# The fiscal decade: The promises, problems and potential of fiscal stimulus

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## IN BRIEF

In the decade ahead, we expect greater use of fiscal stimulus than at any other time in modern history. We also believe that fiscal and monetary policy will be operating in the same direction, in contrast to much of the expansion of the last decade.

- The pandemic recession has triggered the adoption of fiscal stimulus, which has also become more attractive over time due to the failure of monetary stimulus in the last expansion, the pervasiveness of low inflation and the rise of political populism.
- Different countries have different amounts of “fiscal space,” roughly defined as room to expand deficits without causing surging government bond yields or undermining currencies. This can be evaluated by looking at both traditional fiscal ratios and institutional robustness.
- The likely effectiveness of fiscal stimulus also varies, due to country factors that limit fiscal multipliers and structural issues affecting productivity growth.
- Fiscal stimulus is a powerful tool that needs to be handled with care. Done right, it can offer a quicker exit from recessions and broad social benefits. Done wrong, it can divert resources to areas with little potential to improve welfare today or productivity tomorrow. Done too timidly, as we recover from the pandemic recession, it could yield a recovery as frustratingly slow as the last one. However, if done too aggressively, it could boost inflation and interest rates and, by undermining trust in currencies and government debt, severely curtail long-term economic growth.

## A NEW ECONOMIC CYCLE WITH NEW POLICY LEVERS

The COVID-19-induced recession of 2020 will be remembered as an economic shock like few others. Unlike the bursting of the dot-com bubble in the early 2000s, the global financial crisis (GFC) 12 years ago or the eurozone crisis of 2011–12, this recession was not the result of corporate, financial sector or government miscalculations. Instead, it followed a genuinely exogenous shock and a near-universal decision by governments globally to prioritize public health over economic health.

Once this choice was made, its consequences set the tone for the next economic cycle and possibly beyond. Of all the actions taken as the world economy was in triage in early 2020, it was the unleashing of massive fiscal stimulus that will create the most lasting economic impact. In the past decade, as governments adopted fiscal austerity, monetary stimulus became the dominant policy lever; as a result, fiscal and monetary measures often pulled in opposing directions. But the next decade is likely to follow a different trajectory, with monetary and fiscal policy generally complementing each other.

The effects of this new dynamic and, in particular, how different countries and regions deploy and pay for fiscal stimulus, will profoundly shape the new economic cycle that began earlier this year after the outbreak of the coronavirus pandemic.

Over time, we expect financial markets to become more discerning in how they receive announcements of incremental fiscal spending. In the next sections, we consider how much fiscal capacity different regions have and how effective different governments might be in deploying additional spending or tax cuts. Finally, we consider what might go wrong, and what could go right, as we navigate a period of more active fiscal stimulus than at any time in modern financial history.

### The pandemic as catalyst in move to fiscal stimulus

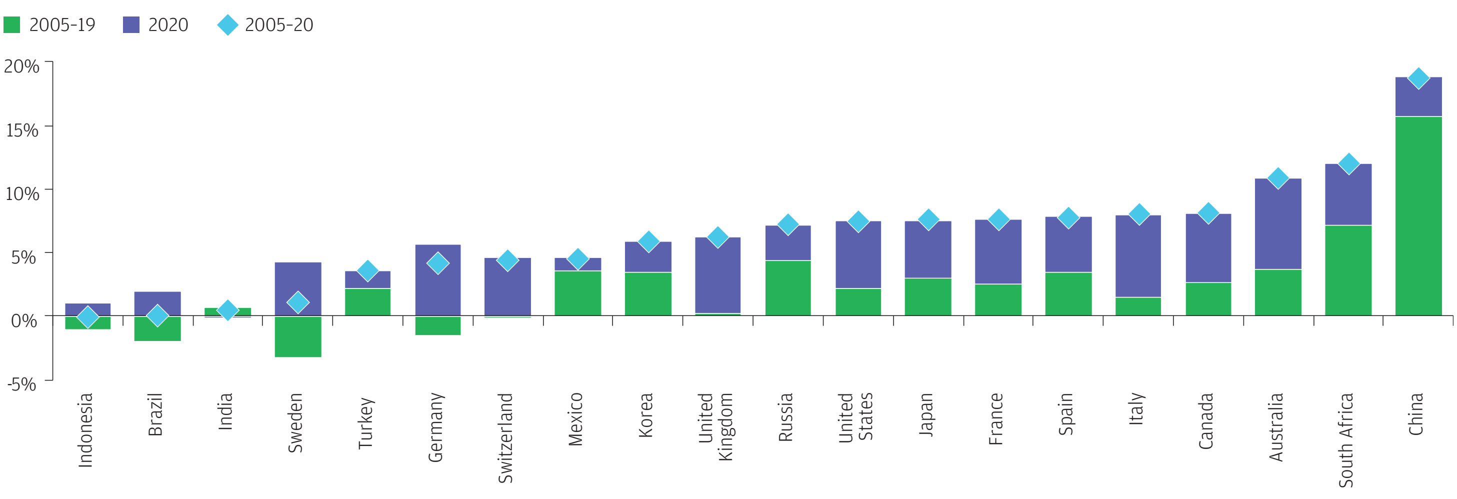
While even fiscal hawks broadly acknowledge the need in this crisis for governments to step in to support the labor force and the wider economy, the sharp reversal of many countries' fiscal policy from their austerity drive of the 2010s has elicited some nervousness (**EXHIBIT 1**). History is littered with examples of how financial markets and investors punish the fiscally profligate – in the worst cases, precipitating a collapse in the currency, hyperinflation and locking governments out of the bond markets.

