Finally, the UK has had slightly faster labor force growth during this period, 0.8%, and thus they have experienced the fastest average growth rate among these developed economic regions.

Macro-economic policy needs a new approach

Another element that is common among the developed economies is their extensive use of aggressive, unconventional monetary policy, and an aversion to employing fiscal policy stimulus. While monetary policy remains highly stimulative in these economies: policy rates are at or near zero, and central banks have expanded their balance sheets multiple times. However, the effect from this massive stimulus has been highly disappointing. Aggressive monetary stimulus has reached diminishing returns in all of these economies. Central banks are beginning to admit that they need help and have started to end future stimulus. Consequently macro policy needs a new approach. Milton Friedman's disciples must be squirming throughout the world.

Japan has been first into stagnation

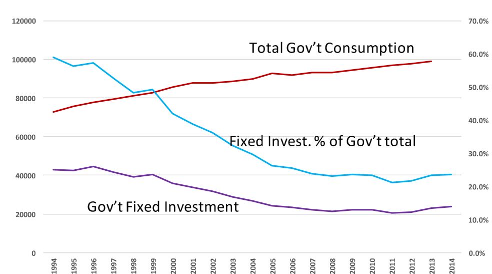
Japan entered the dark era of secular stagnation first. Their economy has grown at a minute pace for the past two and a half decades and is below the level that it was at the start of this century. Their latest government has also been the first among the developed economies to announce a multi-pronged policy prescription to revive their economic growth. However, they have not successfully adopted all the relevant parts of Mr. Abe's proposals, and have even backtracked on their strategy by raising the consumption tax in the midst of their stimulus policy.

Japan GDP Well Below Start of the Century

We are all aware of how far official interest rates have been lowered, and how many trillions of securities the Bank of Japan has purchased in their effort to jump-start the Japanese economy.

Now let's see how the Japanese authorities have abused fiscal policy. As Chart 4 reveals, fixed investment by the Japanese federal government has steadily declined. It has fallen to just 23% of total government consumption, less than half of what it was 20 years ago. Ironically, government consumption now accounts for 20.6% of GDP compared with just 14.6% in 1994. The rise in government spending has been almost exclusively used for income support and a variety of needed social services as the population has aged, and as income growth has atrophied.

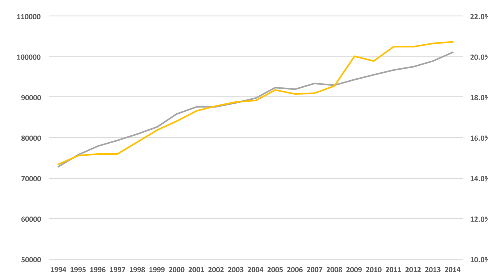
Japan: Gov't Consumption and % Investment Declined



Prime Minister Abe's latest twist in his macro policy troika has been to postpone the next leg of his proposed consumption tax increase, and to promise more government spending with some vague references to additional fixed structural investment. As seen in Chart 4, government spending has risen over the past two decades, but fixed investment, the portion of government spending that has an economic multiplier effect on the entire economy, has dwindled sharply. Certainly more fixed investment is needed to propel the Japanese economy up from the trough that it has labored in for the past two and a half decades.

The Bank of Japan recently announced that the central bank has done all it can do to raise growth and inflation, and that fiscal policy needs to step in and help. The BOJ admitted that monetary policy alone won't be enough to hit its 2 percent inflation target, now or ever. Consequently, this thrusts the impetus for directing the economy to fiscal policy and away from monetary policy.

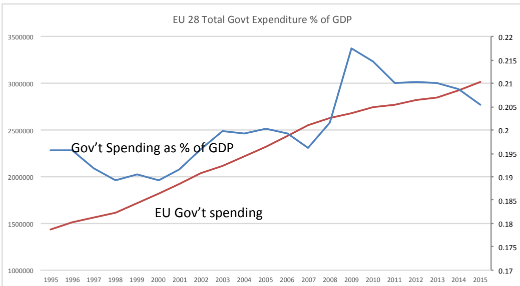
Japan: Government consumption as % of GDP



