Mission Ambition

How mission-oriented policies could shift the economic regime

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Summary

Ideas matter. But with fiscal austerity now a cautionary tale and the neoliberal consensus in tatters, what economic ideas can guide policy-making in the post-covid world? Enter *mission economics*, and a shift to greater fiscal activism as policy-makers seek to deliver green, sustainable, and socially-inclusive growth for their electorates. But the application of mission-thinking will have profound implications for the economic regime. Secular stagnation, the defining feature of the macro-economy for the last decade, is challenged. And capital market assumptions need to adjust lower to reflect both higher valuations and more inflation risk.

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1. Introduction: the power of ideas

"the ideas of economists and political philosophers, both when they are right and when they are wrong, are more powerful than is commonly understood. Indeed the world is ruled by little else."

Keynes, *The General Theory of Employment, Interest and Money*, Ch 24

Keynes's poetic conclusion to *The General Theory* reminds us how ideas can have profound consequences for social welfare. But unlike in the physical sciences, economic ideas don't hold universally over different time periods. Instead, ideas are time-dependent and context-specific in the social sciences because of the complex ways in which behaviour adapts, expectations change, and institutional structures evolve. Keynes' ideas about the economy, for example, were of little use in the high-inflation environment of the 1970s. Or consider the parable of the *Keynesian apple*, which stubbornly refuses to fall from the branch!

Clearly, we need to avoid the wrong ideas. But, ex ante, that is easier said than done. We don't need to look back too far into the history of macro-economics to find a cautionary tale.

The pursuit of *austerity politics* in the aftermath of the 2007/8 financial crisis defined the economic and market environment for a decade. The ideas of economists like Alesina, Reinhart, and Rogoff inspired a world view which said that debt-thresholds act as biting constraints on the economy, that crossing those thresholds inevitably results in material drags on GDP, and that rapid fiscal repair inspires confidence and allows the private sector to drive-on economic recovery. This framework works well in some historic cases, and may even be appropriate for some emerging economies today, but it was a social disaster in western economies during the 2010s. Expansionary austerity, endorsed by the IMF, led to western economies experiencing glacially-slow economic recoveries, undershooting inflation goals, and over-relying on loose monetary policy that fostered rising inequality.

As we exit the covid shock, we can't afford to make the same mistakes again. Luckily, the timing of the global pandemic, occurring as it did just over ten years after the global financial crisis, meant that the lessons of the 2010s were fresh in policy makers' thinking just as covid struck.

In a matter of weeks in 2020, policy-makers in the US and Europe delivered a fiscal and monetary response bigger than what had taken months in the US and years in Europe after the GFC. The slow, jobless recovery of 2010s was replaced with a recovery so fast that GDP is already above pre-covid levels in the US, China and industrial Asia, and the NBER has timed the US recession only 2 months long.

Evidently, the nature of the covid shock as an *exogenous event* sets it apart from the *endogenous*, complex crisis in 2007/8. But a defining difference is also the speed and scale of the policy response, and an apparent unwillingness among politicians to turn back to austerity or fiscal passivity.

Economic ideas were already in significant flux, even before the S&P500 began the process of losing one-third of its market value in Q1 2020. The neoliberal orthodoxy, which was at the centre of mainstream economics in the 1990s, was in tatters. Of the ten universally-agreed development policies inscribed in the *Washington Consensus*, only a couple survive the scrutiny of present-day economists.[2]

As covid struck, economists agreed on what they didn't believe in, but were perhaps less clear on what they *did* believe in. So while central bankers rolled-out their Bernanke/Draghi playbooks, and politicians reached for the fiscal lever, a broad macro-economic framework was lacking and economists involved themselves in esoteric, irrelevant debates[3]. Did modern economists have anything useful to say?

We arrive at the current juncture, with many old economic ideas not fit for purpose, with confidence in fiscal policy building, and politicians targeting some fiendishly-complex public policy problems. A new idea of the *mission economy* is coming to the fore. But what does that mean? And what are its consequences for the macro-economy?

