All Signal, No Noise

MARKET ANALYSIS

MNI Macro Deep Dive: May 2022

Global Fiscal Tightening Slows, But US Bucks the Trend

By Chris Harrison and Tim Cooper

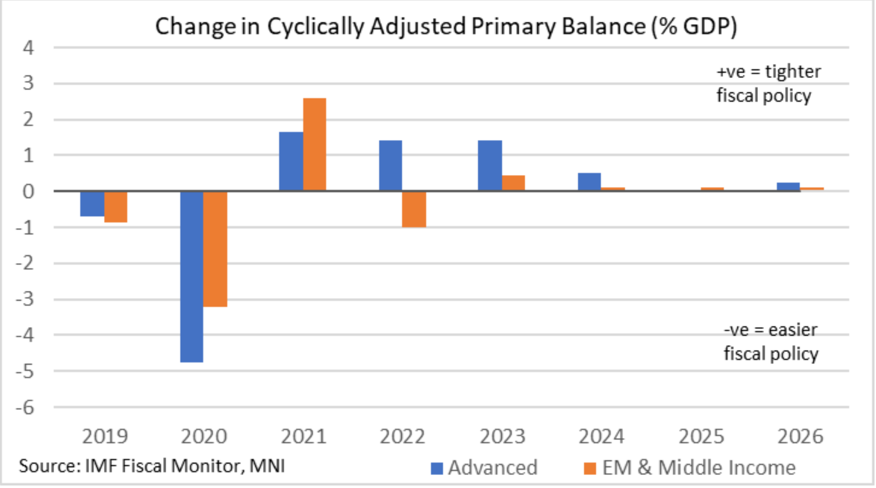
Executive Summary

- Slowdown in global fiscal consolidation will provide a small boost to global growth overall, but there is significant variation in country-by-country dynamics.
- The US and UK are among the most notable tightening stories, while Eurozone and Japanese policy is relatively less restrictive.
- Fiscal restraint in emerging markets is more limited, with Chinese loosening set to reverse prior tightening.
- Tighter fiscal policy may be a factor in government bond yield dynamics, with the flattest curves also happening to be those expected to see the largest cumulative tightening over 2022-23.

Post-Pandemic Consolidation

There are three main reasons behind fiscal tightening following the huge deficits racked up by governments in 2020-21. Firstly, a reversal of pandemic-related deficits (lower stimulus spending and a recovery in revenues), secondly, rising interest rates forcing a reconsideration of spending constraints; and lastly soaring inflation resulting in limited political appetite for further stimulus. While a reversal of pandemic spending is driving most of the current consolidation, ripping inflation is restraining US fiscal policy in particular, and rising rates are set to become an increasingly pertinent issue over the longer term.

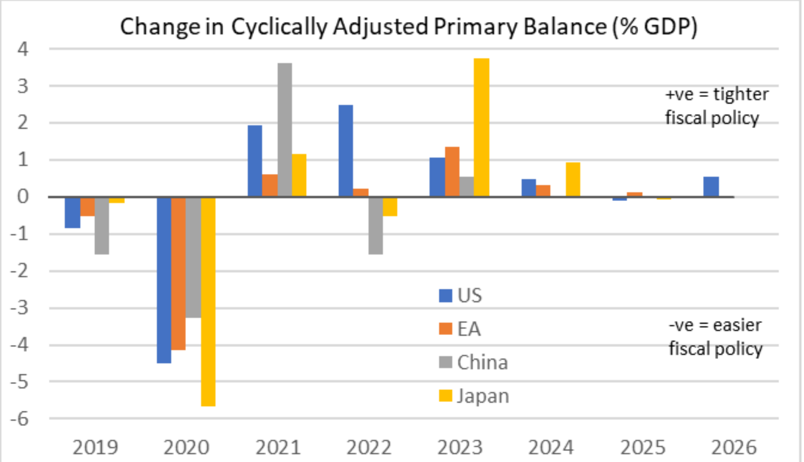
In the immediate future, Developed Markets (DM) fiscal policy is projected to be on a consistent path of solid tightening, with a similar pace in both 2022 and 2023 to what was seen in 2021. Whilst a drag, it in theory will have relatively little *additional* impact on growth. Instead, the net ease from a global perspective comes from Emerging Markets (EM) - with each region roughly having 50/50 weighing - where fiscal policy has swung back to being supportive before mildly re-tightening next year.



