

Economics Group

Special Commentary

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How Well Equipped Are Major Economies for the Next Downturn?

Executive Summary

The next recession is not yet clearly visible on the horizon, but the lack of preparedness for a downturn among central banks in many major developed economies is of some cause for concern, in our view. If a recession happens relatively soon, the burden of policy support would likely fall more on fiscal authorities, although central banks could also push the boundaries and fully utilize all elements of their respective monetary policy toolkits. In this report, we develop a framework to assess monetary and fiscal policy capacity for the U.S., Eurozone, U.K., Japan and Canada, while we also discuss the potential implications of our findings for the global economy and for fixed income and currency markets.

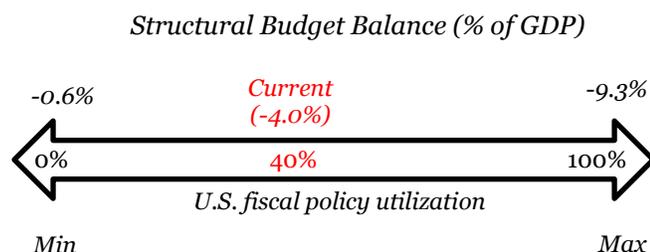
We develop a framework to assess monetary and fiscal policy capacity for the U.S., Eurozone, U.K., Japan and Canada.

Policy Capacity Is Limited for Most Economies

Our framework for policy capacity measures the ability of each economy’s fiscal and monetary authorities to respond to an economic downturn using the typical policy levers. To measure monetary policy capacity, we consider each economy’s central bank policy interest rate adjusted for inflation, or the real policy rate. On the fiscal side, we consider the general government cyclically adjusted budget balance (“budget balance”), which adjusts the general government budget balance for the stage of each economy’s cycle and is, in our view, a good measure of an economy’s fiscal policy stance. In general, those economies with lower real policy rates and larger budget deficits (or smaller surpluses) tend to have less policy capacity to support the economy during a downturn, while the converse is true for economies with higher real policy rates and smaller deficits (or larger surpluses).

Using these two metrics, we calculate a measure of policy utilization, which measures how much policy capacity an economy is utilizing at a given point in time. For example, if an economy’s total policy utilization is 75%, then it is using 75% of its monetary and fiscal policy capacity, while it has only 25% of its overall policy capacity remaining. To calculate policy utilization, we compare the current figures for the real policy rate and budget balance to their range of outcomes over our sample period (2001-present).

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For example (see prior diagram), the U.S. structural fiscal position has ranged from a deficit of 0.6% of GDP to a deficit of 9.3% of GDP over our sample period, implying a range of 8.7%. In the context of this example, if the U.S. structural budget position was a deficit of 0.6% of GDP, it could be said the U.S. is using 0% of its fiscal policy capacity (and has 100% remaining), while if it is running a deficit of 9.3% of GDP, we would say it is using 100% of its fiscal capacity (and has 0% remaining). Using the most recent figures, the U.S. structural deficit of 4.0% implies fiscal policy utilization of 40%, suggesting the U.S. is using 40% of its fiscal policy capacity and has 60% capacity remaining. We can use this same methodology to calculate monetary policy capacity as well. The U.S. real policy rate has been between -3.8% and +3.6% over our sample period, suggesting a range of 7.4%. With a real policy rate at -0.3% currently, our measure of monetary policy utilization is 53%. Taking the average of fiscal and monetary utilization yields us a total or overall measure of policy utilization, which in the U.S. example is 46%.

In essence, our approach allows us to take into account both financial and political constraints.

One particular advantage of this methodology is that it accounts for cross-economy differences in the respective policy approaches of fiscal and monetary authorities. For example, Eurozone countries, in particular Germany, are often known for being more austere in their budgetary approach, while the U.S. and Japan have historically been more willing to run larger deficits. In essence, our approach allows us to take into account both financial and political constraints. Moreover, this approach also allows for comparisons for policy capacity for each individual economy relative to recent history. The results of our study for our five economies of interest are shown in the table below.