2. What is the mission economy?

The idea of the mission economy comes from the research work of Mariana Mazzucato, who argues that western societies need to adopt more fiscal activism, with a purpose. This is not just a

[2] The *Washington Consensus* was coined by John Williamson in the late 1980s to reflect 10 development policies that would be universally-agreed and could be applied to reform emerging economies. The policies reflect a strong pro-market political agenda, including: fiscal discipline, financial liberalisation, privatisation and deregulation.

[3] Macro-economists, for example, spent months after covid hit debating whether it was a demand-side shock or a supply-side shock. An irrelevant issue in the middle of the crisis. Another example would be the lack of research on counter-cyclical policy design prior to the crisis – a big gap in research. There are numerous examples.

Keynesian big government agenda. Mazzucato advocates counter-cyclical fiscal policy combined with purposeful, state-led action to protect our *"earthly oasis"*:

"Doing capitalism differently requires reimagining the full potential of a public sector driven by public purpose … These considerations make it necessary to go beyond the usual dichotomy between those advocating austerity and those who argue that low interest rates and low demand require investment by any means necessary. … Keynes was absolutely right to insist on counter-cyclical government investment, what mission-oriented policies add is the imagination necessary to decide where and how to invest, regardless of the business cycle."

This is big thinking, but what does it really mean? There are so many challenges that could be cast in these terms, the idea could almost be all-encompassing. But Mazzucato hardens the target for us by focussing on the missions defined in the UN's list of Sustainable Development Goals. These are shown in figure 1, and represent seventeen of the world's greatest problems that the UN wants to address by 2030.

Fig 1 – UN Sustainable Development Goals

Source: UN SDGs [*THE 17 GOALS | Sustainable Development (un.org)*]

Mazzucato refers to the UN goals as *"wicked problems"*, given their complexity and need for holistic, multi-disciplinary thinking, as well as the involvement of *both the state and the private sector*. As you look through the list of goals – ending poverty, cleaning the oceans, gender equity – it's hard to imagine a more important set of priorities for today.

3. Practical aspects of the mission economy

Around the world, politicians are embracing the idea of a more active role for the state. The mission economy, as it gains traction as an economic idea, provides an intellectual veneer and an incomplete framework. But the rapid economic recovery from covid has emboldened politicians. As has a desire to capitalise on the climate change and sustainability *zeitgeist* ahead of COP26.

3.1 How much mission-ness will we get?

The US is probably at the vanguard of putting mission ideas into practice. The crisis-fighting fiscal measures (CARES act, December 2020 stimulus and President Biden's American Rescue Plan) are being followed-up by President Biden's *Build Back Better* agenda - the American Jobs Plan, the Families Plan, and the Bipartisan Infrastructure Framework, with further measures potentially to come. As Treasury Secretary Yellen has made clear, "*these policies will promote a dynamic economy with greater opportunity for workers, higher living standards, and, over time, reduced inequality"*.

Europe has also taken significant fiscal strides and, of course, benefits from a stronger starting point in terms of its welfare state. The new €800bn NextGenEU plan, with its centrepiece Recovery and Resilience Facility, provides loans and grants to EU countries both to address the economic and social impacts of covid, as well as to sponsor green and digital transitions.

In China, the 14th Five Year Plan (2021-25) has also championed more balanced and sustainable growth, with a significant focus on innovation and digitalisation. The policy agenda also emphasises improving the social safety net, enhancing domestic growth (so-called *internal circulation*), and achieving carbon neutrality by 2060.

The tone from policymakers is ambitious and optimistic. But there are, naturally, lingering questions about how much of the fiscal plans will actually be delivered, and whether that will be done in a timely way. It would be naïve to assume smooth sailing, however the fiscal track-record during the covid crisis has been impressive so far. Maybe we should begin to believe some of the fiscal good news?

However, outside of China, few of the major economies have a strong track record in terms of state activism. The US, for example, is hampered by a lack of political consensus, which could consign us to a repeat of the fiscal passivity under President Obama's second term. In Europe, the need to co-ordinate between the EU and the member states creates a version of the *principal/agent problem*. The EU raises the NGEU funds, but member states distribute them. Do the new funds just replace monies that would've been spent anyway? And what happens to the EU's fiscal framework? And how should we assess fiscal multiplies and value-for-money? There are many unanswered practical questions.