We use the change in the IMF's latest estimates for the cyclically adjusted primary balances as a fiscal impulse proxy, specifically from the April 2022 Fiscal Monitor. It doesn't include multipliers, which would give a truer idea of growth impact, but still gives a good indication of how fiscal policy is changing given different stages of economic cycles.

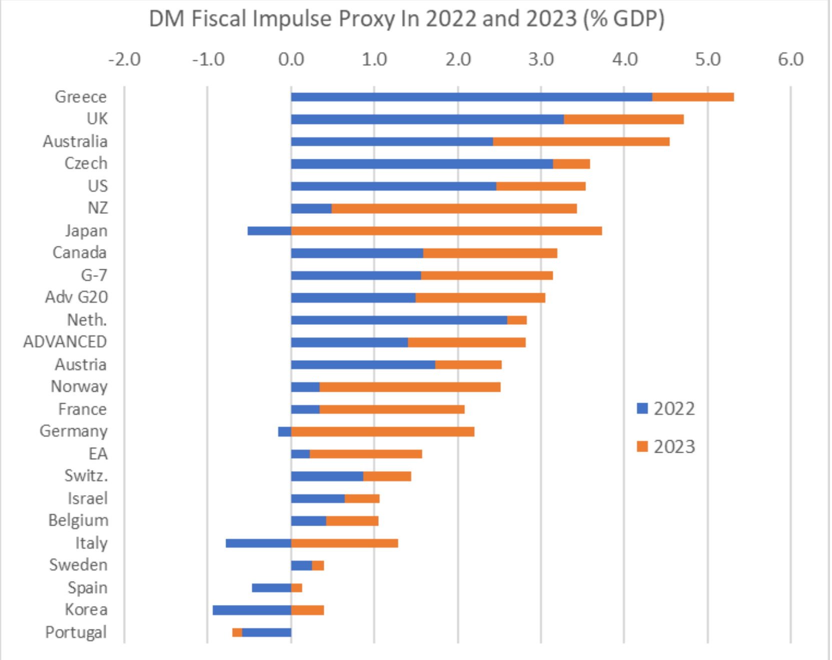
Significant Differences Between Major Economies

However, there's no one-size fits all with fiscal policy, with sizeable differences across major economies from year-to-year. The US is the most consistent, seen on course for slightly faster tightening this year, but is being offset by reduced tightening in the Eurozone plus a small easing in Japan as tighter policies are delayed for 2023, particularly notably in the case of Japan. China drives the EM aggregate, seen on track to ease policy by 1.5% GDP in what's a significant relative loosening after the 3.5%/GDP tightening last year.



Source: IMF Fiscal Monitor, MNI

The differences are more extreme when looking at a wider array of countries. Switching to cumulative tightening in 2022 and 2023 rather than changes in tightening for ease over a large cross-section, we find the following notable observations:



Source: IMF Fiscal Monitor, MNI.
Fiscal impulse defined as change in cyclically adjusted primary balance - i.e. it doesn't include multipliers.

- In the **US,** fiscal policy has arguably been overlooked as a factor restraining economic activity, with Fed tightening receiving much more attention. Fiscal tightening looks set to run on autopilot for the foreseeable future, as direct transfers to households in 2020 and 2021 reverse, and political appetite for further stimulus is basically nonexistent given that inflation has become the top issue for voters ahead of November elections.

- Unlike in many countries, particularly in Europe, US households are "on their own" in facing higher costs. While the growth impact from fiscal tightening will be mitigated by enormous savings built up over the pandemic period, and labor incomes are robust, there are rising headwinds from soaring interest rates and the negative wealth effect from lower financial asset prices. The fiscal drag is clearly visible in the national sector accounts (**see chart to the right**), with household and business surpluses shrinking and government net borrowing returning to more normal levels. Treasury posted a record surplus in April amid bumper tax collections.

- With measures including tax hikes, the **UK** is set for the second largest tightening of the DMs, formed of more than 3pps of GDP in 2022 and a further 1.5pp in 2023. This chimes well with the weak BoE growth forecasts for 2023-24. Some of this will however have been unwound by Chancellor Sunak's latest "cost of living" package which was both larger and more targeted than expected.

- **Eurozone** members tend to significantly lag the tightening in other DMs. Where they are seen tightening, it's mainly in 2023, which in turn is at risk with deficit rules set to be suspended for another year, Next Generation EU support financed by the common EU budget helping underpin member state spending, and programs to limit the impact of higher energy prices on households. Indeed, much of the positive impact of energy-related transfers to households is merely to offset the big drag from higher commodity prices so the overall growth impact will be muted at best.