At the same time, countercyclical fiscal stimulus is widely – if sometimes cautiously – accepted as a key economic policy tool. Arguments between fiscal hawks and fiscal doves tend to center on assessments of fiscal multipliers. Put another way, each incremental dollar that a government spends – whether directly or via targeted tax cuts – should boost GDP by at least that dollar over the long run. Fiscal hawks point out that governments generally do a fairly poor job of generating meaningful multipliers. Meanwhile, fiscal doves argue that the fiscal multiplier is too crude a measure to use on its own and fails to account for the wider role governments play in society.

From either perspective, it's clear that the recent surge in fiscal stimulus – for many countries, the largest peacetime increase in government spending on record – will swell the ratio of government debt to GDP (**EXHIBIT 2**). Some believe that debt ratios are already

**Fiscal policy has accelerated sharply in 2020 in most countries, and in several cases has reversed sharply from the austerity drive of the 2010s**

**EXHIBIT 1: CHANGE IN GOVERNMENT SPENDING SHARE OF GDP, 2005–19 AND 2020 (% OF GDP)**

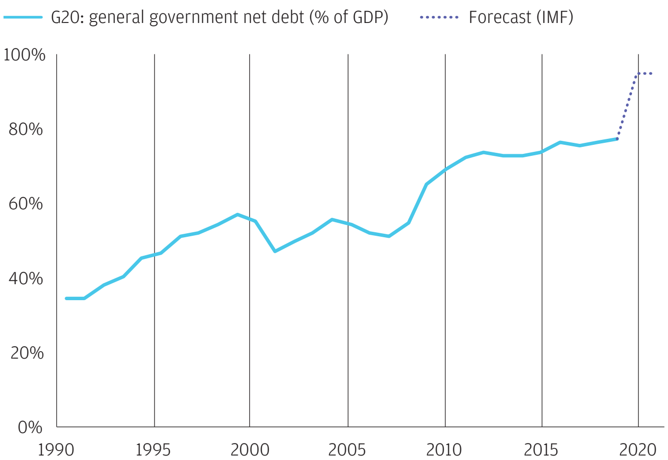



Source: Fiscal Monitor, International Monetary Fund, April 2020.

at dangerously elevated levels. But in a world of negative real interest rates, it may also seem financially imprudent for governments not to invest, particularly in the immediate aftermath of the worst economic shock since the Great Depression.

**A surge in fiscal stimulus will swell the ratio of government debt to GDP**

**EXHIBIT 2: G20 GENERAL GOVERNMENT DEBT-TO-GDP RATIO, 1990-2021**




Source: Fiscal Monitor, International Monetary Fund, April 2020.

Higher debt-to-GDP ratios and greater fiscal stimulus also point to a bigger role for government in the economy and markets. Again, this could prove controversial, given the risk that a larger government sector could crowd out a generally more efficient private sector. But "big government" does not equate to inefficiency in all countries and all situations. Indeed, in regions where fiscal stimulus is channeled toward supranational initiatives, such as green energy, or large-scale infrastructure programs, governments may deploy capital more successfully than the private sector.

Determining how to deploy fiscal stimulus and how to pay for it – including the controversial question of debt monetization – will vary widely from country to country. In this paper, we don't seek to argue for a right or wrong way to approach these questions, but instead look at which countries have more or less fiscal flexibility and which approaches to deploying fiscal stimulus may be most successful. In short, we consider whether financial markets and investors should welcome or fear bigger fiscal deficits and a larger role for government in the economy.

## IF NOT NOW, WHEN?: GOVERNMENT CHOICES AND POLICY ACTIONS

While the coronavirus pandemic has catalyzed a tectonic shift toward fiscal stimulus around the globe, political pressure to move away from overt austerity and tight fiscal policy has been growing for some time.

However, popular disgruntlement with fiscal conservatism is, of course, not the only reason fiscal stimulus was adopted so widely and enthusiastically in the wake of COVID-19. In the last cycle, only the U.S. succeeded in entering a rate hiking cycle, and even then weakness elsewhere quickly forced the Federal Reserve (Fed) into retreat. For the rest of the developed world, a decade of zero and even negative rates failed to stimulate either inflation or growth, despite generating an ample amount of liquidity and capital. At best, a lot of excess capital found its way into savings – possibly acting as a brake on the velocity of money and in turn contributing to disinflation. At worst, excess capital may have widened the gap between the capital and labor shares of the economy. Either way, monetary stimulus in isolation notably failed to boost inflation expectations in the last cycle and may have reached a natural limit to its efficacy.[1] This prompted our contention in last year's Long-Term Capital Market Assumptions (LTCMAs) that navigating any future recession would require fiscal as well as monetary support.

A further and compelling reason previously recalcitrant governments underwent an almost 180 degree conversion to fiscal stimulus has been the nature of the coronavirus recession. The 2020 recession was not organic but entirely driven by government choices. Few observers would conclude that governments were completely wrong in shuttering economies to protect public well-being, but at the same time, many would agree that it is government's obligation to fix the economic mess that ensued. Without an errant corporate or financial sector to blame, governments have felt more pressure to begin rebuilding confidence and to protect as much as possible of the economy's productive capacity. With voters already tired of austerity and real interest rates negative in most major currencies, even the most vocal fiscal conservatives have lined up in support of greater spending and lower taxes.