Table 1

Wells Fargo Policy Capacity Utilization					
	Real Policy Rate	Budget Balance	MP Util.	Fiscal Policy Util.	Total Util.
U.S.	-0.3%	-4.0%	53%	40%	46%
Eurozone	-2.0%	-0.9%	90%	0%	45%
U.K.	-1.9%	-1.8%	78%	32%	55%
Japan	-1.1%	-4.1%	62%	16%	39%
Canada	-1.7%	-1.1%	73%	50%	61%
Average	n/a	n/a	71%	27%	49%

Source: International Monetary Fund, U.S. Department of Labor, Federal Reserve Board, Bloomberg LP and Wells Fargo Securities

Most major developed market central banks have little capacity to ease monetary policy at present in the event of a near-term recession.

Before we discuss each economy individually, we first make a few observations on the overall preparedness of authorities in major developed markets for a downturn in economic activity. The most obvious takeaway from this table is that most major developed market central banks have little capacity to ease monetary policy at present in the event of a near-term recession, with an average monetary policy utilization among these five economies of around 70%. Meanwhile, fiscal authorities in general seem to have a high degree of capacity to stimulate growth if need be, as fiscal policy utilization is 50% or lower for all the economies in our study, while average fiscal policy utilization is just 27%. Thus, it seems these economies in general would have to rely more on fiscal stimulus rather than monetary policy to support growth in the event of a near-term recession.

Taking into account both monetary and fiscal policy, the economies in our study are only moderately well positioned to respond to the next recession, with average total policy utilization of around 50%. As Figure 1 shows, total policy utilization for most economies in our study is higher now than it was immediately prior to the global financial crisis in 2008 (i.e., remaining policy capacity is lower). That is particularly the case for monetary policy authorities, where the average monetary policy capacity utilization is 71% for the economies in our study at present compared with around 20% immediately prior to the 2008 crisis. While a global recession is not, in our view, imminent, we see some downside risks for the global economy, including a sharper-than-expected slowdown in the Chinese economy or a significant worsening in the Italian fiscal situation. The

confluence of downside risks to the global economy, in our view, increases the impetus for major central banks to normalize monetary policy. Fortunately, the central banks in our study are for the most part normalizing monetary policy, which could allow them to recoup some monetary policy capacity ahead of the next recession. However, most central banks have a long way to go to get back to “normal.” Fiscal policy alone may be insufficient to cushion the economy in the event of recession. In that context, and as we discuss in the next section, some economies may have fiscal constraints that could limit their ability to respond to economic weakness.

Fiscal policy alone may be insufficient to cushion the economy in the event of recession.

Figure 1

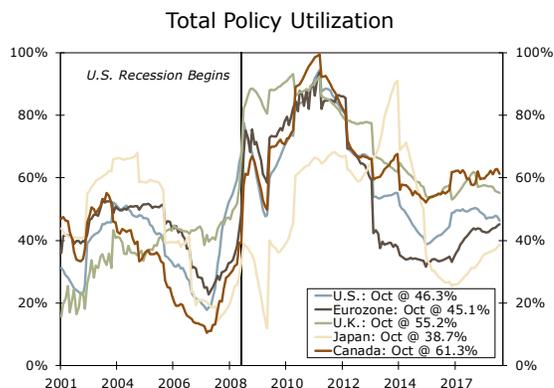
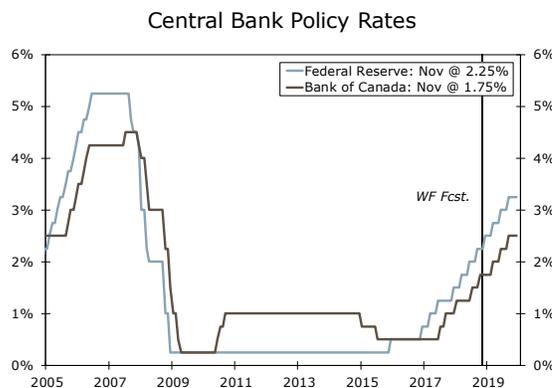