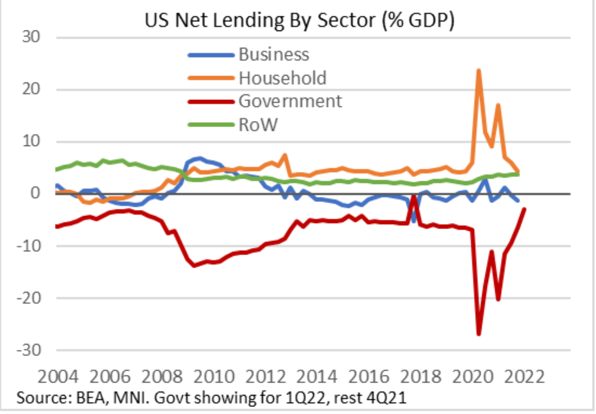
- **Greece** stands out for being on track for the most aggressive tightening, in contrast to minimal tightening and/or outright easing in Italy, Spain and Portugal.

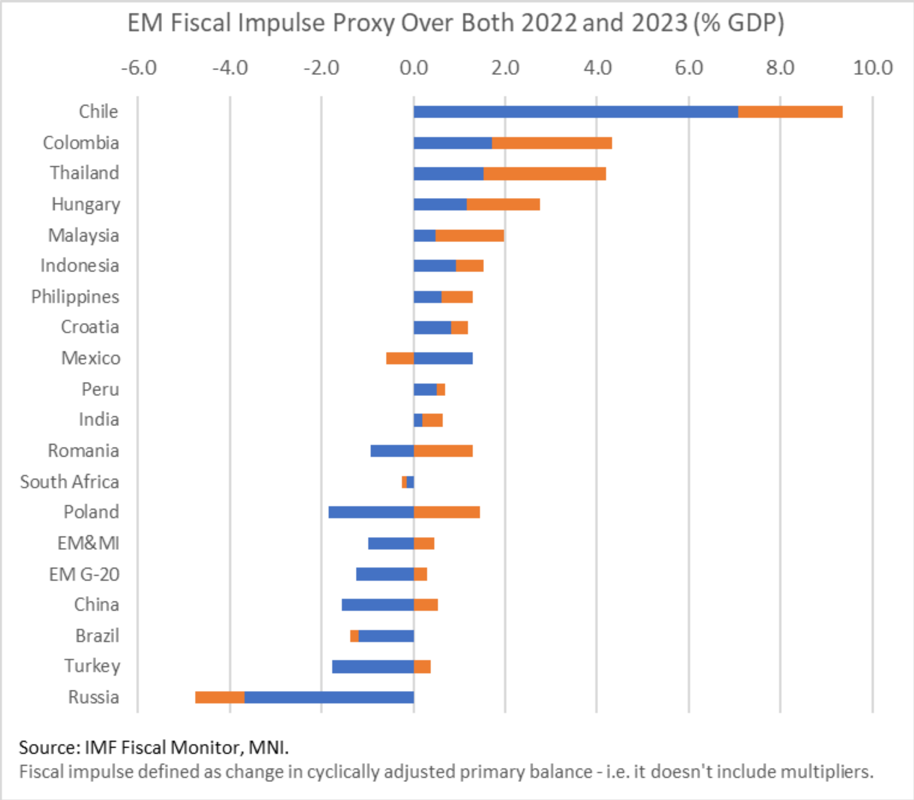
Generally Limited Tightening Across EM

Turning to EMs, one clear takeaway is that most countries are expected to see notably smaller fiscal tightening than in DMs.

- There are two outliers in **Chile** (sizeable tightening) and **Russia** (sizeable easing), although we urge caution with the Russian estimate considering the uncertainty of fiscal trajectory following the invasion of Ukraine which has also no doubt muddied the cyclical adjustment.

