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Malign or benign? Two paths for government and economy post-crisis

What did we used to talk, write or read about before COVID-19?

We have heard that the response is too little, too late or conversely, that it is too onerous.

We've also heard that the virus will mean the death of global capitalism or that the episode demonstrates the desirability of a stronger and more assertive role for government.

The virus has wrought calls for bold and innovative macroeconomic policies (think massive government spending, QE infinity or monetary financing of budget deficits – modern monetary theory in its most extreme form).

There are, however, kernels of sense in much of this policy action, including the fiscal efforts of all governments here in Australia, and subsequent analysis. But some of it is also downright crazy.

In one of the more thoughtful commentaries on the crisis, *The Economist* notes that it is no accident that the state grows in crises. That is unavoidable because only governments can coerce and mobilise the vast resources as rapidly as necessary to confront a crisis like a pandemic.

However, previous episodes of crisis have seen the expansion of government's role in the economy take on a permanent hue.

In some areas of economic activity that is not a bad thing. Arguably, one thing that governments should have been focused on was more adequate preparation for a pandemic. As laudable as some of the responses of global policy authorities may have ultimately been, their implementation has been far from smooth, reflecting a lack of preparedness.

The current crisis should also be a reminder that it is perhaps a good idea to aim for budget balance or even surplus in normal times.

Australia, for example, is fortunate that its low public debt-to-GDP ratio has given us a lot of room for massive government spending to get the country through this period of cryogenic suspension. Our past and current governments, in general, have been quite good at being guardians against public spending excess. Other countries are less well placed.

But just as governments have a lot to think about to manage the current crisis, including a policy exit strategy, so do investors.

Unusual dimensions

The nature of government and central bank engagement in the economy going forward is tricky.

It can be benign. In other words, learning the appropriate lessons from the pandemic to prepare for future crises, at the same time as withdrawing from areas of the economy no longer in need of support as the case for draconian lockdown measures recede and the world returns to business as usual.

In this circumstance, fiscal and monetary support are withdrawn judiciously, bond yields stay low and equities bounce back, either sharply, if countries are successful in navigating the worse of the pandemic by say the end of the third quarter this year, or more haphazardly if we are not.

Moreover, conventional relationships between financial asset prices (quality versus risk) assert themselves more readily.

One unusual dimension of the current crisis has been the episodic indifferent performance of high-quality assets – gold, low-duration high-quality securitised debt, even government bonds prior to the re-ramping of QE.

Or, it can be malign. In this circumstance, controls over prices and wages persist, temporary emergency government spending is not withdrawn and becomes mostly money financed (i.e. MMT), governments retreat to autarkic protectionist policies and industries are nationalised in the interests of supporting national champions.

In other words, the world retreats to the dreary, cumbersome, rigid mixed economy capitalism that characterised the stagflationary 1970s. This time around, however, it is potentially with even more unsavoury societal dimensions that include intrusive surveillance, lack of protections around data privacy and increasing restrictions on the movement of people.

In this scenario, the inflation genie gets out of the bottle, economic growth languishes, equities and bonds (other than inflation-linked) do poorly while clever hedge funds (where they exist) do well.

Or it can be a mix of benign and malign scenarios.

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