### Damned if you don't?

One factor that limited fiscal profligacy in past decades was the prospect that bond investors would eventually punish excessive spending and government leverage. In the 1980s and 1990s, the threat of high inflation, a run on the currency and bond vigilantism loomed large for finance ministries. More recently, however, economies around the world have seen a steady trend down in

[1] See David Kelly et al., "The failure of monetary stimulus," *2020 Long-Term Capital Market Assumptions*, J.P. Morgan Asset Management, November 2019.

inflation due to labor-saving technology, increased globalization, greater income inequality and an aging population. This receding threat of inflation has in turn spurred easier monetary policy, expressed through both lower short-term interest rates and a sharp increase in central bank balance sheets. We expect the calming influence of central bank buying on bond markets to swamp the impact of any would-be bond vigilantes for some time to come. Moreover, with long-term interest rates at historically low levels, governments find themselves able to finance far larger deficits and accumulated debt than would have been the case in earlier decades (**EXHIBIT 3**).

Disinflationary trends in recent decades and, in particular, during the last, long economic expansion suggest relatively limited risk of high inflation or interest rates in the next few years. And with previous rules of thumb[2] concerning debt-to-GDP limits now breached without apparent consequence, governments will be challenged for unnecessary fiscal conservatism far more than for excessive spending. Over the longer run, we do expect easy monetary policy plus expansionary fiscal policy to increase the upside risks to inflation, but until the output gap narrows sufficiently in the coming cycle, concerns about inflation are unlikely to quell the calls for higher fiscal spending.

In the near term, at least, financial markets may welcome higher government spending and lower taxes as much as voters do. Investors will be primarily concerned with minimizing economic disruption in the short run and preventing the loss of productive potential in the long run. As a result, fiscal stimulus – even with substantial increases to the debt-to-GDP ratio – has been welcomed by equity markets and generally shrugged off by bond markets.

Eventually, however, market attention will likely turn toward the sustainability of fiscal support. When it occurs, that analysis will focus not only on metrics such as national leverage but also on the scope and opportunity different nations and regions have to deploy fiscal dollars in a way that boosts productive capacity – ideally, generating a positive fiscal multiplier. To be clear, there is no one way that this might be done, and what suits one region may not work well in another. A country like the U.S., with an innovative private sector and dynamic capital markets, may favor deploying fiscal stimulus through the tax system. A region like Europe, with significant popular support for greening the economy, may favor a program of government investment in decarbonization and energy efficiency.

## THE CAPACITY FOR FISCAL STIMULUS

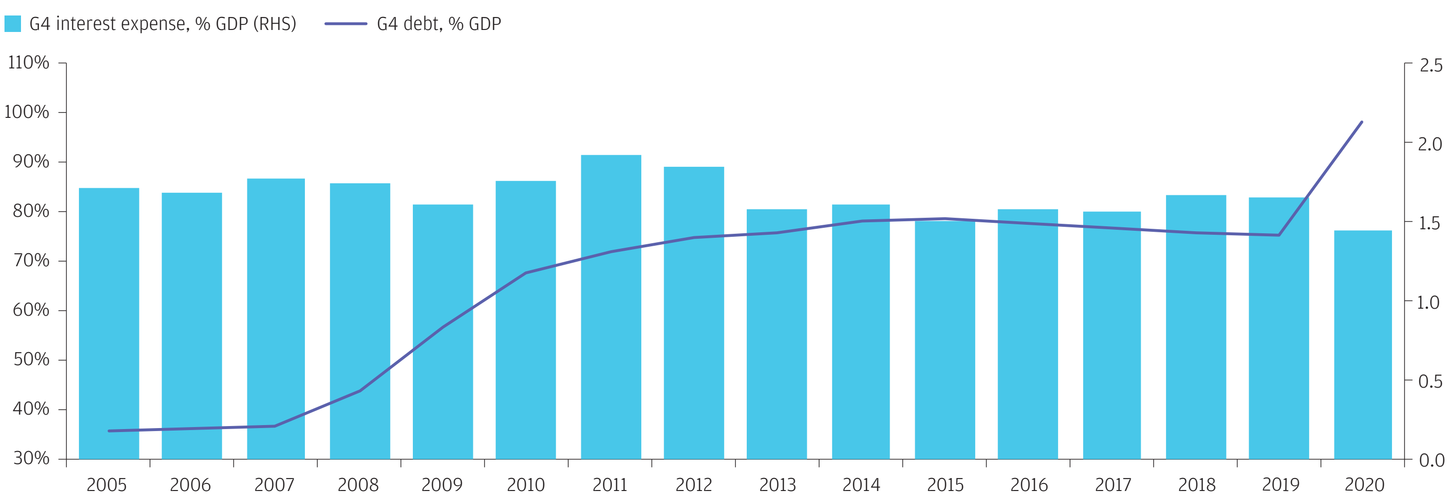
Our analysis focuses first on which nations and governments have the greatest ability to increase spending or cut taxes.

It is, of course, mechanically possible to calculate how large a primary budget deficit a government could run while still allowing the debt-to-GDP ratio to stabilize below a specified level. This estimate depends on assumptions regarding interest rates and economic growth, and countries with fast growth, low interest rates and low initial debt will always tend to look better in this kind of analysis. However, this does not provide any guidance on what a maximum sustainable debt-to-GDP ratio might be. Additionally, the

[2] See Carmen M. Reinhart and Kenneth S. Rogoff, "Growth in a time of debt," NBER Working Paper No. 15639, January 2010.

**With long-term interest rates at historically low levels, governments can finance larger deficits than in earlier decades**

**EXHIBIT 3: G4 GOVERNMENT DEBT AND INTEREST COSTS, % OF GDP**




Source: Fiscal Monitor, International Monetary Fund, April 2020.
Note: 2020 figures are forecasts.

denomination of any increase in government debt seems a relevant factor, especially for emerging market governments, which often borrow in hard currencies.