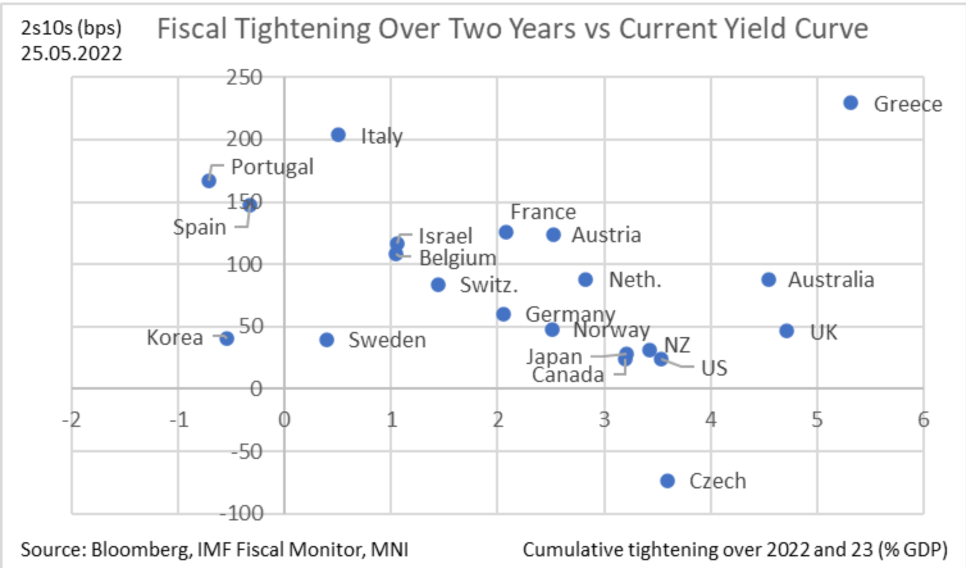
- Latest commodity price movements aren't taken into account in these projections yet there's little correlation between commodity exporters/importers and the degree of tightening expected: exporters **Colombia** and **Brazil** sit either end of the spectrum, as do importers **Thailand** and **Indonesia**.





Are Different Tightening Paths Priced?

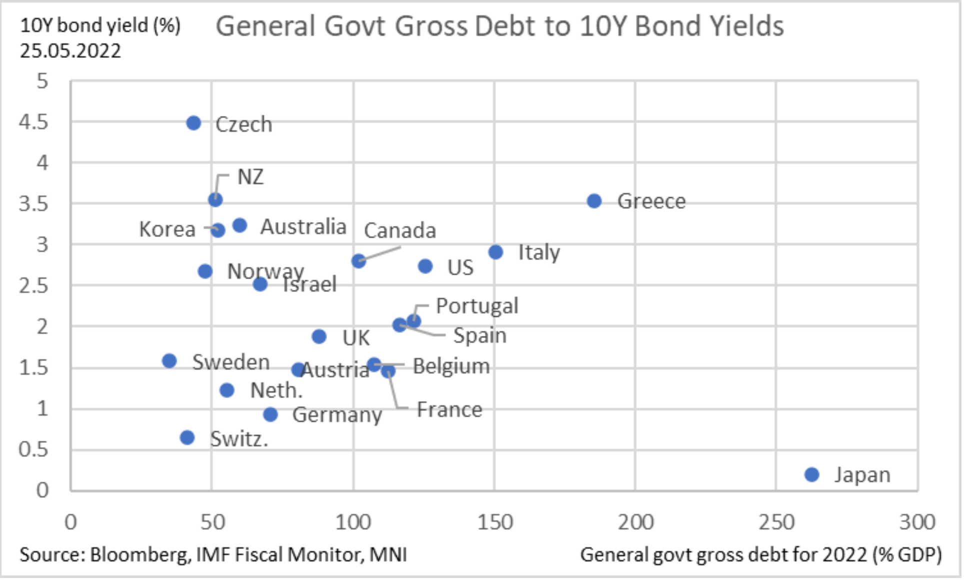
Fiscal policy is clearly just a single factor behind yield curves yet the countries that have the flattest curves also happen to be those expected to see the largest cumulative tightening over 2022 and 2023. Of the G10, the UK and Australia could be more prone to further flattening. That's not to say the impact of tighter fiscal policy can't be felt further on growth expectations though, with only the Czech curve already inverted and with scope for others to follow suit if recession fears do mount.



Debt Sustainability Could Eventually Come Back Into The Picture

Stepping away from the near-term growth implications that this piece is focused on, rampant inflation has had the benefit of highly favourable debt sustainability conditions. Nominal GDP growth has far outstripped effective rates of interest on debt stocks, seeing debt-to-GDP ratios fall back despite running large deficits -- see data appendix. According to the IMF, inflation surprises reduced public debt-to-GDP ratios in advanced and EM economies (ex-China) by 1.8 and 4.1 percentage points, respectively, in 2021.

Inflation risks to fiscal sustainability cut both ways. Higher-than-expected inflation can reduce deficits in the short run, but higher inflation expectations and risk premia can more than offset that impact via higher yields demanded by investors. If inflation does slow as central banks hope, debt sustainability criteria can sour quickly with softer nominal growth and rising borrowing costs coming back into focus, even with longer average terms to maturity. Existing levels of debt could become a greater determinant of where bond yields trade and in the case of EU members, potentially force additional tightening to meet compliance of fiscal rules when eventually re-implemented, ultimately feeding back into growth concerns over the medium-term.



