Let’s imagine a hypothetical European country whose Parliament is led by an unlikely coalition of two populist parties, one from the right and one from the left. The party on the right wants tax breaks to stimulate business investment offset by cuts in government spending, while the party on the left wants social programs financed by higher taxes. How do you think the two parties compromise? It is safe to say it won’t be for higher taxes and fewer social programs. Fiscal responsibility would be the first casualty of any agreement. When protesters hit the streets, they probably aren’t chanting for sustainable borrowing. It wasn’t long ago that the popular consensus in Europe and the United States pointed in the opposite direction. Fiscal responsibility was the primary goal of the treaty creating the European Union and many candidates in the U.S. ran on platforms of lower deficits.

It shouldn’t be a surprise that as politicians and voters have become less worried about debt, they’ve found academics to back up their views. Economists have always had diverse opinions on debt. Some will tell you that government is wasteful, and any money it borrows from the private sector will be allocated inefficiently. They point to evidence showing that countries with high debt loads tend to grow slowly. On the other side, you find the recently ascendant “modern monetary theory” (MMT) economists who argue that fiscal restraint has cost society and the economy. They maintain that as long as a country has its own sovereign currency, debt is not a problem because it can always be paid off by creating more money. Between, you have more traditional economists such as Keynesians and some old fashioned monetarists. General, these economists believe that government spending has benefits, but if there is too much it will “crowd out” private sector investment by increasing the cost of borrowing. They have viewed deficit spending as something to be avoided except in times of economic weakness when it can be used as a buffer against deficient investment and spending in the private sector. As soon as the private sector recovers, the government budget can and should return to balance. Sure, there are some traditional economists who favored a larger state and more debt than others, but few would go so far as to say the amount of debt didn’t matter.

We certainly won’t try to resolve the theoretical controversy on deficit spending or discuss the merits of the different economic theories, but we will note that recently there has been a subtle shift in the debate. Some traditional economists are saying that current economic conditions allow for more deficit spending than in the past. Economists generally measure debt as a percentage of the total economy or GDP. This debt/GDP ratio will fall in the medium term as long as the economy is growing faster than the rate of interest. They use some fancy equations to prove it, but the intuition is fairly simple: if the economy is generating more income than the government is paying on interest, then the government will be able to get enough tax revenue to keep debt levels manageable. Debt ratios may go up in the short run, but they will come back down later.

Right now, most major economies are growing faster than their respective target rates so some economists argue that there is plenty of room to run deficits. There are, however, a few things that could go wrong. Growth could turn out to be lower in the future than is currently expected. Interest rates could also rise, though some argue the central bank could help the government out by holding rates low. Traditional economists have argued that if governments run up a lot of debt and finance it by printing money or keeping rates low there will be inflation. Other words, the government can control the amount of its sovereign currency or the value it has, but not both.

As we’ve pointed out repeatedly, inflation has been low, and many policymakers would prefer if it were a little higher. If the biggest risk turns out to be something you want, well then it’s not much of a risk. However, the changing attitudes toward deficits are not evident in aggregate fiscal projections outside of the U.S. Because economies are generally doing well, current deficits are not that large and, according to the IMF, won’t be increasing that much. A few countries, such as Brazil and Turkey, have been hurt by weak growth and are running large deficits, but the European Union has been, for the most part, successful in keeping countries fiscally responsible, with the exception of France. Deficits in China are rising a bit, but Germany will likely continue to run a surplus. There are some budget hawks left in Northern Europe.

Nonetheless, current deficit forecasts may underestimate the political pressure for more spending. If we do see larger deficits, it will probably be stimulative for short-run global growth. In the longer run it could turn inflationary if governments decide to monetize the debt instead of raising taxes. or markets, it would probably initially be good for asset prices, but asset price inflation could slowly transition to price inflation. Fiscal policy is more difficult to measure than monetary policy because it doesn’t move in 25bp increments at regular meetings. This means investors have to pay close attention to politics across the world. One effect of fiscal spending is that it will move markets, though it’s probably not the policy goal. That’s something all economists can agree on.
As inflation has been low in recent years, such a policy might mean targeting higher inflation in the next few years. This would mean that the Fed would seek to make up for periods of below-target inflation with subsequent periods of above-target inflation. Given that the current macro backdrop remains supportive for consumption growth (low unemployment rate, rising wages, and low interest rates), market participants may be discounting the December data as a temporary quirk, perhaps related to a sudden deterioration in consumer confidence amid a sharp stock market sell-off. Next week’s data will provide key information to test this sanguine interpretation.

Bank of Japan Meeting (Friday)
The Bank of Japan (BoJ) has adopted a set of aggressive easing measures in recent years, including large-scale asset purchases, a negative short-term interest rate target, and a “Yield Curve Control” policy aimed at holding 10-year government bond yields near zero. These policies appear to have contributed to positive trends in the Japanese economy over the last few years, as growth has been healthy, the labor market has tightened, and wages have picked up. However, inflation remains well short of the BoJ's 2% YoY last July 2018 to 1.6% YoY in January. Core measures of inflation have been more stable, with CPI less food and energy only falling from 2.4% to 2.2% over the same period. Given the Fed’s recent conversations around changes to its policy approach, an upside surprise to core inflation would likely be welcomed, but it seems it would now take a sustained upward trajectory to inflation to get the Fed thinking about further interest rate hikes.

U.S. Retail Sales (Monday)
U.S. retail sales for January will be released next week as statistical agencies work to remedy the data delays caused by the government shutdown. The last retail sales release, covering December 2018, surprised significantly to the downside with the largest one-month drop for the headline number since September 2009. The “control group,” a direct input to the Consumption component of GDP, experienced its largest one-month decline since 1999. While a portion of the monthly weakness can be attributed to falling energy prices, the majority of the disappointment appears to have come from other categories. Given that the current macro backdrop remains supportive for consumption growth (low unemployment rate, rising wages, and low interest rates), market participants may be discounting the December data as a temporary quirk, perhaps related to a sudden deterioration in consumer confidence amid a sharp stock market sell-off. Next week’s data will provide key information to test this sanguine interpretation.

U.S. CPI (Tuesday)
Perceptions around inflation and what it means for monetary policy in the U.S. have taken a turn recently. The Federal Reserve has shifted toward more neutral policy guidance since the start of the year and is also researching and discussing important medium-term changes to its policy framework. The Fed will continue to focus on monthly inflation readings but may be viewing them through a more dovish lens than was the case a few months ago. After a sharp fall in oil prices in the final quarter of 2018, headline CPI has fallen sharply from 2.9% YoY last July 2018 to 1.6% YoY in January. Core measures of inflation have been more stable, with CPI less food and energy only falling from 2.4% to 2.2% over the same period. Given the Fed’s recent conversations around changes to its policy approach, an upside surprise to core inflation would likely be welcomed, but it seems it would now take a sustained upward trajectory to inflation to get the Fed thinking about further interest rate hikes.

The weak growth/debt arguments which Rogoff and Reinhart popularized several years ago have not been as prominent in the recent debate.

Deficits tend to rise the most during recessions because government revenue collapses while spending does not.

The experience in Japan was very different. When Japan ran up large deficits, it had large external surpluses and a stable internal funding base. It didn’t experience foreign divestment so it was able to maintain the value of its currency. If a country reliant on foreign investment did the same, it might experience divestment and currency devaluation, leading to inflation. If every country tried to monetize large deficits simultaneously, there could be universal devaluation where people lose preference for sovereign currencies, also leading to inflation. Ok, I’ve ended a debate that has puzzled economists for years in a single footnote. Maybe.

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