A more nuanced approach, such as that of Moody's, does attempt to estimate this maximum sustainable borrowing capacity, expressed as a share of GDP, before a country would run into severe fiscal troubles. In the Moody's approach, reaching a country's calculated limit does not mean that a default is a certain outcome, but it implies that a drastic correction in public finances would be needed to avoid such an outcome. The measure also uses the budget deficit, debt load as a share of GDP, and market interest rates. In our framework, we feature the Moody's score as well as our forward-looking estimates for R-G (real interest rates minus the real GDP growth rate) and public debt as a percentage of GDP. While there is some overlap between the Moody's score and these stand-alone measures, we favor some granularity to get a sense of the specific strengths and weaknesses for each country in this numerical assessment.

We believe, additionally, that a full assessment of fiscal capacity should go beyond these purely numerical calculations to include the concept of institutional robustness as a determinant of whether markets might welcome or question a government's incremental borrowing for the purposes of fiscal stimulus.

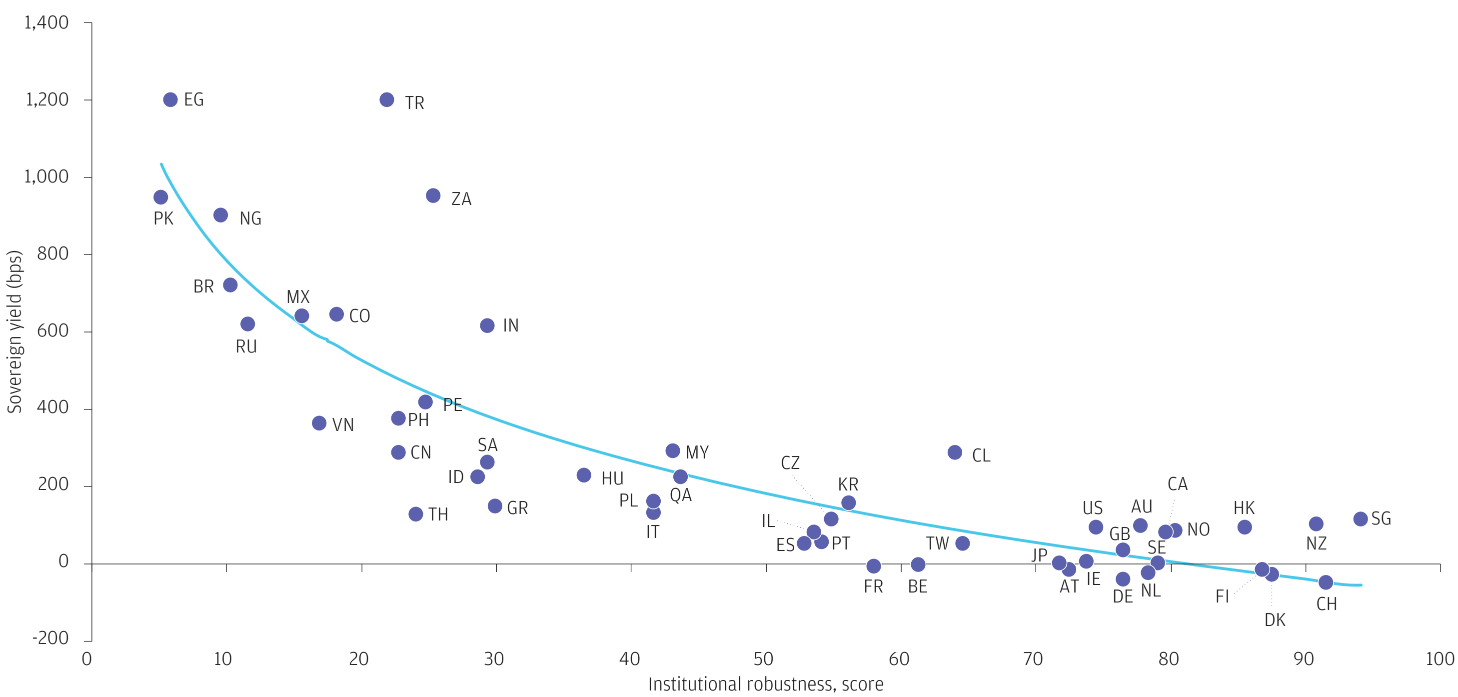
Simply put, more robust institutions appear to foster greater tolerance of increased government debt. We have ranked countries in terms of institutional robustness by combining three indicators: Corruption Perceptions, Economic Freedom and Governance.[3] Within a group of 50 countries, each indicator is percentile-ranked and then combined into an average per year per country. Generally, the rank order does not change drastically over the 25 years we examined, and the broad ordering is unsurprising – Singapore, New Zealand, Switzerland and Denmark consistently scoring highest and countries like Nigeria, Ecuador and Egypt typically scoring poorly.

While it isn't necessarily of the greatest value to compare one country's score with another's, an assessment of institutional robustness is useful in spotting patterns or misalignments. First, we note that there appears to be significant nonlinearity in market pricing with respect to the perception of institutional robustness. Comparing sovereign bond yields with institutional robustness, the highest scoring third of countries have near-zero bond yields while those in the lowest third have much higher sovereign yields, with much greater variance (**EXHIBIT 4**). In our view, countries with medium-to-higher institutional robustness operate in a different space from countries with lower institutional robustness. Countries with a poor score might find efforts to finance even reasonable and necessary fiscal stimulus severely hampered by very high yields.

[3] Corruption Perceptions (Transparency International), Economic Freedom (Fraser Institute) and Worldwide Governance (World Bank).

**Countries with medium-to-higher institutional robustness operate in a different space from countries with lower institutional robustness**

**EXHIBIT 4: THE NONLINEAR RELATIONSHIP BETWEEN INSTITUTIONAL ROBUSTNESS AND SOVEREIGN YIELDS**




Source: Bloomberg, Fraser Institute, Transparency International, World Bank.

