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Research & Strategy Insights

Fiscal forward guidance needed

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Key points

- We fail to see any clear improvement in the US on the pandemic front
- Joe Biden made his first "big speech" on the economy last week. We take the occasion to discuss fiscal policy strategy. We think governments should engage in "forward guidance" on the fiscal stance.

The US handling of the Covid pandemic continues to be our main focus. Some states which have rolled back on some of their reopening measures were experiencing a re-deceleration in the number of cases in the course of last week, but a record number of cases on Sunday in Florida suggests more effort is needed. The number of casualties has started to re-accelerate. This is likely to add to public opinion awareness of the magnitude of the crisis. The Q3 rebound is definitely being dented.

The Covid crisis is of course affecting the presidential elections, but although the national average of polls has been giving Joe Biden a steady lead of about 9 points since mid-June, the November race is far from "done and dusted".

Joe Biden made his first "big speech on the economy" last Thursday. As we suggested in Macrocast a few weeks ago, those who hope that a post-Trump America would seamlessly return to unbridled free trade may be disappointed. "Buy American" was central to the Democratic candidate's pitch. But maybe more fundamentally, whoever is the next US President will have to navigate a complex situation, offering enough accommodation after the emergency package to help the mechanical post-lockdown rebound turn into a proper recovery, as well as respond to a profound change in public opinion in favour of more economic protection from the government, while laying the ground for a sustainable public debt trajectory which cannot count on eternal monetary policy forbearance.

The electoral calendar makes the issue more pressing in the US, but all governments will have to face complex equations. We think that, ideally, fiscal authorities should engage in "forward guidance", that is provide economic agents with an explicit – albeit flexible – sequence for the fiscal stance across the next three to five years. We think explicitly making fiscal consolidation dependent on progress towards closing the "output gap" could be the right pathway, allowing sustained support to the economy at a time of need while keeping investors "on board", reassuring them against risks of "runaway policies". This will be dependent on swift cooperation between governments and central banks though.

Is pausing re-opening working?

Last week we focused on the impact of the re-acceleration in the pandemic in the US on real-time activity. To gauge the macroeconomic cost the key issue is how quickly states will be able to get the pandemic back under control. Evidence is so far ambiguous. Some states which have rolled back on some of their reopening measures were experiencing a re-deceleration in the number of cases in the course of last week, but a record number of cases on Sunday in Florida (15,300) suggest more effort is needed. In Texas the epidemic has been merely plateauing, while in California the propagation of the virus continues to accelerate.

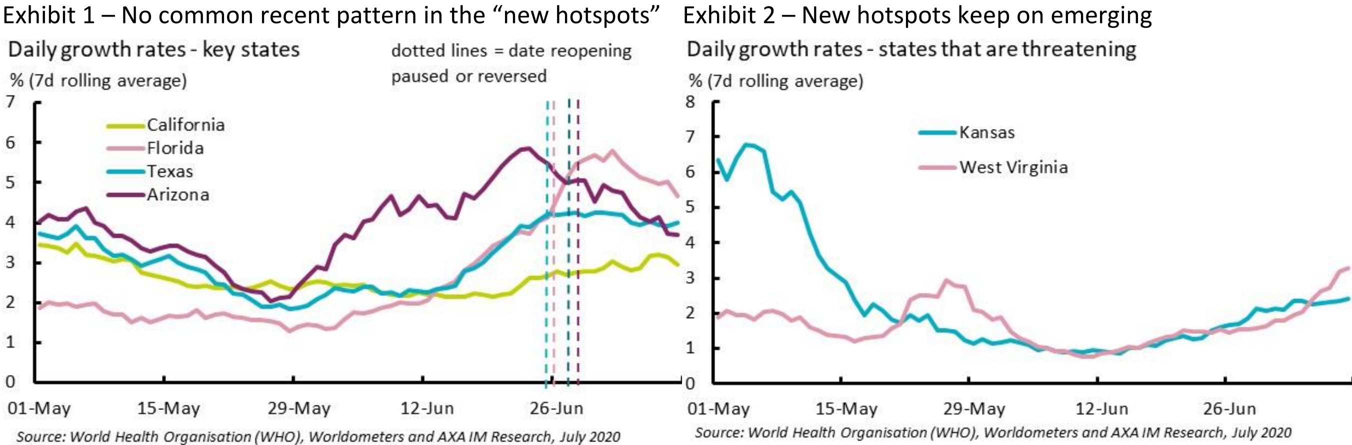

Exhibit 1 – No common recent pattern in the "new hotspots"