3.2 Can we afford the mission economy?

Perhaps the biggest macro-economic question remains around affordability. Based on IMF forecasts, advanced economy debt ratios are set to remain above 120% of GDP from 2021 through to 2030. That implies an assumption of no return to austerity and also that future mission policies will either be self-funded (e.g. using taxes), or will leverage and *crowd-in* resources from the private sector (a specific objective of COP26).

Debt ratios at 120% are enough to make a Keynesian blush. And even though Reinhart and Rogoff's research on debt thresholds has long been discredited, there are still reasonable questions about how much fiscal space we have left.

Modern economists understand that debt ratios are very flawed yardsticks. They embed an error of construction by comparing a stock variable (debt) with a flow variable (GDP). Instead, our assessment of debt sustainability should compare stock-to-stock ratios (i.e. debt versus the present value of future GDP), or flow-to-flow ratios (i.e. interest expense).

For advanced economies, figure 2 shows a scenario of *rising debt ratios*, but *falling interest expense*. The obvious conclusion is that debt sustainability looks different if prevailing interest rates are at 1%, or at 5%.

If advanced economy interest rates stay low, then the lead indicator is Japan (with its 200% debt/GDP and zero yielding JGBs). Advanced economies have much more fiscal room than we could have ever assumed ten years ago. Meanwhile, the situation looks more complicated for emerging economies.

Fig 2- DM debt & interest expense

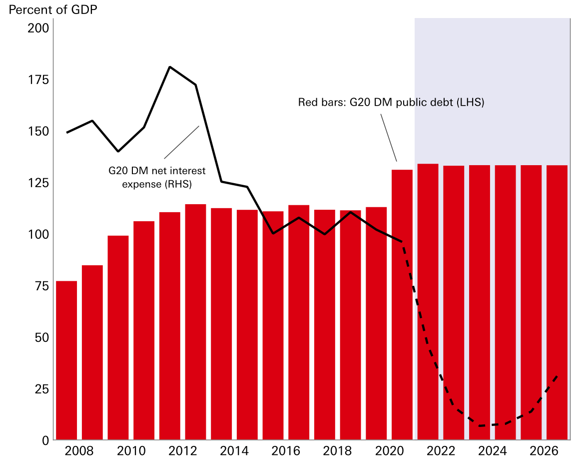
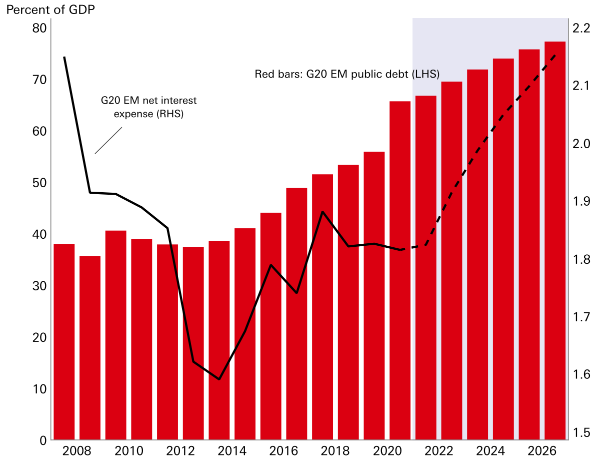


Fig 3 - EM debt & interest expense



Source: Macrobond, IMF, HSBC Asset Management

3.2 Some pleasant fiscal arithmetic

To formalise this important idea, I make a brief digression to refer to the basic debt arithmetic equation:

$$d_t = \frac{(1+r)}{(1+g)} d_{t-1} - s_t$$

Today's debt ratio (*d*) is determined by the relationship between interest rates (*r*) and growth (*g*), lagged debt, and the primary surplus (*s*). Some simple manipulation of this relationship for a stable debt ratio (i.e. $d_t = d_{t-1}$), yields:

$$s_t = \frac{(r-g)}{(1+g)} d$$

That means that *policy-makers can run primary deficits and still keep debt ratios constant, if interest rates remain below growth rates.*

Mission politics relies on some deficit financing. The NGEU programme is explicitly financed by debt issuance. And even Mr Biden's fully-funded spending plans require short-term deficit financing (e.g. the Job and Families plans add about 1% to the deficit over the next decade, taking it to c 5%). That means that *the persistence of $r < g$ is the critical economic assumption* that balances the fiscal arithmetic and facilitates the pursuit of mission policies.