Note: Sovereign yield is average 10-year bond yield from January 1, 2020, to September 30, 2020. Institutional robustness score is an average of each country's percentile rank in Corruption Perceptions (Transparency International), Economic Freedom (Fraser Institute) and Worldwide Governance (World Bank).

Next, we overlay institutional robustness with an assessment of fiscal space, which adds a useful corollary. Combining these measures shows that some countries that are in the middle of the pack in measures of fiscal space – e.g., the UK, Switzerland and Germany – actually have reasonable capacity to raise and service debt to support fiscal spending (**EXHIBIT 5**).

To be clear, our framework and the resulting ranking do not constitute an empirical study of fiscal capacity. However, we would expect countries with a high combined score to have disproportionately greater latitude to pursue fiscal stimulus than those with even a middling ranking, while countries toward the lower end might not even be able to deploy reasonable fiscal tools before the market started to punish them via bond yields or FX moves.

## THE EFFECTIVENESS OF FISCAL STIMULUS

Having the capacity to deploy fiscal stimulus does not necessarily imply it will be used effectively. Historically, many wealthy and successful nations have misallocated capital on a grand scale – which alone could justify the skepticism of many observers about the efficacy of fiscal stimulus. We take a more nuanced view. If spending is disciplined and capable of either stimulating near-term demand to minimize the lasting impact of a recession or boosting long-term potential growth, it can be seen as an effective policy tool. In this section, we consider which governments and nations have more opportunity to deploy fiscal spending in a productive manner.

That fiscal spending can counter the effects of a recession over the short run is relatively uncontroversial, and the power of such fiscal stimulus in boosting economic growth boils down to a question of multipliers. The idea of a fiscal multiplier is straightforward: If the

**Some countries have reasonable capacity to raise and service debt to support fiscal spending**

**EXHIBIT 5: COMBINED RANKING OF FISCAL RATIO SPACE SCORES**

| | In z-score terms, a positve number is "good" for fiscal space | | | | | |
|---|---|---|---|---|---|---|
| **Country name** | **R-G** | **Public debt % GDP** | **Moody's fiscal space** | **Institutional robustness** | **State of public finances** | **Total fiscal capacity** |
| Switzerland | 0.2 | 0.6 | 0.1 | 2.3 | 0.3 | 1.5 |
| Sweden | 0.5 | 0.9 | 1.1 | 1.1 | 0.8 | 1.2 |
| Canada | -0.1 | 0.3 | 1.2 | 1.2 | 0.5 | 1.0 |
| Australia | 0.0 | 0.4 | 1.4 | 1.0 | 0.6 | 1.0 |
| India | 3.0 | 1.3 | 0.9 | -0.6 | 1.7 | 0.7 |
| Germany | 0.1 | 0.1 | 0.1 | 0.9 | 0.1 | 0.5 |
| United Kingdom | 0.2 | -0.6 | 0.1 | 0.9 | -0.1 | 0.5 |
| United States | 0.2 | -1.0 | 0.9 | 0.8 | 0.0 | 0.5 |
| China | 1.2 | 1.3 | 1.7 | -1.0 | 1.4 | 0.2 |
| Korea | -0.1 | 0.8 | -0.2 | 0.1 | 0.2 | 0.1 |
| France | 0.3 | -1.0 | 0.1 | 0.1 | -0.2 | 0.0 |
| Indonesia | 0.0 | 0.6 | 0.6 | -0.6 | 0.4 | -0.1 |
| Japan | 0.0 | -2.3 | -0.5 | 0.6 | -0.9 | -0.2 |
| Spain | -0.4 | -0.8 | -0.7 | 0.0 | -0.6 | -0.3 |
| Turkey | -0.5 | 0.5 | -1.3 | -1.1 | -0.5 | -0.4 |
| Italy | -1.1 | -1.7 | -1.3 | -0.1 | -1.4 | -0.7 |
| South Africa | -1.3 | -0.3 | -1.3 | -0.8 | -1.0 | -1.1 |
| Russia | 0.2 | 1.2 | -1.2 | -2.0 | 0.0 | -1.2 |
| Mexico | -0.3 | 0.0 | -1.2 | -1.6 | -0.5 | -1.3 |
| Brazil | -2.1 | -0.1 | -0.4 | -2.1 | -0.9 | -1.8 |

Source: International Monetary Fund, OECD, World Bank, J.P. Morgan Asset Management.

Note: Total fiscal space score = Z-Score (0.5*(Total fiscal ratios score) + 0.5*(Institutional robustness)), where Total fiscal ratios score = 1/3*(R-G) +1/3*(Public debt % GDP) + 1/3*(Moody's fiscal space).

government buys a dollar's worth of goods and services, then the providers of those services will end up with a dollar's worth of income.

Some of that income will be taxed, some will be saved, some will be spent on imports, and some will buy more goods and services in the economy. The providers of those goods and services will then spend a fraction of the income they received in buying further goods and services, and so on. The multiplier is simply the sum of the initial dollar spent and all the subsequent fractions of income spent as a result.

Fiscal multipliers tend to be larger in countries with low tax rates, low marginal propensities to save and low marginal propensities to import. In theory, spending multipliers are higher than tax cut multipliers because all direct government spending represents GDP, while some of the money initially provided by tax cuts is diverted to savings and imports. By and large, fiscal multipliers are strongest when there is considerable slack in the economy, as extra demand in a full employment economy would – in theory, at least – tend to push up interest rates, thereby crowding out private investment spending.

