

Gridlock itself is not the problem

Anatole Kaletsky | GaveKal | 12 November 2014

The votes are in and the result is yet more gridlock in Washington. For the US, there is nothing unusual in this situation. Presidents have been opposed by both houses of Congress in 32 out of the 70 years since WWII, and opposed by one house in another 14 years. However, political paralysis is becoming the norm in many democracies, especially in Europe. An important question is therefore how different countries and regions can cope with political gridlock.

The answer depends on whether big reforms are needed to achieve acceptable economic and social outcomes, or whether public policy is already well positioned, in which case political gridlock is fine. Differing conditions today in the US, Europe and Japan exemplify this contrast.

For the US, gridlock is not a problem. In fact, another two years of Washington paralysis may be just what the doctor ordered, at least from an economic standpoint. In an ideal world, Washington could do many things to improve the US economic and social environment. The US tax structure could be reformed, immigration rules rationalised, trade deals negotiated and approved, wasteful health spending curbed and the many other dysfunctions of US society either fixed or ameliorated. But, in a democracy so deeply divided, it is probably appropriate, as well as inevitable, that reforms in these areas must await more consensus.

Some economically significant objectives may even be advanced by the election outcome. Republican Senators have generally been much more moderate and willing to strike deals with the White House than their House colleagues. And now that their party is in full control of the Congress, the Republicans need to show their ability to govern and not just to oppose, especially with the 2016 Presidential election approaching. The implication should be a more responsible attitude to politics and an end to such economic sabotage as last year's debt ceiling confrontation and government shut-down. The first test of this new attitude will come in mid-December, when Congress is supposed to pass 2015 spending bills, with a second, more important, milestone next March, when the Treasury debt ceiling will need to be raised.

More generally, both parties are now eager not to do any damage to an economic recovery that is gradually accelerating and becoming more sustainable. As a result, US macroeconomic policy is almost certain to be unaffected by the election outcome. The federal budget is in good shape, as confirmed by the unprecedented reduction of the deficit announced this week by the Congressional Budget Office. As for monetary policy, there is unlikely to be any need for major changes in the next year or two – and, if unexpected

events call for a monetary response, the Federal Reserve will be able to take action it deems necessary without regard to the election outcome, since Washington gridlock guarantees the Fed a level of independence that other central banks can only dream of.

The situation in Europe and Japan is very different, as they both desperately need radical reforms in monetary, fiscal and structural policies.

In Japan, such reforms were impossible for almost 20 years until the election of a strong government in December 2012 under Shinzo Abe. Abe's "Three Arrows" program of monetary, fiscal and structural reflation started to transform the Japanese economy last year but got paralysed by the inter-ministerial bureaucratic conflict which is Japan's equivalent of US partisan gridlock. Last week, however, the Abe program was unexpectedly and dramatically revived with a further big monetary stimulus from the Bank of Japan and a huge stock market boost from the \$1trn Government Pension Investment Fund – actions only possible under a strong government with a clear sense of purpose.

If the euro is to survive in the long-term, Europe needs coordinated reforms comparable to Japan's Three Arrows program. The misguided fiscal rules, written into the Maastricht treaty in 1989 and then aggravated under German pressure in the 2012 euro crisis, will have to be rewritten by European governments. The European Central Bank will have to follow the Fed, Bank of Japan and Bank of England in vastly expanding its balance sheet by buying government bonds, despite concerted opposition from Germany. The ECB, despite the strict political independence theoretically guaranteed by the EU treaties, has in practice shown itself to be much more subservient to politicians than the Fed or even the BoJ. In fact, the ECB has recently been frozen like a rabbit in the headlights of German politics over the issue of its balance sheet expansion.

National politicians in France, Italy and Spain must also adopt tough structural reforms that can only be implemented and made to work with the help of aggressive fiscal and monetary expansion. Unfortunately, there seem to be no European politicians able or willing to take controversial monetary, fiscal and structural decisions. Gridlock may be perfectly acceptable in Washington these days – but Europe, like Japan, now badly needs strong political leadership.



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