Figure 2



Source: International Monetary Fund, U.S. Department of Labor, Federal Reserve Board, Bloomberg LP and Wells Fargo Securities

Low Fiscal Capacity Raises Stakes for Fed and BoC

The Federal Reserve and the Bank of Canada (BoC) are, in our view, leading the way among developed market central banks in terms of monetary policy normalization. The Fed has raised its policy rate a cumulative 200 bps since late 2015 and currently projects that it will raise rates a further 100 bps by the end of next year, while it is simultaneously reducing the size of its balance sheet by reducing reinvestments of maturing asset holdings. Meanwhile, the BoC has raised its policy rate a cumulative 125 bps since mid-2017, while we look for an additional 75 bps of tightening next year. U.S. monetary policy utilization of 53%, particularly when considered in the context of the U.S. central bank’s plan to raise rates further and continue to reduce its balance sheet, bodes relatively well for the Fed’s ability to respond to a downturn through the monetary policy channel, in our view. Canada’s score on monetary policy utilization is less favorable at 73%, and thus the BoC’s plans to raise rates further are welcome to the extent that they help the BoC accumulate more dry powder ahead of the next downturn.

U.S. monetary policy utilization of 53% bodes relatively well for the Fed, in our view.

However, despite leading the way in terms of monetary policy normalization, Canada and the United States are the least favorably positioned in terms of fiscal policy capacity, with fiscal policy utilization of 50% and 40%, respectively. Moreover, the U.S. fiscal deficit is already projected to widen further in the coming years after recent tax cuts and spending increases from the U.S. government. The more limited capacity of U.S. and Canadian fiscal authorities to ease policy highlights the importance of these countries’ central banks continuing to normalize policy, in our view.

Eurozone, Japan and U.K.: Onus on Fiscal Policy

Central banks in the Eurozone, Japan and United Kingdom have lagged their peers in the United States and Canada in normalizing monetary policy in recent years. The European Central Bank (ECB) and Bank of Japan (BoJ) have not yet begun the process of interest rate normalization, with the ECB signaling its first rate hike will likely come during H2-2019, while the BoJ has not signaled any intention of a cycle of short-term policy rate increases any time soon. Meanwhile, the Bank of England (BoE) has been saddled by Brexit concerns since mid-2016, which led the central bank to cut rates 25 bps in the immediate aftermath, while it has raised its policy rate only 50 bps since then to 0.75%. Given Brexit uncertainty is likely to persist in the coming weeks and months, the

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Nominal short-term interest rates in Japan have essentially been at zero over the past two decades.

BoE may be limited in its ability to normalize monetary policy further for the time being. Monetary policy utilization for the Eurozone and U.K. is 90% and 78%, respectively, the two highest scores in our study.

Surprisingly, Japan is utilizing just 62% of its monetary policy capacity. However, a look back at history shows nominal short-term interest rates in Japan have essentially been at zero over the past two decades, with changes in real interest rates driven almost entirely by changes in inflation. With nominal rates still essentially at zero, the BoJ would either have to cut nominal rates well into negative territory or spur sustained positive inflation to see an accommodative drop in real rates. Given the ongoing concerns around the profitability of Japanese banks, a deeply negative short-term policy rate could be problematic, while generating higher inflation has also been a challenge for quite some time for the BoJ. Accordingly, Japan's monetary policy utilization score may not be as favorable as it seems at first glance.

From a fiscal perspective, however, the Eurozone, Japan and United Kingdom appear better positioned. Based on our framework, the Eurozone is using none (0%) of its fiscal policy capacity at present, a welcome observation given the ECB has limited capacity to ease policy. To be sure, Eurozone fiscal capacity might not be quite as high as these figures suggest for two key reasons. First, debt levels are elevated among some of the region's large economies, and thus the potential for many Eurozone economies to ease fiscal policy may be fairly limited, as exemplified by the ongoing dispute between Italy's government and the European Union over Italy's plans to ramp up stimulus. Moreover, given each country runs fiscal policy independently, there seems to be limited scope for a coordinated fiscal response from the major Eurozone member states, while there may also be an aversion to large-scale fiscal stimulus from some of the region's major economies, such as Germany, that have historically been more hesitant to engage in fiscal stimulus (Figure 3). However, there would likely still be some degree of easing by Eurozone fiscal authorities in the event of recession, particularly if the ECB has little room to provide support. In that context, the apparent challenges faced by Eurozone fiscal authorities in responding to economic recession, in our view, increase the impetus for further normalization from the ECB ahead of the next recession.