DATA APPENDIX (SOURCE: IMF Fiscal Monitor)

	General Govt Overall Balance (% GDP)							General Govt Gross Debt (% GDP)					Av. Term to
	2019	2020	2021	2022	2023	2024	2025	2019	2020	2021	2022	2025	Maturity, 2022
ADVANCED	-3.0	-10.5	-7.3	-4.3	-2.9	-2.8	-3.0	104	123	120	116	113	7.2
Australia	-4.4	-8.6	-7.7	-5.2	-3.4	-2.2	-1.6	47	58	60	60	62	7.2
Austria	0.6	-8.3	-5.8	-3.9	-2.4	-0.7	-0.7	71	83	83	81	73	11.5
Belgium	-1.9	-9.1	-6.0	-5.1	-4.4	-4.8	-4.8	98	113	108	107	113	9.3
Canada	0.0	-11.4	-4.7	-2.2	-0.8	-0.7	-0.5	87	118	112	102	93	5.7
Czech Rep.	0.3	-5.6	-6.1	-3.5	-3.0	-2.4	-1.8	30	38	42	43	44	2.6
EA	-0.6	-7.2	-5.5	-4.3	-2.5	-2.0	-1.8	84	97	96	95	91	
France	-3.1	-9.1	-7.0	-5.6	-3.8	-3.4	-3.3	97	115	112	113	113	8.2
Germany	1.5	-4.3	-3.7	-3.3	-0.7	-0.1	0.3	59	69	70	71	63	6.3
Greece	0.2	-10.9	-8.7	-4.8	-1.8	-1.3	-1.1	185	212	199	185	168	
Italy	-1.5	-9.6	-7.2	-6.0	-3.9	-3.3	-3.0	134	155	151	151	146	7.1
Japan	-3.0	-9.0	-7.6	-7.8	-3.5	-2.5	-2.5	236	259	263	263	259	8.1
Korea	0.4	-2.2	-0.6	-1.6	-1.1	-1.1	-1.2	42	49	50	52	57	9.6
NZ	-2.5	-4.0	-4.9	-4.9	-1.8	-1.2	-0.4	32	43	49	51	49	7.6
Norway	6.6	-2.8	0.9	5.9	5.6	4.4	3.4	41	47	48	48	46	4.5
Portugal	0.1	-5.8	-2.8	-2.4	-1.6	-1.1	-0.9	117	135	128	122	110	7.2
Spain	-2.9	-11.0	-7.0	-5.3	-4.3	-3.9	-3.9	96	120	119	116	114	7.9
Sweden	0.6	-2.8	-1.0	-0.7	0.0	0.3	0.3	35	40	37	35	30	5.1
Switz.	1.3	-2.8	-1.9	-0.9	-0.3	-0.1	0.0	40	42	42	41	39	10.4
UK	-2.2	-12.8	-8.0	-4.3	-2.3	-1.5	-1.4	84	103	95	88	76	14.6
US	-5.7	-14.5	-10.2	-4.8	-4.0	-4.4	-5.2	109	134	133	126	125	5.9

	2019	2020	2021	2022	2023	2024	2025	2019	2020	2021	2022	2025	
EMERGING & M	-4.6	-9.3	-5.3	-5.7	-5.5	-5.4	-5.3	55	65	66	67	74	7.6
Brazil	-5.9	-13.3	-4.4	-7.6	-7.4	-5.6	-4.9	88	99	93	92	94	5.4
China	-6.1	-10.7	-6.0	-7.7	-7.1	-7.0	-6.9	57	68	73	78	90	7.3
India	-7.5	-12.8	-10.4	-9.9	-9.1	-8.5	-8.0	75	90	87	87	85	10.6
Mexico	-2.3	-4.4	-3.8	-3.2	-3.2	-2.9	-2.8	53	60	58	58	60	8.4
Russia	1.9	-4.0	0.7	-4.0	-5.3	-4.8	-4.1	14	19	17	17	21	7.3
South Africa	-4.7	-9.7	-6.4	-5.8	-6.1	-6.6	-7.0	56	69	69	70	80	11.8
Turkey	-4.7	-5.1	-3.5	-6.9	-7.5	-6.6	-6.6	33	40	42	44	47	5.3