In **EXHIBIT 6**, we show average taxes, imports and savings as a share of GDP, and measure economic slack (rather crudely) as the percentage decline in real GDP from the fourth quarter of 2019 to the second quarter of 2020. The simple exercise paints a relatively clear picture suggesting that, among developed economies, the U.S., Japan and Spain should have relatively high fiscal multipliers while Sweden, Switzerland and Korea should have relatively low ones. In emerging markets, Brazil, India and Indonesia should benefit more in the short term from expansionary fiscal policy compared with Mexico, Turkey and China. It should be noted that, due to the sharp fall in GDP caused by the pandemic, fiscal multipliers for most major countries, with the exception of China, are probably higher than the average taxes, imports and savings, as a share of the economy, might suggest.

But this is not the whole story. For a start, there is no one-size-fits-all solution, as governments have varied discretionary opportunities to levy taxes or borrow to finance projects that might increase productivity over the longer term.

**Fiscal multipliers are typically strongest when there is considerable slack in the economy**

**EXHIBIT 6: FACTORS IMPACTING SHORT-TERM FISCAL MULTIPLIERS ACROSS COUNTRIES**

| Country name | 2018 tax revenue (% of GDP)* | 2018 imports (% of GDP) | 2018 net savings (% of GNI**) | GDP H1 2020 (% change) |
|---|---|---|---|---|
| Australia | 23.0 | 21.4 | 3.9 | -7.2 |
| Brazil | 14.2 | 14.5 | 0.9 | -11.9 |
| Canada | 12.9 | 34.0 | 3.2 | -13.4 |
| China* | 9.4 | 18.3 | 23.2 | 0.4 |
| France | 24.2 | 32.8 | 4.4 | -18.9 |
| Germany | 11.5 | 41.3 | 10.8 | -11.5 |
| India | 12.0 | 23.6 | 19.9 | -24.8 |
| Indonesia | 10.2 | 22.0 | 14.7 | -7.6 |
| Italy | 24.3 | 29.1 | 3.3 | -17.6 |
| Japan | 11.9 | 18.3 | 5.4 | -8.5 |
| Korea | 15.6 | 37.0 | 15.9 | -4.4 |
| Mexico | 13.1 | 41.2 | 6.1 | -18.0 |
| Russia | 11.4 | 20.6 | 17.2 | -4.1 |
| South Africa | 27.5 | 29.6 | 1.0 | -16.7 |
| Spain | 14.2 | 32.4 | 6.8 | -22.7 |
| Switzerland | 10.1 | 53.9 | 12.6 | -10.5 |
| Sweden | 27.9 | 43.4 | 11.0 | -8.1 |
| Turkey | 17.9 | 30.6 | 10.6 | -11.1 |
| United States | 9.6 | 15.3 | 2.6 | -10.2 |
| United Kingdom | 25.5 | 32.0 | -1.3 | -22.1 |

Source: International Monetary Fund, OECD, World Bank, J.P. Morgan Asset Management.

* Tax revenue ratio as of 2017. ** GNI = Gross national income.

In many countries, the last decade was a period of declining public investment spending and increasing fiscal restraint. Today, as fiscal purse strings are being loosened to counter the shock of COVID-19, expanding investment in areas like transportation and digital infrastructure may seem an obvious choice. But since the positive externalities of such projects are often not properly valued in asset markets, it falls on governments to finance such initiatives. For all the perceived inefficiencies of economies with large public sectors, such countries may be better placed to invest in large-scale projects with positive externalities and to offer more automatic stabilizers[4] in times of crisis.

Some countries (e.g., China and Japan) already have significant public capital stock as a share of GDP. For these nations, further investment spending may have a lesser effect on growth and productivity than it would in nations with a lower capital stock, such as Brazil, Germany and the UK. For a country such as China, there may be as much to gain through reducing the red tape that can depress spending and investment as there would be in increasing the level of fiscal spending itself. In general, however, emerging economies may have more obvious investment opportunities due to generally lower levels of capital stock – provided they can afford them.

The ability to direct fiscal stimulus to discretionary opportunities is also constrained by structural spending needs – for pension obligations and health care, especially for rapidly aging economies – reflected in sharply rising old-age dependency ratios. Japan, Germany and France are likely to face the biggest limitations in this regard, while many emerging economies, with the notable exception of China and Korea, score relatively well. Military spending is another constraint, which could become an increasing headwind should geopolitical threats escalate.

Above all, good stewardship of public investments is crucial over both the short run and the long run. Putting aside opportunities for corruption and self-enrichment of government officials, which tend to be greater in emerging economies, making such decisions is difficult at best. In assessing a country's ability to deploy fiscal stimulus effectively and boost long-term potential growth, we weight stewardship equally with the combined weight of investment opportunity and fiscal constraints.

**EXHIBIT 7** provides a portrait of the potential effectiveness of fiscal stimulus in promoting higher productivity in the long run. Based on the measures of discretionary opportunities, structural flexibility and stewardship, countries like the U.S., Australia, the UK and Canada appear to have more potential to deploy fiscal stimulus in a way that can boost long-term productivity than do Russia, Brazil and Mexico. What is striking is that some emerging economies score well, since reasonable stewardship allows their potential to increase capital stock to boost their ranking. However, where stewardship is in question, even a very high score for opportunities is overtaken by the risk of capital being misallocated over the long run.

It should be noted that many targeted areas of government spending or tax incentives could be worthwhile even if they have a negligible short-term impact on either aggregate demand or productivity. For example, the productivity benefits of improving primary education may not accrue for decades. Other spending decisions, such as allocations to preserve the environment or improve health care, may have huge positive impacts on society while doing little to boost economic output.