3. Economic consequences of the mission

Of course, the success of mission economics should be judged by the solutions we can collectively muster to the *"wicked problems"* in figure 1. Success is *not* defined by making the debt arithmetic work! But economists do have an important social responsibility to ensure that, as mission policies are pursued, the system is steered responsibly and can navigate the risks.

3.1 Secular stagnation is not inevitable

For more than a decade, the global macro-economy has been stuck in an era of *secular stagnation*; a combination of a rising propensity to save and a falling desire to invest. The resulting *excess savings* have dragged down growth, reduced inflation, and pushed real interest rates lower.

Consequently, the secular stagnationists, primus inter pares Larry Summers, describe modern economies as having a *savings absorption problem*. How, they wonder, can the system absorb all of the excess savings without creating asset price bubbles?

A globally-synchronised uptick in investment spending, implicit in the mission economy plans, would therefore be an important moment for the macro-economy. It could address the core driver of secular stagnation, and shift the economy from its current sub-par equilibrium.

3.2 The megatrend of low interest rates

But the possibility of that transition depends on how much of the secular trends, such as the decline in interest rates, reflects bad policy and the legacy effects of austerity, and how much other factors are involved.

Figure 4 reminds us that low interest rates is a mega-trend, with the 1970s (not the present) looking like the anomaly. Some studies suggest the low interest rates has 500 years of momentum behind it[4]. And when we look at cross-country data (figure 5) there is no sign of *crowding-out* anywhere in advanced economies.

[4] Schmelzing (2020) shows how global real interest rates have been on a declining trend since the 14th century.

Fig 4 – long term UK bond yields

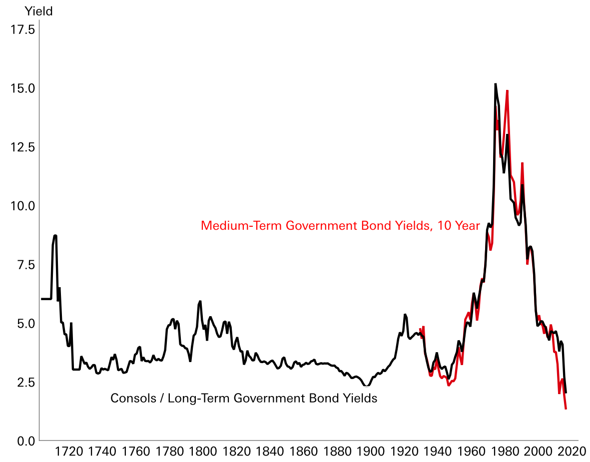
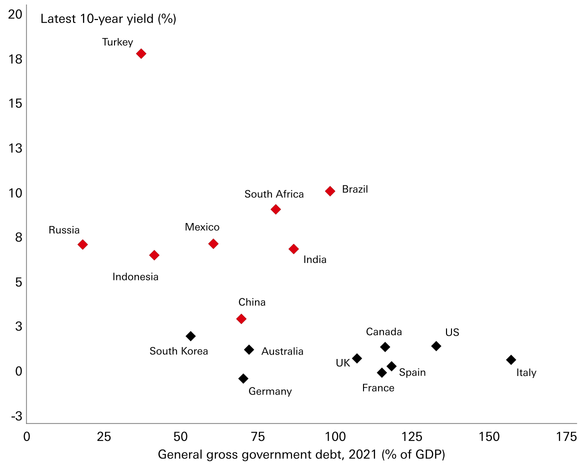


Fig 5 – G20 debt ratio versus 10y bond yields



Source: Macrobond, HSBC Asset Management

We can boil-down the low interest rate mega-trend to eight fundamental drivers[5]:

(i) demographics and cross country convergence increases global savings;

(ii) worker bargaining power over wages remains limited;

(iii) pace of technological progress remains slow at frontier;

(iv) diminished risk appetite from private investors raise safe asset demand;

(v) repeated inflation undershoots anchor inflation expectations;

(vi) rates in the US, and to a lesser degree in China and the euro area, lower the floor for others;

(vii) stability of government regimes is high if not increasing;

(viii) lower level of taxes and foreign currency debt make consolidation feasible if necessary.

