181 – 22 May 2023

Investment Institute Macroeconomics

Fiscal Woes

- We review the recent batch of stability programmes in light of the recent EC proposals for new fiscal surveillance rules in Europe. A simultaneous fiscal adjustment is looming for 2024.
- As we are still waiting for a resolution of the US debt ceiling drama, we explore some of the ramifications of a failure to agree.

The political debate is far from over on the European Commission's proposals for a reformed fiscal surveillance framework, but as they stand, they would incorporate "minimum adjustment" values for most Euro area countries, i.e., reducing the structural deficit by at least 0.5% of GDP and bringing back the debt ratio below its starting value. We test the new batch of the stability programmes submitted by all national governments earlier this month against these potential rules. Seven of the eight member states we study (the larger ones by GDP weight) would pass. Yet, in several cases, the room for manoeuvre in case of accident would be limited, and we note that these plans assume a "benign landing" of the European economy, with inflation normalizing without much of an adverse effect of the ongoing monetary tightening on GDP growth. Moreover, since most of the member states are planning a front-loaded fiscal adjustment with a significant effort in 2024, the "feedback" effect of such a simultaneous austerity turn may be understated, especially since – according to the ECB research itself – the impact of its monetary tightening on growth is likely to still be significant next year.

But none of this is for immediate consumption: the market is understandably focused on the US debt ceiling drama. While we wait for a possible resolution, we explore the ramifications of a "no deal" configuration. We believe the Fed would be forced into massive intervention to salvage the Treasury from the risk of losing market access. It is however doubtful the Fed could do much to deal directly with the adverse macro consequences of the deferment of non-interest spending. Looking ahead, even if a short-term fix is found, we are concerned that fiscal issues have become so ideologically charged in the US – in contrast with what prevailed until the beginning of this century. As both parties bicker over the debt ceiling, they are losing sight of the fact that significant action will be needed within the next few years to put US public debt on a sounder footing. This would call for a large measure of bipartisanship which looks unattainable in the present configuration.

The rulebook is dead, long live the rulebook!

European economists – your humble servant included – tend to devote inordinate amounts of time and energy to dissecting the European Union (EU) fiscal rules, despite a general lack of interest in the market. Investors may be forgiven their inattention. Since the previous versions of the fiscal surveillance frameworks failed to be enforced, there is little reason to believe the next reforms will be met with more compliance. Investors would be then better off working out their own assessment of each country's debt sustainability conditions, based on what the national governments say and more importantly actually do, or have been able to do in the past, than pouring over masses of dry reports from the European Commission (EC).

Fiscal rules still matter however for at least two reasons. First, even if they are rarely complied with *ex post*, at least *ex ante* national governments must commit. The multi-year plans, encapsulated in the Stability Programs (P-stabs), function as reference points internally and externally. Local parliamentary oppositions can seize on governments failing to deliver. This creates some incentive to at least try to comply, or to minimize gaps from targets. Second, beyond the fact that compliance with fiscal rules is explicitly part of the assessment the European Central Bank (ECB) would perform before granting a member state support via the Transmission Policy Program, **they are crucial to get any further institutional progress on fiscal federalism.** Understandably, "creditor countries" such as Germany could be forgiven for demanding more fiscal rectitude before committing to more debt mutualization. At least agreeing on a set of rules probably is a necessary condition to get a push towards a Next Generation Pact 2.0.

Political expediency is not the only reason previous sets of rules failed to get efficiently enforced. **The increasingly complicated framework was to a large extent detached from the realities of steering an economy through cycles** (e.g., the rigid rule forcing high debt country to plug the gap between their actual debt ratio and 60% of GDP by at least 5% per year) **while addressing structural issues** (the latter being tackled via a separate process). The more sophisticated and apparently rigid the rules became, the higher was the probability that the "exemption clauses" would be invoked and surveillance suspended, or simply ignored.

The proposals the EC put on the table in late April address some of these issues. **The national reform plans and the P-stabs would be merged in one holistic process during the "European semester."** A proper "quid pro quo" could be found between the intensity and granularity of the structural reforms train and the delay to get the fiscal trajectory back in order: in exchange for reforms which would need to be *"commensurate with the degree of challenges to public debt and medium-term growth",* and front-loaded, the fiscal adjustment period would be extended from four to seven years. Importantly, a "single operational indicator" would underpin the whole surveillance process: the governments' "*nationally financed net primary expenditure*" (more on this concept later) which should simplify monitoring. Finally, the new framework would strengthen the role of national independent fiscal authorities in assessing the merged fiscal and reform plans.

This would allow for a set of trajectories tailored to the initial conditions and choices of each national government, supported by a dialogue with the EC on the plausibility of the plans. The "end target" would consist in bringing and keeping the deficit below 3% of GDP in a sustainable manner and to *"put and keep public debt on a plausibly downward path by the end of the adjustment period*". This flexible approach – which would give the Commission a very wide appreciation margin – was (and still is) criticised by both "hawkish" and "dovish" member states.