Exhibit 2 – New hotspots keep on emerging

In Arizona the deceleration – albeit from very high levels – started before the state reversed some of its re-opening measures (Exhibit 1). This fact may play into the hands of those in the US who argue against lockdowns, but on the whole, we suspect that the overall pace of re-opening in the US has taken a lasting hit, holding back the economic rebound in Q3. The number of casualties has started to re-accelerate with a long lag relative to the rise in cases, as more than 800 daily deaths were recorded for 4 days in a row by last Friday. This is likely to add to public opinion awareness of the magnitude of the crisis and convince Governors, even when they are personally very reluctant to re-engage in forms of lockdown, to take a very cautious approach to activity normalisation.

Another element to consider is that new hotspots continue to emerge in various parts of the country, detrimental to a full normalisation in transportation and **keeping the issue very present in public opinion, with ripple effect on consumer and business confidence**. At the moment, such resurgence is appearing in Kansas and West Virginia (Exhibit 2). These two states account for a very small share of the US GDP, but similar developments could emerge anywhere.

CIVIQS has been regularly polling US registered voters since the end of February on their level of concern. **As of 10 July, 63% respondents declared themselves "extremely" or "moderately" concerned about Covid-19.** This still looks a bit out a step with the renewed intensity of the epidemic when compared with "peak stress" in early April (then 75% were concerned) but the rebound from early June (54%) is very significant. This suggests that beyond administrative decisions on containment measures, people may be inclined to "take things into their own hands" and change their consumption behaviour to protect themselves, triggering an additional impact on the economy.

Biden's complex equation

Attitudes towards the pandemic remain heavily coloured by political leanings. The same CIVIQS survey suggests that on 10 July **Democrats were six times more likely to declare themselves "extremely concerned" about Covid than Republicans**, of whom only a third consider themselves "extremely" or "moderately" concerned, against 88% of Democrats and 60% of independents. The Covid crisis is of course affecting the presidential elections, but not overwhelmingly so. According to the data compiled by Nate Silver's 538, Donald Trump's approval rating has fallen to 40.1% on 8 July. This is the lowest level since February 2019, but it is still higher than at the trough in the high thirties in the second half of 2017. Although the national average of polls has been giving Joe Biden a steady lead of

about 9 points since mid-June, the November race is far from “done and dusted” since the Republican candidate still seems to be able to keep the support of his base.

Donald Trump’s forte so far has been the electors’ assessment of the economy, and this is an area on which Joe Biden needs to catch-up, providing a credible policy-mix to accompany the exit from the pandemic while appealing to three very distinct political tribes at the same time: an increasingly radicalising Democratic faithful base, the “disgruntled Democrats” who shifted to Trump in the swing states in 2016 and the moderate Republicans unhappy with the current President’s style.

Joe Biden made his first “big speech on the economy” last Thursday. As we suggested in Macrocast a few weeks ago**, those who hope that a post-Trump America would seamlessly return to unbridled free trade may be disappointed.** “Buy American” was central to the Democratic candidate’s pitch. A “supply chain review” would require federal agencies to buy only materials and services produced in the US. An additional USD400bn (over 4 years) in federal procurement will have to go to US sourced goods and services – and the definition of “home-made” will be tightened.