Which of these forces weaken as the mission economy is rolled-out? Most of the trends look highly persistent. Under mission politics, we should expect some excess savings to be absorbed, but the regime of historically-low interest rates (broadly-speaking) to persist.

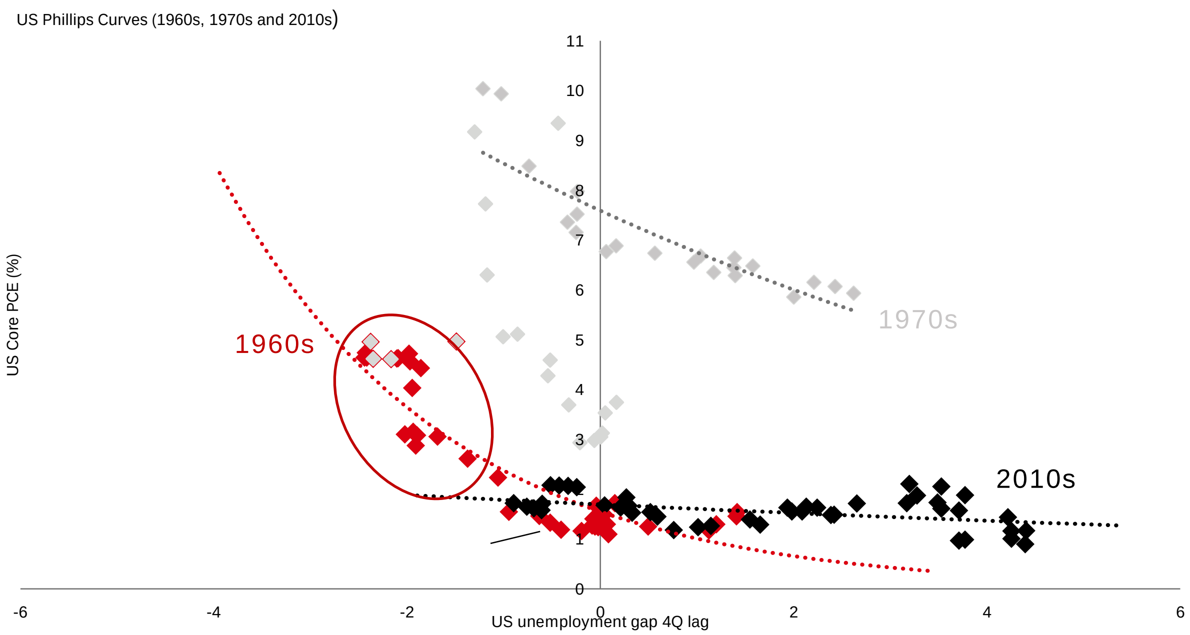
[5] The list of economic driver variables is from Adam Posen's excellent 2021 speech.

3.3 Economists should follow *the stars*

In a famous speech, Fed Chair Powell referred to the structural parameters of the economy as *stars*. There is *rstar* (the equilibrium interest rate), *ustar* (the natural rate of unemployment) and *pi star* (the inflation objective). As the mission economy rolls-out, an important task for economists is to *follow these stars* and track if they change.

We know that even if *rstar* rises significantly from current levels, the term structure of interest rates would still be meaningfully below plausible growth rates (even assuming no productivity boom from mission investments). That means we should have clear margin of safety in the fiscal arithmetic for now. But the stakes are high; small shifts in the relationship between *r* and *g* can have big consequences when debt ratios are so large.