High levels of government debt in Japan may be somewhat of a hindrance for Japanese fiscal authorities in easing policy.

Japan's fiscal policy utilization of just 16% suggests the Japanese government has quite a bit of scope to ease policy if a recession hits. Similar to the situation in Europe, this is an important observation in the context of the BoJ's limited scope to ease monetary policy. High levels of government debt in Japan (the debt-to-GDP ratio is nearly 240%) may be somewhat of an obstacle for Japanese fiscal authorities in easing policy. However, the bulk of Japanese government debt is owned by domestic entities, with nearly half owned by the central bank (Figure 4), while long-term bond yields in Japan remain exceptionally low. Accordingly, the Japanese government may feel compelled to push the fiscal envelope and support the economy using fiscal measures in the event of a recession despite already-high debt levels, particularly given BoJ monetary policy constraints.

Figure 3

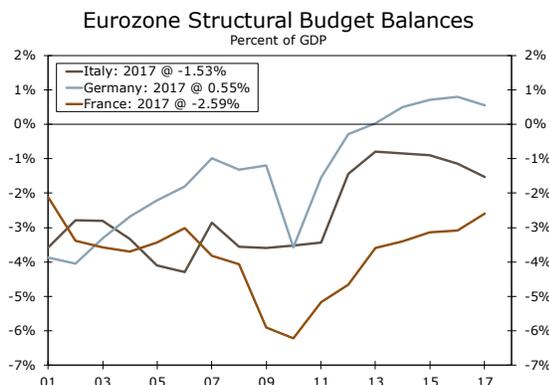
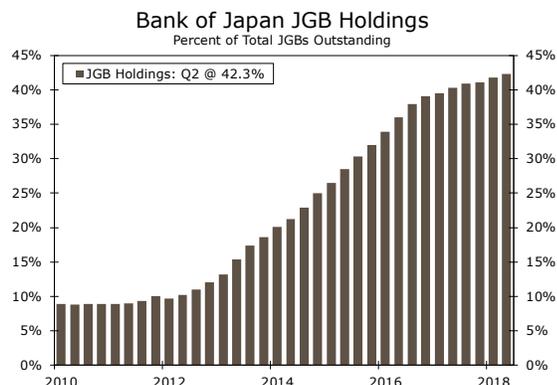


Figure 4



Source: International Monetary Fund, Bloomberg LP and Wells Fargo Securities

U.K. fiscal policy utilization of 32% suggests a fair bit of capacity for growth-supportive fiscal stimulus. Given the Bank of England is already deploying a significant portion of its own policy capacity at present, the U.K. would likely thus resort to fiscal easing if there is a near-term recession, which could become a reality in the worst case “no-deal” Brexit scenario. The U.K. government’s recent budget proposal signaled a shift toward a modest easing bias, suggesting a willingness to move in a more accommodative direction on the fiscal side which would likely only increase if growth slows sharply. Also working in the U.K. government’s favor is a moderate debt-to-GDP ratio which has actually edged lower in recent years (it currently stands just below 90%). Accordingly, U.K. fiscal policy could be relied upon more heavily in the next recession, particularly if the BoE faces challenges in normalizing monetary policy more significantly.

U.K. fiscal policy could be relied upon more heavily in the next recession.

Economic and Market Implications

The fact that most developed economy central banks generally have limited policy capacity to fight the next recession, in our view, has several potential implications. While we have discussed the potential for more reliance on fiscal policy easing, we could also see central banks pushing the boundaries of monetary policy and reducing policy rates to new lows in an effort to support the real economy in the next downturn. More specifically, central banks could increasingly test the zero lower bound and reduce nominal short-term rates into negative territory. That could particularly be the case if the low inflation environment prevailing in most developed economies persists, as central banks will have to cut nominal interest rates even further to achieve a substantial reduction in real interest rates.