Biden’s support for the North American Free Trade Agreement (NAFTA) and openness to China while in the Senate is an electoral weakness for him and he is clearly trying to appeal to the protectionist-leaning blue-collar voters in the swing states. But we find it encouraging that his policy platform is also providing for USD300bn in federal research funding to electric vehicles and 5G. The Covid pandemic has focused minds on emergency demand support, but we cannot forget that before the pandemic hit the US economy had been held back for years by poor productivity gains and sluggish investment.

Biden will gradually unveil all the details of his macroeconomic platform in the coming weeks, but in the primaries, he came out as the most restrained of the candidates on the size of his public spending pledge. Still, the pandemic changes the terms of the debate. The case for fiscal stimulus is of course more blatant today than last winter. But Biden, should he win next November, would also be the one to deal with the “public debt fallout” of the current crisis. More than most other contenders – including his Republican opponent – his instincts would probably lead him towards a cautious fiscal normalisation. To appeal to moderate Republicans sending a message against fiscal irresponsibility could be an asset.

He will need to balance the stance very carefully though, to keep onboard a democratic electorate which has radicalised on economic issues over the last few years. The Clinton era, when a Democrat presided over several years of fiscal surplus without triggering much debate in his own party, is long gone. We noted in Macrocast last week that the fiscal package voted by the democrat-held House of Representatives would raise the public deficit by 8% of GDP this year and nearly 7% in 2021.

To keep the Democratic left on board, Joe Biden agreed to work alongside Bernie Sanders on a “unity taskforce” which has released its report last week. Some of Sanders’ flagship proposals from the campaign have been left out, for instance the “Medicare for all” which would have set up in the US a European-style universal healthcare insurance system, in favour of “extending Obamacare”. Still, **the report is consistent with a significant *structural* increase in US public spending**, for instance by making the replacement rate of the unemployment benefits more generous or ushering in a wide public investment program and tax incentives to make the US economy carbon-neutral by 2050.

We note that **a lot of these proposals do not only suit an active but small minority of Americans**. Using CIVIQS polls again, for the first time since the launch of the scheme, **50% of respondents on 10 July want Obamacare to be extended**, with only 36% repealed. There seems to be a generic demand for “more government” in the US. The Covid crisis may have precipitated this, but the seeds were probably already there.

Beyond the immediate electoral arithmetic, the next US President will have to navigate a complex situation, offering (i) enough accommodation after the emergency package to help the mechanical post-lockdown rebound turn into a proper recovery, (ii) respond to a profound change in public opinion in favour of a “catch-up” in the

level of economic protection more similar to what has been on offer for decades in Europe, while (iii) laying the ground for a sustainable public debt trajectory which cannot count on eternal monetary policy forbearance. The political calendar makes the issue more pressing in the US, but all governments will have to face complex equations.

We think that, ideally, fiscal authorities should engage in "forward guidance", that is provide economic agents with an explicit – albeit flexible – sequence for the fiscal stance across the next three to five years.

The fiscal triangle

At the moment across the world, everything conspires to push public debt higher. The fiscal balance deteriorates because (i) the recession takes tax receipts down and mechanically raises some spending items (e.g. unemployment benefits– and (ii) governments launch significant stimulus programmes. These are the automatic stabilisers at play in the first mechanism: the *cyclica*l component of the deficit rises. In the second mechanism the *structural*, or discretionary component of the deficit increases. Monetary policy can help to make this sustainable, but it cannot prevent public debt from rising: even after the extraordinary accommodation offered by the central banks, the collapse in GDP is so deep that the gap between "r" – the government's funding cost – and "g" – the economy's growth rate – remains huge.