Fig 6 – The modern US Phillips Curve has flattened considerably since the 1960s and 1970s



Source: Macrobond, HSBC Asset Management

For *pi star* and *u star*, there is little to suggest that the flat Phillips Curve relationship that prevailed pre-covid has changed. It takes more than one year's worth of rapid recovery and deficit spending to create the multi-year persistent positive output gaps that presaged the Great Inflation of the 1970s.

Economists' workhorse inflation model remains the *expectations-augmented Phillips Curve* which puts economic slack and inflation at the centre of the inflation determination process. But there is new evidence that modern Phillips Curves may be *hyper-Keynesian*, with the state of household and business expectations taking primacy.

Greater fiscal activism inevitably creates concerns of more inflation risk in the medium-term. But it's important to recognise that the propagation mechanism for this is through the *expectations channel*, rather than the old Keynesian hydraulics. That means that the credibility of policy-makers is the determining variable.

For now, there is little reason to doubt that central banks' inflation credibility won't hold. However, the shift in Fed and ECB policy frameworks does imply higher inflation over the next decade. The inflation future might look more like the late 1990s, with 2-3% inflation as the medium term norm.

A flat Phillips Curve also opens the door to policy experimentation, co-ordinated between fiscal and monetary authorities. Mrs Yellen famously talked about the *high pressure economy* when she was Fed Chair. Especially in the US, we should expect to see a greater use of automatic stabilisers to mitigate future unemployment spikes too. European labour markets were much less volatile through the covid shock, as employee/employer relationships were protected by furlough and *kurzarbeit* programmes. Recent US fiscal initiatives have also sought to recognise the *care economy* and support labour supply.

These policies are aimed at achieving a *reverse hysteresis* to push *ustar* lower. The risk for economists to monitor will be how sticky those inflation expectations prove to be in practice.

3.4 Could there be a squeeze on corporate profits?

Mission economics requires us to remember that nature sits alongside capital and labour in the production function. Each of those factors of production should command a pay-off (a factor reward). But in recent decades, the reward to capital has been out-sized (figures 7 & 8). Increasingly, this trend looks incongruous in the mission economy.

Elevated profit margins could face a mean-reversion. First, from heightened regulatory scrutiny and higher taxes - either as directly-applied mission principles (see figure 1), or as a politically-expedient means to fund fiscal activism. Second, due to rising wages as policy-makers experiment with hot labour markets and policy design. And third, as natural capital receives an appreciating market price, forcing firms to recognise the true costs of production.

This doesn't necessarily mean a war on the profit share, or paint a very bearish picture for stocks. Simply that we should expect corporate profit margins closer to historic norms going-forward. That may, in turn, act as a cap on animal spirits and stock market exuberance.

Fig 7 – US profit and labour share % GDP

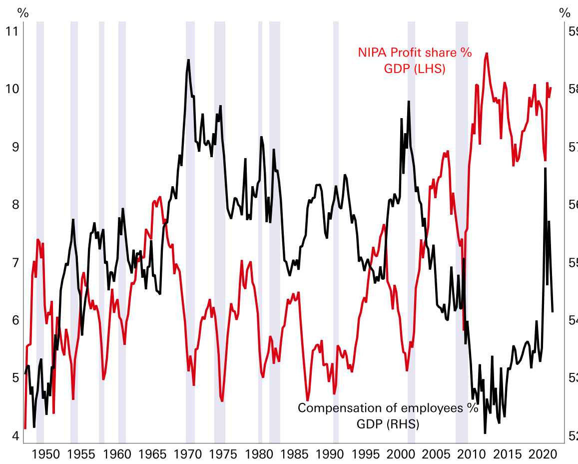
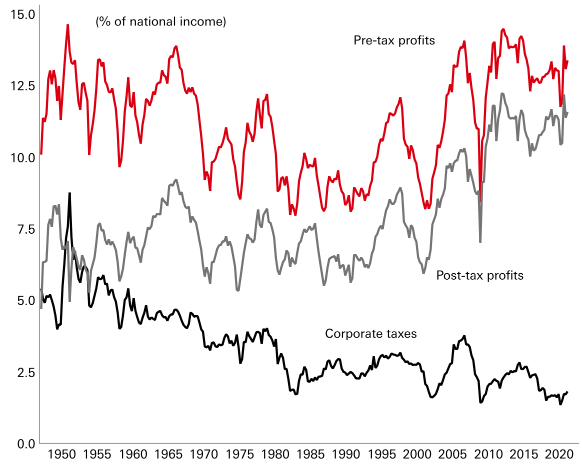