The name of the game in the EU: austerity

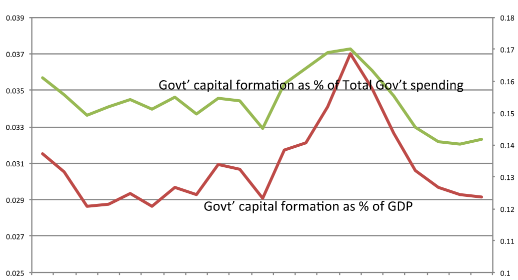
Growth in the EU stalled with the EU centric enforced restrictive policy of austerity. Government expenditures peaked in 2009 the middle of the great recession and unfortunately they have fallen steadily since, and now account for only 20% of GDP. Moreover, fixed capital formation in 2015 was less than it was in 2008. After years of imposed fiscal discipline, fixed investment throughout the EU slumped to just 3% of GDP.

EU TOTAL GOV'T EXPENDITURES AS % OF GDP
is Falling



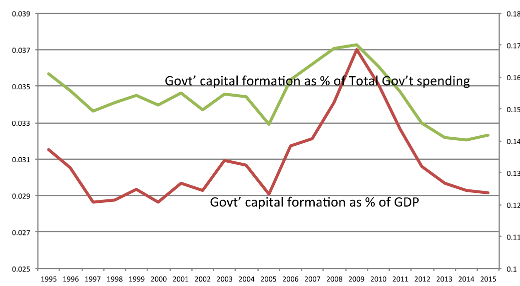
Immediately after the 'great recession' EU sovereign debt levels climbed well above GDP in most member countries. Under the austere leadership from German financial ministers the EU members agreed to mend their debt problems with extremely tight budgets. There was no room for new capital expenditure within these budget guidelines. Consequently, the EU economy stumbled under the weight of budget paralysis.

EU Gross Gov't Capital Formation
Slumped



Unlike the more forward, progressive intent of the macro authorities in Japan there is little, or no movement in the EU at present to instigate a new round of fiscal spending. Consequently, sustainable improvement in economic growth seems less likely to occur in the next few years in the EU than in the other developed economies. Fiscal austerity in the post-recession period has caused EU economic growth to decelerate to an average of just 0.3% per annum, less than half the pecuniary growth of Japan in the same period.

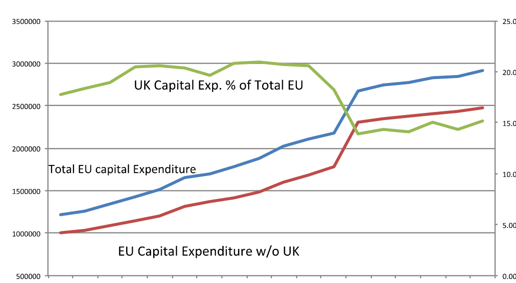
EU Gross Gov't Capital Formation
Slumped



Maybe Brexit will make a difference

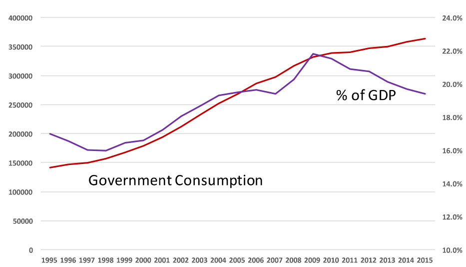
The UK, which recently sought political independence from the EU, also managed to have slightly more freedom in setting its budget than the continental members of the EU. Nevertheless, the same dreary pattern of diminished capital investment dominated the UK economy.

UK's Contribution to EU Capital Expenditure
Diminished after Recession



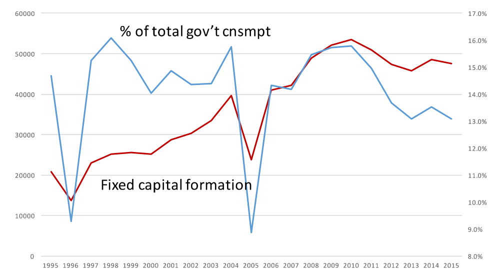
The UK government's contribution to total government spending in the EU has declined from the great recession onward. Moreover, as shown in the next chart, UK government spending has similarly declined. Whether the UK government was attempting to practice EU budget austerity, or turned more conservative in their approach to government spending, is unclear. All the same, UK government spending slowed noticeably over the past several years.