Past the peak of the pandemic crisis, when economies start normalising, every government will have to navigate between (i) a readiness not to "kill the recovery" by moving too quickly to fiscal restraint, thus not replicating the collective mistake of 2010 and (ii) an effort at making their public debt trajectory "monetary policy proof", i.e. ensuring sustainability after central banks start normalising their policy. **We think explicitly making the fiscal stance dependent on progress towards closing the "output gap" could be the right pathway, allowing sustained support to the economy at a time of need while keeping investors "on board". This will be dependent on swift cooperation between governments and central banks though.**

The first step is to recognize the importance of the government's fiscal policy on the shape of the recovery. This was at the root of the policy mistake of 2010, when governments were persuaded that fiscal tightening could be implemented with negligible impact on growth. Olivier Blanchard's famous piece in the International Monetary Fund (IMF)'s World Economic Outlook of October 2012, on which he expanded in a January 2013 paper made the point forcefully. He could trace the IMF's forecasting error post-2010 to using a far too low multiplier coefficient, i.e. by how much one unit of fiscal retrenchment reduces GDP.

One of Blanchard's key points was that the value of the multiplier changes across economic circumstances, and that it is particularly high when monetary policy has hit the zero-bound on nominal interest rates. This is quite intuitive – if interest rates are already at zero before the fiscal retrenchment starts, then monetary policy cannot offset its impact on aggregate demand. This limit applies today.

Blanchard's point on multipliers rising well above 1 in times of extreme crisis and monetary policy limitations can be consistent with self-defeating fiscal consolidations. Let's consider a case in which the multiplier is equal to 2 (Blanchard quotes Auerbach and Gorodnichenko who put the value of the multiplier at up to 2.5 in times of recession). Then if a government reduces the *structural* component of its deficit by 1% GDP – i.e. engages in a tighter fiscal stance – then GDP falls by 2%. Since the elasticity of the *cyclical* component of the deficit to GDP is robustly estimated at 0.5 in European countries, the overall deficit – the sum of the structural and cyclical components – is unchanged. Governments end up with less growth and no fiscal gain.

This alone would argue in favour of treading extremely carefully with the fiscal stance immediately after exiting the Covid recession. This much is probably consensual, but the real debate is on the speed at which a consolidation should be considered after that. This entails a discussion on the long-term effect on the recession.

Two forces will work in opposite direction. First, "hysteresis", i.e. the notion that a recession can deteriorate trend, or potential GDP growth, as unemployment can permanently deplete human capital, or that the collapse in capex

triggers a “capital deficit” and a slowdown in productivity growth which can lower the speed limit of the economy. **Second, “creative destruction”,** the notion that crises force a reallocation of labour and capital towards the most productive sectors, which ultimately lifts aggregate output. Recessions there act as unpleasant but ultimately positive “purges” of the system. If “creative destruction” dominates, then providing fiscal support for long is the wrong approach.

The debate if far from settled, but in modern economies, over the last 30 years, the net effect of these two forces has been negative more often than not. In Exhibit 3 we took the example of the US, the UK and France and looked at the average growth rate in potential GDP, as estimated by the OECD, in the five years before and after the recessions they went through over the last 40 years. In most cases, the recession was followed by a slowdown in potential growth.

The only exceptions are the early 1980s recessions in the two Anglo-Saxon countries, which were followed by an *acceleration* in potential growth. We would be tempted to interpret those two recessions as the result of a conscious decision to “purge” a previously malfunctioning economic model (stagflation). Recessions ushering in powerful structural reforms can lift potential growth (similar developments were observed in Sweden and Canada in the early 1980s). This is in a way a policy-driven creative destruction process. But the ongoing Covid-driven recession is a purely exogenous shock which owes nothing to any internal malfunction. That it will have some lasting scarring effects is the most plausible assumption in our view.

Exhibit 3 – Recessions often deteriorate potential growth

Potential GDP growth before and after recessions

Source: OECD, Macrobond and AXA IM Research, July 2020

We already argued in Macrocast that while the current acceleration in state-guaranteed loans is unsurprisingly re-opening a conversation on the “zombification” of parts of the European corporate sector, assessing whether “too much support” is granted is going to be difficult, since lockdowns do not follow an economic logic and perfectly viable businesses can be jeopardised. **Relying on creative destruction dynamics to justify a quick withdrawal of policy support is very risky in our view.**

When should fiscal policy move to a tighter stance then? We argue this should happen just before the economy has closed the output gap, i.e. that GDP has not only returned to its pre-pandemic level, but also that it has recouped all the “missed growth” – i.e. how much it should have grown while it was in recession. Indeed, as the economy closes the output gap, unemployment returns to its structural level, wage dynamics normalise and, in theory at least, inflation goes back to the central bank target.