Fig 8 – US profit shares and corporate tax rates



Source: Macrobond, HSBC Asset Management

3.5 Asset class expected returns are lower for longer

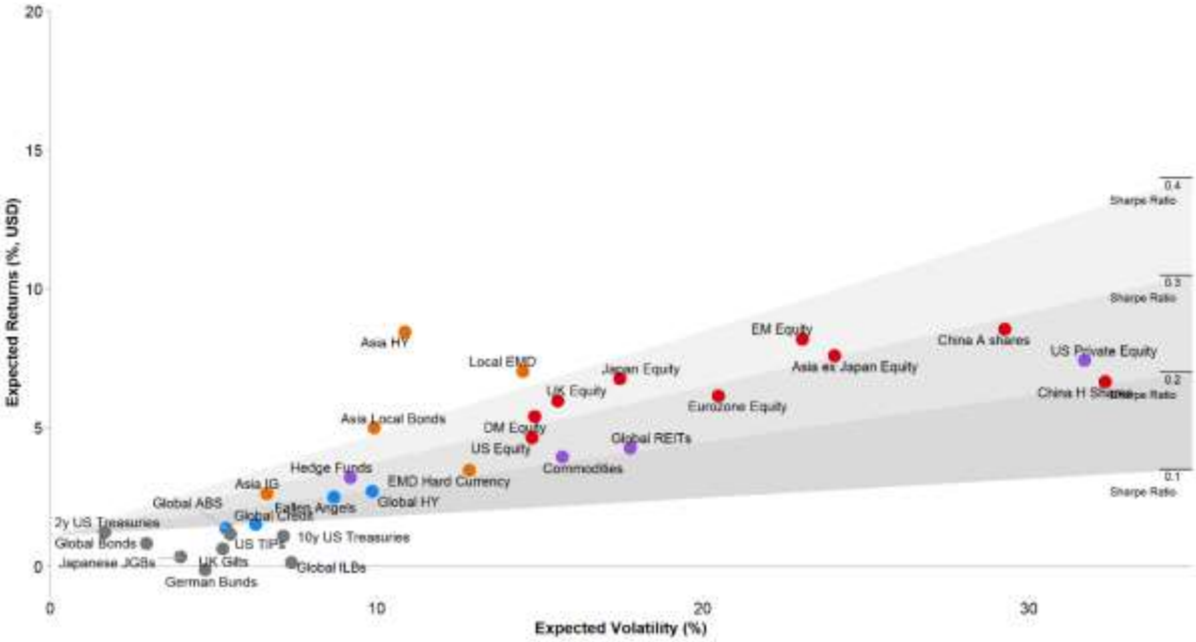
The confluence of issues above implies that mission economics will have profound implications for capital market assumptions too.

The first important aspect is again in terms of the discount rate. Despite more fiscal activism, a regime of historically-low interest rates seems set to prevail. Co-ordinated fiscal and monetary policy means that we should expect a de facto *financial repression,* and persistently-negative real interest rates.

Second, that sets the tone for capital market expectations right across the risk curve. Asset class expected returns (figure 10) are built-up by combining the scenario for low interest rates with an assessment of market-implied risk premia. But implied risk premia also look low today – they are negative in long-term bonds, thin in credits, and below normal in global equities. As markets have rallied post-covid, risk has been re-priced and risk premia are now much lower than normal.

Altogether, it means that the capital market line is *lower and flatter* that we might typically assume. And this occurs at a point in time when inflation risk is rising. It means that investors need to accept the reality of lower prospective investment returns. Or they need to shift their strategic asset allocations to new asset classes, outside of the conventional opportunity set. Institutional investor market trends demonstrably favour the latter.