UK: Government Spending Stopped Rising with GDP since the Recession



Most notable is the reduction in fixed capital formation initiated by the UK government over the post-recession period. Whether as a percentage of UK GDP, or of overall UK government spending, real fixed capital formation has declined.

UK: Fixed Capital Formation Decreased in Post Recession Period



Conclusion: Fiscal stimulus needs to replace fiscal austerity and moribund monetary policy

The era of bold monetary policy experimentation that began with the global financial crisis is now drawing to a close. Since Japan exited from the monetary easing game, other countries will doubtless follow. More and more, economic policy makers will look to fiscal initiatives and to deeper structural reforms to boost growth and stop deflation. Monetary policy has reached its moment of diminished returns and now policy makers must shift to fiscal policy and structural reform to promote more economic growth and higher inflation.

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	KEY INDICATORS TABLE (AS OF 31 OCTOBER 2016)							
INDEX	**LEVEL (LC)**	**%1MO (LC)**	**%1MO (USD)**	**%1YR (LC)**	**%1YR (USD)**	**INDEX**	**LEVEL**	**%1YR**
S&P500	2126.15	-1.82%	-1.82%	4.50%	4.50%	3MO LIBOR	0.88	164.68
FTSE	6954.22	1.03%	-4.75%	13.79%	-9.91%	10YR UST	1.83	-14.78
NIKKEI	17425.02	5.93%	2.34%	-6.92%	7.00%	10YR BUND	0.16	-68.49
HANG SENG	22934.54	-1.41%	-1.41%	5.20%	5.13%	10YR SPG	1.20	-28.29
STI	2813.87	-1.87%	-3.86%	-2.51%	-1.86%	10YR SGS	1.89	-23.33
EUR	1.10	-2.26%		-0.23%		US ISM	51.90	5.06
YEN	104.82	3.42%		-13.10%		EU PMI	53.50	2.29
CMCI	1095.57	0.67%		7.08%		JP TANKAN	5.00	-37.50
Oil	46.86	-2.86%		0.58%		CHINA IP	6.10	8.93

Source: Bloomberg

APPENDIX

GLOSSARY OF KEY TERMS (Source: Bloomberg, with tickers in parenthesis. In US$ where applicable)
S&P500: capitalization-weighted index of the prices of 500 US large-cap stocks (SPX)
FTSE: capitalization-weighted index of the prices of the 100 largest LSE-listed stocks (UKX)
NIKKEI: capitalization-weighted index of the largest 225 stocks of the Tokyo Stock Exchange (NKY)
HANG SENG: capitalization-weighted index of companies from the Hong Kong Stock Exchange (HSI)
STI: cap-weighted index of the top 30 companies listed on the Singapore Exchange (FSSTI)
EUR: USD/EUR exchange rate: 1 EUR = xx USD (EUR)
YEN: YEN/USD exchange rate: 1 USD = xx YEN (JPY)
CMCI: Constant Maturity Commodity Index (CMCIPI)
Oil: West Texas Intermediate prices, $ per barrel (CLK1)
3MO LIBOR: interbank lending rate for 3-month US dollar loans (US0003M)
10YR UST: 10-year US Treasury yield (IYC8 – Sovereigns)
10YR BUND: 10-year German government bond yield (IYC8 – Sovereigns)
10YR SPG: 10-year Spanish government bond yield, proxy for EU funding problems (IYC8 – Sovereigns)
10YR SGS: 10-year Singapore government bond yield (IYC8 – Sovereigns)
US ISM: US business survey of more than 300 manufacturing firms by the Institute of Supply Management that monitors employment, production inventories, new orders, etc. (NAPMPMI)
EU PMI: Purchasing Managers' index for the 17 country EU region (PMITMEZ)
JP TANKAN: Bank of Japan business survey on the outlook of Japanese capital expenditures, employment and the overall economy, quarterly index (JNTGALLI)
CHINA IP: China's Industrial Production index, with 1-month lag (CHVAIOY)
LC: Local Currency