[4] Automatic stabilizers are aspects of government welfare and tax systems that tend to operate countercyclically and thus reduce the severity of recessions. These include progressive tax schedules, which result in proportionately bigger declines in tax revenue than taxable income, and unemployment benefits, which expand as the jobless rate increases.

**Our model estimates the potential effectiveness of fiscal stimulus in promoting higher productivity**

**EXHIBIT 7: PRODUCTIVITY-ENHANCING POTENTIAL OF FISCAL STIMULUS BY COUNTRY**

| Country name | Discretionary opportunities | Structural flexibility | Stewardship | Overall score |
|---|---|---|---|---|
| United States | 88 | 67 | 69 | 73 |
| Australia | 60 | 70 | 77 | 70 |
| United Kingdom | 75 | 56 | 72 | 68 |
| Canada | 63 | 38 | 90 | 66 |
| Switzerland | 42 | 36 | 100 | 62 |
| Korea | 54 | 72 | 54 | 58 |
| Sweden | 27 | 41 | 100 | 57 |
| India | 93 | 100 | 33 | 57 |
| South Africa | 69 | 93 | 38 | 55 |
| Indonesia | 100 | 85 | 28 | 51 |
| China | 58 | 81 | 36 | 50 |
| France | 43 | 32 | 64 | 49 |
| Spain | 34 | 54 | 54 | 48 |
| Germany | 39 | 17 | 87 | 48 |
| Turkey | 88 | 93 | 20 | 43 |
| Japan | 58 | 9 | 79 | 42 |
| Italy | 37 | 29 | 44 | 38 |
| Russia | 66 | 86 | 13 | 31 |
| Brazil | 90 | 78 | 10 | 29 |
| Mexico | 72 | 80 | 8 | 24 |

Source: Haver, IMF, UN Department of Economic and Social Affairs, SIPRI, World Bank, J.P. Morgan Asset Management; data as of September 14, 2020.

Note: We use a geometric mean with a double weighting to stewardship to better account for outliers and to emphasize the importance of good stewardship of investment above other factors.

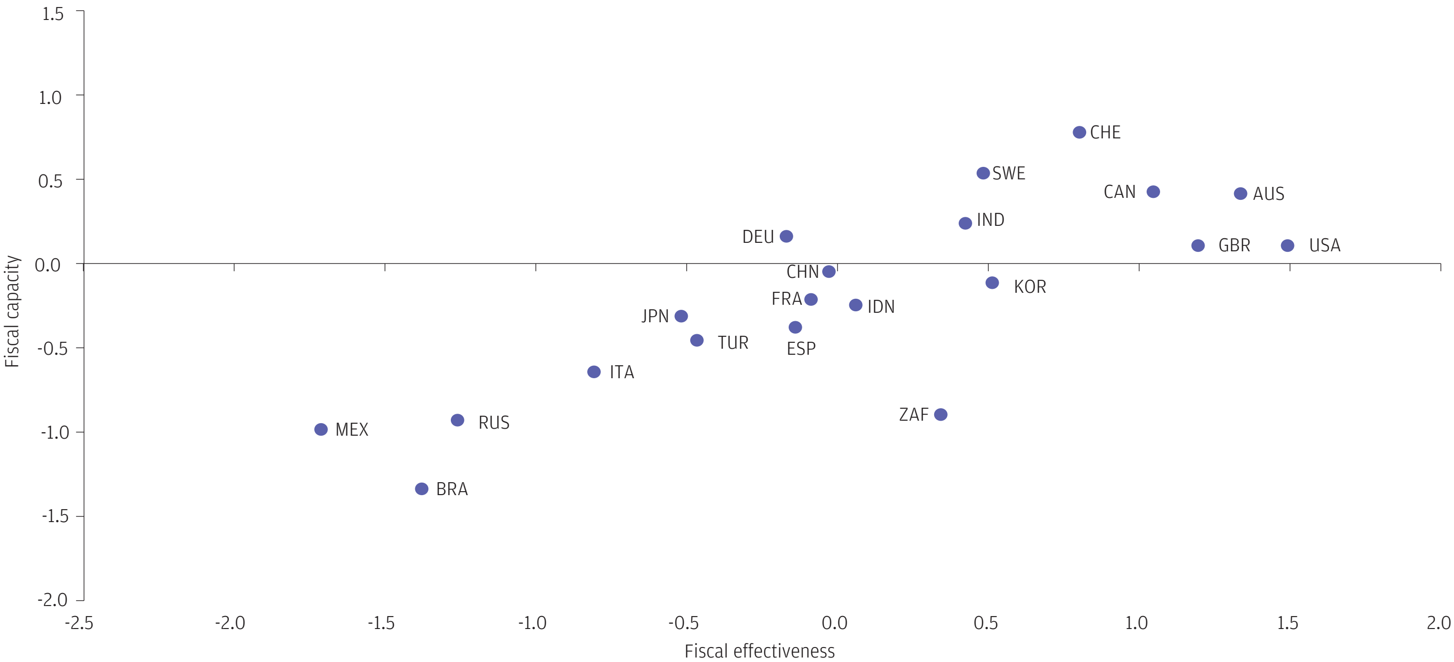
## Deploying fiscal stimulus: Identifying winners and losers

Combining our assessment of which nations have the greatest ability to increase fiscal stimulus with our assessment of those nations with the greatest scope to deploy fiscal stimulus effectively is an instructive process (**EXHIBIT 8**). For simplicity, we have represented this on two axes, with those nations toward the upper right having greater ability to fund fiscal spending and more scope to spend it effectively compared with those in the lower left. Those nations at the extremes are not a huge surprise – fiscal stimulus announcements from those nations in the top right are likely to be welcomed, or at least absorbed, by markets. By contrast, investors are likely to remain skeptical of fiscal spending by nations in the bottom left – even if it is deployed in a well-intentioned attempt to address cyclical economic stresses.