The effects of negative interest rates are a subject of debate, but one implication that has drawn attention is the effect on commercial bank profitability.¹ If maintained for an extended period of time, research suggests negative short-term interest rates can erode bank profitability. In Japan and several European countries, commercial bank deposits at the central bank are subject to a negative interest rate, implying that commercial banks must pay the central bank to hold their deposits. Another perhaps more obvious implication of persistent low or negative interest rates is the potential for a greater degree of leverage and risk-taking across sectors of the economy, which could be associated with asset price bubbles. Along those lines, research from the Bank for International Settlements (BIS) discusses the risk of a “debt trap,” as leverage has continued to increase on trend across cycles as interest rates have trended lower, making it harder to raise rates against a backdrop of greater leverage.²

Research suggests negative short-term interest rates can erode bank profitability.

Separately, limited capacity to cut short-term interest rates could lead central banks to again resort to unconventional monetary policy measures such as quantitative easing (QE), which, in our view, would have substantial effects on financial markets and the real economy. One of the channels through which QE was designed to support the economy was by lowering yields and increasing prices of “risk-free” assets, thereby encouraging market participants to make investments in higher-yielding assets. Thus, renewed QE among large developed-market central banks could be more supportive for riskier asset classes. Moreover, it could lead to an even greater degree of central bank ownership of public and private sector assets. In Japan, the central bank already owns nearly half of all outstanding Japanese government bonds. Other central banks, such as the Federal Reserve and ECB, hold much lower shares of total sovereign bonds, but may increase their ownership in the next downturn through new QE purchases, particularly if they are unable to fully roll off their holdings accumulated during prior QE programs. Greater central bank ownership of public and private sector assets could result in more market distortions, particularly in fixed income markets, including compression of term premia and reduced trading activity.

Turning to foreign exchange markets, one possible implication of a sustained period of lower or more negative short-term interest rates is that interest rate differentials across currencies could become more compressed. Research from the BIS has shown that exchange rates tend to display

Interest rate differentials across currencies could become more compressed.

¹ ECB: “Monetary policy and bank profitability in a low interest rate environment.”

<https://www.ecb.europa.eu/pub/pdf/scpwps/ecb.wp2105.en.pdf>

² BIS: “Low inflation and rising global debt: just a coincidence?”

<https://www.bis.org/speeches/sp180802.pdf>

more sensitivity to interest rate changes when interest rates are closer to their effective lower bound.³ If rate differentials are compressed, even slight interest rate changes could have a significant effect on exchange rate movements. Another potential implication for FX markets of limited policy capacity among monetary authorities is that central banks could increasingly focus on the exchange rate as a policy lever to support the real economy. This could be the case in particular for export-reliant economies, such as the Eurozone or Japan, where central banks may enact policies or use verbal tactics to induce downward pressure on, or limit appreciation of, their currencies in an effort to support domestic economic growth.

There could be more reliance on fiscal policy in the next downturn.

In all, we do not view major economies as especially well prepared at present to respond with policy measures to stimulate economic growth in the event of a near-term recession. That is particularly true for central banks, many of which have only just begun the process of monetary policy normalization, and are in general less well-equipped at present to ease policy compared to their level of preparedness before the 2008 crisis. In our view, this suggests there could be more reliance on fiscal policy in the next downturn, while monetary authorities may also push the envelope if fiscal measures prove insufficient. Monetary authorities becoming more aggressive in easing policy could mean sustained periods of low or negative short-term interest rates and more unconventional monetary policy measures such as QE, which could have far-reaching implications for markets and the real economy. More broadly, limited policy capacity among major economies to combat the next recession could leave the global economy vulnerable in the case of an unexpected downturn.

³ BIS: “Monetary policy’s rising FX impact in the era of ultra-low rates.”
<https://www.bis.org/publ/work626.pdf>

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