Fig 10 – Asset class expected returns (market implied risk premia) in USD terms

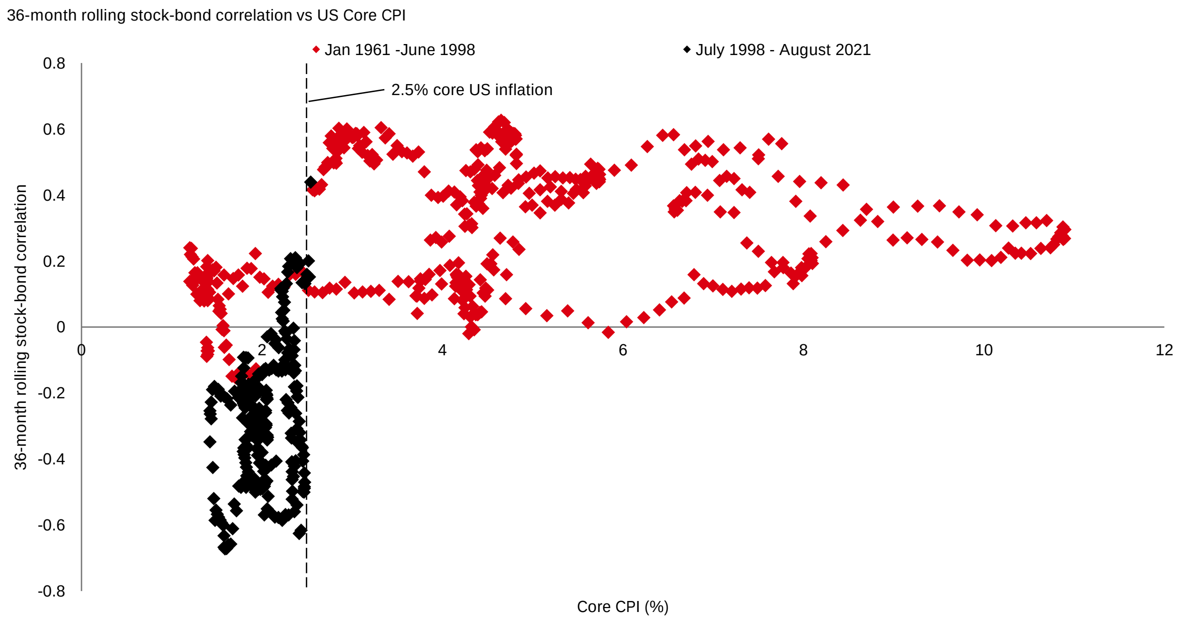


Source: HSBC Asset Management

The third important implication for capital market assumptions is in terms of the future role government bonds will play in investment portfolios. As inflation risks rise and fiscal activism replaces monetary dominance, the stock/bond correlation looks set to change (figure 11).

Bonds have been a cheap and reliable hedge for investors over the last decade, but the new environment of the mission economy could change that. Consequently, investors will need to work harder to secure portfolio diversification and resilience.

Fig 11 – Stock/bond correlations will shift with the inflation regime



Source: Macrobond, HSBC Asset Management

4. Conclusion: Mission ambition, but will it live up to the hype?

At the end of *The General Theory*, Keynes asks whether all of it is *"just a visionary hope?"*. We might ask the same about the mission economy. Policy-makers are clearly ambitious, and are motivated to tackle the problems of climate change and social inclusion in the biggest way of my lifetime. But there are many uncertainties. Keynes, for one, feared that *"vested interests"* would slow-down the acceptance of his own ideas. That warning should be heeded, although I suspect there is already sufficient momentum to drive the mission agenda forward.

Ultimately, it is ideas that matter. And the debacle of *expansionary austerity* reminds us that the wrong ideas can do social damage. Economists should feel able to hold new ideas, like *the mission economy*, to account, and to carefully think through consequences and risks. But we cannot afford to be wedded to outdated ideas about how the economic system works. Above all, we shouldn't be afraid of endorsing good ideas when we see them.

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