Outside these clusters, the message is more nuanced. China, for instance, has ready access to capital, but it isn't clear that it has much to gain from simply throwing fiscal stimulus at its economy. Instead, for China, continued streamlining of administrative procedures or further rationalizing the banking infrastructure could be at least as impactful as a boost in raw fiscal spending. Pension funding in nations with aging demographics also affects fiscal choices. Despite the huge opportunity across Europe to invest in green energy and transportation, the challenging demographic profile in countries like Italy and Germany may limit even these advanced nations' capacity to freely deploy fiscal spending in the most productive fashion. Clearly, there are winners and losers in a period of greater fiscal spending, but there are also important subtleties driven by long-term structural economic and social factors.

**Winners and losers will emerge in a period of greater fiscal spending**

**EXHIBIT 8: COMBINING FISCAL CAPACITY WITH THE POTENTIAL TO DEPLOY FISCAL STIMULUS EFFECTIVELY**




Source: J.P. Morgan Asset Management; data and assessments as of September 30, 2020.

## CONCLUSIONS

This article is titled "The fiscal decade" as a prediction rather than an endorsement of future government policy. Following the relatively unsuccessful use of monetary stimulus in the last decade and given the greater acceptance of budget deficits today by both politicians and central bankers, fiscal stimulus will likely play a significant role in shaping the investment landscape in the years ahead. Whether this will ultimately be celebrated or lamented depends on the care with which policymakers deploy their powers.

*Of course, there are good reasons for adopting a policy of greater fiscal stimulus.*

In many economies in recent decades, either because of macroeconomic concerns or an uneven income distribution, aggregate demand has fallen short of aggregate supply and the central governments have acted as "spenders of last resort," helping the economy back to full employment. Indeed, for all the horrors of World War II, the government spending it necessitated finally put an end to a decadelong depression.

There are also many things a government can and should do that the private sector would never have the incentive or credibility to attempt. In the past, this list has included providing basic retirement income, building great networks for travel and utilities, and achieving impressive advances in medicine and communications. In the future, governments could lead efforts to preserve the planet, leverage human skills through better education and eradicate diseases, including the virus that has laid us low in 2020.

Government debt, if not taken to extremes, can play two very important roles in the functioning of an economy. First, the general creditworthiness of the government, given its authority to levy taxes and fees, can be used to finance investment spending today at relatively low interest rates. Second, government debt gives millions of individuals a reliable way to save for retirement, confident of repayment for decades into the future.

*However, each of these good purposes is subject to abuse.*

Fiscal stimulus can actually do more harm than good, if not applied countercyclically. European countries adopted austerity measures in the midst of the recession triggered by the European sovereign debt crisis. At the other extreme, in 2017, the U.S. implemented major unfunded tax cuts even as the U.S. unemployment rate continued to move toward near-record lows.

Equally troubling has been the misuse of government spending or tax cuts to promote activities that undermine, rather than enhance, the public welfare. Taxpayer money, rather than achieving worthwhile goals, has too often been diverted to ill-conceived, badly executed projects rather than hospitals and schools. However, even when governments have ostensibly set out to promote public welfare, they have often failed by backing the wrong technology or undermining incentives within the private sector economy.

Most ominously, however, taken to an extreme, undisciplined fiscal stimulus can undermine trust in government debt and, with a sufficiently compliant central bank, national currencies.

*The question so many ask is, "Where is the limit?"*

A decade ago, economists Kenneth Rogoff and Carmen Reinhart argued that pushing the debt-to-GDP ratio beyond a threshold of 90% would be associated with much slower economic growth.[5] However, the experience in many nations over the course of the 2010s suggests that debt-to-GDP could rise meaningfully above that threshold with limited side effects.

In our view, the real limiting factor on governments is likely not the level of debt but the level of debt service. If interest rates and inflation remain very low, then governments can clearly increase borrowing without significant consequences. However, when higher interest rates cause interest costs to absorb a significant share of the government budget, squeezing other areas of spending, both taxpayers and investors take notice.

This potential risk of higher interest rates in turn is largely driven by the risk of higher inflation. For almost four decades, inflation has trended downward in both developed and emerging economies. Part of that decline has been a normal reaction to excess supply in recessions. However, a larger part of it has been driven by greater income inequality, which has tended to reduce the demand for goods and services relative to their supply, and greater competition, largely due to automation and information technology, which has reduced inflation pressures across the board.

Going forward, as the global economy recovers from recession there is some risk of a cyclical upswing in inflation. More significantly, if policymakers use fiscal policy to reduce income inequality, it might well increase the demand for goods and services while reducing the demand for financial assets such as bonds, increasing both inflation and interest rates.

If these forces prove sufficient to drive inflation higher, even in the face of continued competition, then long-term rates could rise, limiting the scope for further fiscal stimulus. Moreover, this could only be temporarily ameliorated by central bank purchases of government bonds, since outright debt monetization, while reducing real government bond yields, could also lead to even higher inflation, pushing nominal yields higher still.

Given a starting point of low interest rates, low inflation and considerable slack in the global economy, active fiscal policy will likely define the decade ahead. However, whether this turns into the decade of fiscal-powered economic progress or the decade of fiscal crisis will depend on the care with which governments and central banks deploy the tools they now seem ready to use.

[5] See Carmen M. Reinhart and Kenneth S. Rogoff, "Growth in a time of debt," NBER Working Paper No. 15639, January 2010.

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