If governments are credible on their fiscal stance, the central bank will take its impact on the economy into consideration. In the absence of a pre-announced fiscal consolidation, an imminent closure of the output gap would be the signal for the central bank to prepare a tightening in monetary policy, to adjust to the acceleration in inflation. However, with a looming counter-cyclical move from the government the central bank would postpone its own policy normalisation, anticipating the delay in closing the output gap the fiscal move will trigger. Exactly as the European Central Bank (ECB) explicitly argued a few weeks ago that at the current juncture monetary policy

alone cannot keep the economy on a path consistent with price stability and that fiscal policy needs to help, the ECB in a few years from now could explain that given the start of a fiscal tightening, it does not need to hike rates as much and as quickly as it would normally do given the looming inflationary pressure.

With policy rates maintained close to zero – and the government bonds acquired during QE continuing to be re-invested – governments could proceed gradually with its fiscal tightening, since interest expenditure would not balloon out of control. The setback for GDP growth would be limited, inflation would remain positive and gently growing, resulting in interest rates falling in real terms. By the time the output gap is finally closed, and monetary policy starts normalising, fiscal plans would be well understood by the market and overshooting on credit risk premia can be avoided.

Many accidents can derail such a roadmap. The output gap is notoriously difficult to pinpoint in real time. True also, governments cannot easily pre-commit beyond the mandate of sometimes volatile parliamentary majorities. In the case of the ECB, a lack of trust between member states is an obvious hurdle. But what we describe here is a possible "quiet path", where fiscal authorities provide fiscal support while making it clear this is no "run-away" policy and that long-term fiscal sustainability will be ensured.

We do not think this would jeopardize the independence of the central bank though. The ECB would be entirely free to tighten monetary policy quickly if inflationary pressure were to re-emerge while governments renege on their tightening pledge. Market discipline would then play its role, ultimately forcing governments into tougher fiscal retrenchments that what they could have implemented if they had acted early.

Still, to work well, such cooperation between monetary and fiscal policy would benefit from an ex ante, explicit trajectory sketched out by the governments. This would draw heavily on the current stability programmes produced by member states as part of the EU fiscal surveillance, but in a more flexible way. Contrary to the EU's Stability and Growth Pact and its automatic rebalancing clauses (diversely enforced…), exogenous setbacks and positive surprises on growth would delay or hasten the shift to a fiscal tightening. To deal with the lack of precise real-time estimate of the output gap, governments could ex ante define a target level for the unemployment rate under which it would shift to a fiscal tightening. If the unemployment rate – a good proxy of capacity underutilisation – were to fall faster than expected, then the fiscal tightening would be brought forward. In our current baseline, a reduction in the structural deficit could be scheduled for 2023 (voted in 2022), but if the labour market was close to equilibrium by the end of 2021, then starting the fiscal consolidation in 2022 already (voted in most countries in the late summer of 2021) would make sense.

ECB: dispel some doubts

For now, both fiscal and monetary authorities are still dealing with the recession. Still, the ECB has probably done enough last month to take a breather at its Governing Council meeting this Thursday. Some communication fine-tuning may be needed though. In the last two weeks some Council members have mentioned the possibility that the central bank would not need to spend everything it has provisioned for since the beginning of the crisis. Since the latest figures from the central bank show that indeed it has reduced its quantum of purchases in the last weeks, we would not be surprised to hear a lot of questions on the strength of their commitment.

