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The End of Fiscal Obstruction

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Recent developments point to an intriguing change in the global economic policy mix. For the first time in a long while, monetary policy will no longer be the only game in town when it comes to battling the depressing impact on aggregate demand and prices of the global excess of desired saving over desired investment (the "global savings glut," which I discussed in the September Macro Perspectives*). The new ally? Fiscal policy! After a wave of austerity in the major advanced economies added to the global savings glut and subtracted from demand growth for several years, public spending and tax policies in the United States, the eurozone and Japan look set to become (mildly) growth-friendly in the coming years.*

POST-CRISIS POLICY: AN UNEVEN PATH

To see why the prospective change from obstructive to constructive fiscal policy in the G-3 economies is so important, it is instructive to recap briefly what went wrong with the economic policy mix in recent years, and why:

- When the global financial crisis hit in 2007–2008 and led to the Great Recession of 2008–2009, monetary and fiscal policymakers in all the major economies were pulling on the same string in order to prevent another Great Depression – and successfully so. Nationally and internationally synchronized monetary and fiscal stimulus ended the recession in mid-2009.
- However, when economies recovered in 2010–2011 and budget deficits had swollen massively (though appropriately so, I would argue), fiscal policy in the U.S. and Europe soon reversed course and became restrictive.
- In Europe, this reversal was the consequence of the so-called euro debt crisis that started in Greece and, due to a late and insufficient policy response, ate its way through the entire eurozone periphery. Market pressures and bailout programs that mandated austerity led to a forced tightening of fiscal policy in the crisis countries that was not balanced by additional easing in the core countries such as Germany. The latter even tightened their own fiscal belts in the erroneous belief that austerity would lift confidence and thus be expansionary.

- The consequence was another eurozone-wide recession and (eventually) a U-turn by the ECB – which had made a clear policy mistake in mid-2011 by raising interest rates twice – toward various forms of monetary easing, including Mario Draghi's promise to do "whatever it takes" in 2012, the introduction of negative interest rates in 2014 and a large-scale asset purchase program (aka quantitative easing or QE) in early 2015.
- In the U.S., tighter fiscal policy was the result of Congressional gridlock between Republicans and Democrats, which first led to budget compromises that involved an expiration of the earlier payroll tax cuts and the Bush tax cuts for high incomes, and later the imposition of a spending freeze (the sequester).
- In addition, several showdowns over the debt ceiling and temporary government shutdowns increased the fiscal headwinds to the U.S. economy through a rise in policy uncertainty. (For a detailed account of how fiscal policy complicated monetary policy and meant that the Federal Reserve was the only game in town, see Ben Bernanke's recently published memoir of the crisis and its aftermath, "The Courage to Act.")
- In Japan, fiscal policy was tightened later than in Europe and the U.S., but then more abruptly: The Abe government's consumption tax hike in April 2014 even pushed the economy back into recession and led the Bank of Japan to extend its qualitative and quantitative easing program (QQE) in October 2014.

To summarize, in each of the G-3 developed economies (and others such as the United Kingdom), fiscal policy has been a major headwind for growth and inflation in recent years, forcing central banks to go ever further out on a limb to try to stimulate their struggling economies. This is often forgotten by commentators who claim that super-expansionary unconventional monetary policies led to disappointing results in terms of economic growth, employment and inflation. Central bankers were not only fighting the powerful post-crisis forces of deleveraging in the private sector, but also had to compensate for fiscal policy obstruction.

A CLEARER FISCAL PATH AHEAD

But that was then. If I read the recent signs correctly, fiscal policy in the G-3 countries looks set to change course and become (mildly) supportive for growth starting from next year. Here's why and how.

For starters, the surprising U.S. budget deal recently signed into law – which suspends the debt limit through March 2017 and increases federal spending by more than $80 billion over the next two years – reduces the uncertainty about a potential default and amounts to a fiscal stimulus of around 0.25% of GDP in 2016 and 0.15% in 2017. True, this is a relatively small feat, but every quarter-point counts for an economy where real GDP is growing at a meager pace of 1.75% or so.

Moreover, there is some hope that additional fiscal relief in the form of an overseas profit repatriation tax bill and an increase in infrastructure spending might be forthcoming even before next year's presidential elections. However, don't hold your breath: We may have to wait until after the election to get a larger fiscal deal.

In the eurozone, fiscal policy should also turn mildly expansionary next year as a consequence of two developments: fiscal fatigue and immigration. Fiscal fatigue has set in almost everywhere in the eurozone after many years of belt-tightening, and both the Italian and the French governments are resisting the European Commission's demands for additional austerity in 2016.

Meanwhile, the influx of refugees in large numbers into Germany, Austria and other countries implies a significant fiscal boost as the immigrants, most of whom are not able or allowed to take up work initially, have to be provided with shelter, food, medical services, education and training. In Germany, immigration could add up to 1.5% to the total population this year, and estimates suggest an overall fiscal impulse from spending on immigrants and some other (unrelated) fiscal measures of as much as 1% of GDP in 2016.

In Japan, where the central bank passed on an opportunity in late October to ease monetary policy further despite its downwardly revised growth and inflation forecasts, there is much talk about a fiscal stimulus package, which could be announced in mid-November. It is interesting that several influential government advisors including Etsuro Honda and Koichi Hamada recently called for more fiscal rather than monetary expansion. So, while another consumption tax hike is currently scheduled for April 2017 (but may still be called off or postponed again), next year's fiscal stance in Japan now looks likely to become expansionary.

MACRO SIGNIFICANCE OF THE FISCAL POLICY SHIFT

As we see it, there are three implications of this shift from obstructive to constructive fiscal policy:

1) G-3 fiscal policy will start to lend support to what has remained a bumpy, below-par and brittle (BBB) global expansion to date, and should thus help risk assets to continue to do reasonably well even at a time when the returns due to monetary easing are diminishing.

2) Fiscal support for demand reduces, though probably doesn't eliminate, the pressure on central banks to come up with ever more unconventional ways of monetary easing.

3) Depending on the strength and the duration of the fiscal impulses, it may potentially help to offset the depressing impact of the global savings glut on the equilibrium interest rate and contribute to a rise in real and nominal interest rates from rock-bottom levels over time.

To be sure, what currently seems to be in store for fiscal policy next year is unlikely to move the needle on growth, inflation and interest rates *significantly*. However, in an ailing global economy with BBB growth and inflation below target, every penny from the government counts. Clearly, the emerging trend from growth-obstructive to more constructive fiscal policies is welcome and bears watching, especially if it is synchronized across the G-3 economies and might gather momentum over time. Fingers crossed.

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