We think it should be relatively straightforward for Christine Lagarde to explain that the reduction in the purchases is a mere adaptation to better market conditions, but that there is no new preference for restraint from the central bank. We note however that as the European Council is busy negotiating the Recovery and Resilience Fund – the very form of "federal fiscal support" which would lighten the ECB's burden – the President of the ECB may not want governments to feel "too comfortable" about the level of protection they get from the central bank. This could make for a tricky choice of words. There is never an easy day in central banking.

Country/Region	What we focused on last week	What we will focus on this week
	• Daily new cases set new records, but pace of increase slowed following new restrictions • Jobless claims fell in latest week to 1.317mn and 18.06mn. • US non-mfg ISM posted biggest one-month rebound, 2nd highest rebound on record • US 10-yr yields fell to April low	• New cases likely to rise further, growth rate hoped to decline further • US retail sales June – spending up to May stronger than expected, expect another lift • Jobless claims – any deterioration following reimpositions of virus restrictions • Fed's Beige Book Survey
	• German IP disappointed at just +7.8%mom in May, while factory orders rebound was also lower than expected at 10.4%mom • EA retail sales bounced back 17.8%mom in May • Spanish government adds EUR40bn to the guarantee lending scheme • Irish Paschal Donohoe elected Eurogroup president	• The ECB meeting could be an uneventful one, but communication will be key. Questions on PEPP commitment (after comments on ceiling) and medium-term inflation are likely. We do not exclude an increase in the tiering multiplier given the sharp rise in excess reserve. • EU Council to advance on Recovery Fund discussions, but too early for agreement
	• Chx Sunak added £30bn stimulus including Stamp Duty and VAT cuts and a bonus to employers to re-employ furloughed workers • UK-EU negotiations continue – little apparent progress • RICS housing survey posted material gains • UK tensions with China over HK and 5G tech	• Monthly GDP (and broader output) we forecast ~4%mom rise in May, contributing to -20%qoq in Q2 and -10.7%yoy in 2020 • CPI inflation for June, expected to ease from 0.5% in May, we forecast 0.8% – 2020. • May labour market data, unemployment expected to remain broadly unch ~4%
	• May household spending fell by 0.1%mom • Bank lending accelerated in June at 6.8%yoy from +4.8% in May. The credit channel works • The Economy Watchers poll surged to 38.8 from 15.5, a historic rebound • May machinery orders remains weak (-16.3% yoy), despite a small increase from April.	• BoJ will hold its July meeting. We do not expect any changes in the current monetary policy framework. • July Reuters Tankan Diffusion Index
	• Headline inflation rose in June due to severe rainfall pushing up food prices, while PPI deflation narrowed on improved growth momentum	• Q2 GDP growth may have reached above 2% reflecting continued economic normalization
	• Malaysia central bank remained dovish this week by cutting the policy rate by another 25bps to 1.75%, a record low. • The central bank of Peru continues expansionary policy stance maintaining the policy rate at 0.25% and implementing further liquidity injection operation.	• Central Bank meetings: Poland, Chile, South Korea. • Turkey current account balance (May), India inflation (June), Poland unemployment (June).

upcoming events		
	US:	Tue: NFIB small business optimism, CPI; Wed: Empire State, IP, Beige Book released; Thu: retail sales, weekly jobless, Phily Fed inex, NAHB index; Fri: housing starts, Michigan cons sentiment
	Euro Area:	Tue: Ez IP, Ge ZEW surveys, final Ez, Ge, SP HICP; Wed: final It HICP; Thu: final Fr HICP, ECB meeting, press conference; Fri: Special European Council, final Ez CPI
	UK:	Mon: Governor Bailey LIBOR speech; Tue: BRC retail sales, May GDP, IP, construction output, OBR Fiscal Sustainability Report; Wed: CPI, RPI; Thu: unemployment, earnings; Fri: GfK conf
	Japan:	Mon: tertiary industry activity index; Tue: final IP, capacity utilisation; Wed: BoJ meeting, Reuters Tankan Index; Fri: final national core CPI
	China:	Tue: trade balance; Thu: new home prices, Q2 GDP, IP, retail sales, fixed asset investment

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