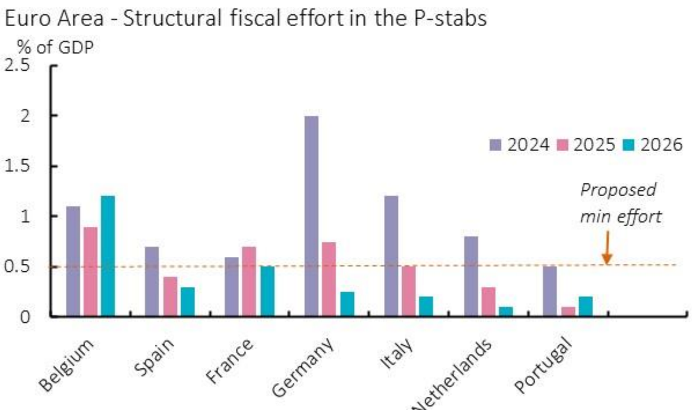
The hawks were concerned with the lack of clear quantified intermediary targets, the doves were disappointed that there was no "carve-out" in the spending target to exclude public investment, e.g., capital expenditure directed to the green transition. Following their unenthusiastic reaction to a first blueprint at the end of the last year, the hawks were granted a key concession: countries in need of adjustment would have to reduce their structural, primary deficit (i.e. corrected for the impact of cyclical conditions and debt servicing costs) by at least 0.5% of GDP per annum, and the debt ratio, by the end of the adjustment period, would have to be lower than at the starting year. From a quantitative point of view, the most tangible point which the doves got from the new framework was the removal of the forced debt reduction trajectory of 5% of the public debt gap to 60% of GDP.

The austerity turn is for next year

The legislative process on the new framework is far from over. While the Commission's stated goal is to make it enforceable in time for the "European semester" of 2024, experience would teach us to expect a significant delay. Despite the inclusion of the minimum adjustment thresholds in the package Finance Minister Lindner wasted no time expressing his disagreement with the new proposals. Yet, **the inclusion of the 0.5% threshold and the "lower debt" target gives us an interesting yardstick to assess the new series of P-stabs which have been transmitted to the EC earlier this month.**

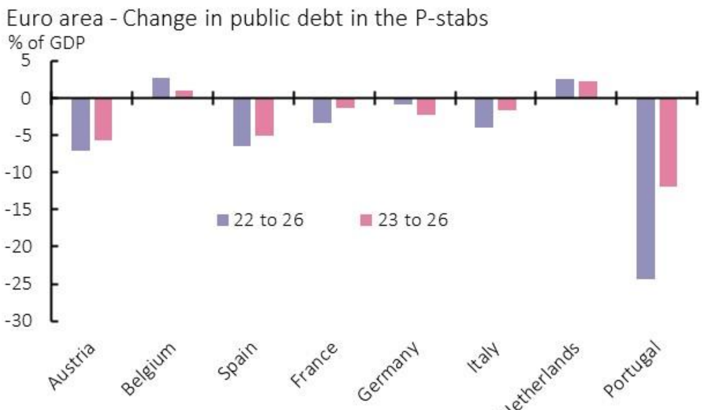
But before we get there, we need to spend a bit of time on boring methodology. The EC proposal is precise on the definition of the "nationally financed net primary expenditure": *expenditure net of discretionary revenue measures and excluding interest expenditure as well as cyclical unemployment expenditure and expenditure on Union programmes fully matched by revenue from Union funds."* Some headlines are thus too simplistic in presenting the new framework as solely focused on government spending, since a change in tax rates would qualify as "discretionary revenue measure." What the surveillance system would however exclude is the expenditure funded by the EU grants transiting via the Recovery and Resilience Fund. Finally, the impact of the cycle would be taken in consideration, via the correction for the impact of the changes in the unemployment rate on public spending. In a nutshell, **this single operational indicator is not very different from the primary structural balance used in the current P-stabs.**

Exhibit 1 – Sticking to the 0.5% rule…



Source: European Commission and AXA IM Research, May 2023

Exhibit 2 – …but no or minor det reduction in some cases



Source: European Commission and AXA IM Research, May 2023

In Exhibit 1, we look at the change in the primary structural balance – also called the "structural effort" – currently planned by the national governments (using the P-stabs from May 2023), for the eight largest economies of the Euro area. They would all fit the criteria set by the EC proposals. The structural adjustment is planned to be front-loaded with a significant effort in 2024 in most countries. In the following years, the effort fades but this would be consistent with the proposed rules, since most countries plan to have brought their overall deficit below 3% of GDP by 2024 (Austria, Germany, the Netherlands, and Spain) or 2025 (Belgium and Italy) which would allow them to escape from the minimum effort rule. The case of Portugal is specific: with a total deficit already below 3% of GDP and debt expected to fall rapidly, this country would not have to comply with the minimum reduction pace. **France however stands out as the only country in our sample which plans to bring its deficit back to 3% of GDP by 2027 only.** Paris may have anticipated the new framework though since it is planning to maintain a structural effort of at least 0.5% of GDP – but just slightly above - until the end of the program horizon.

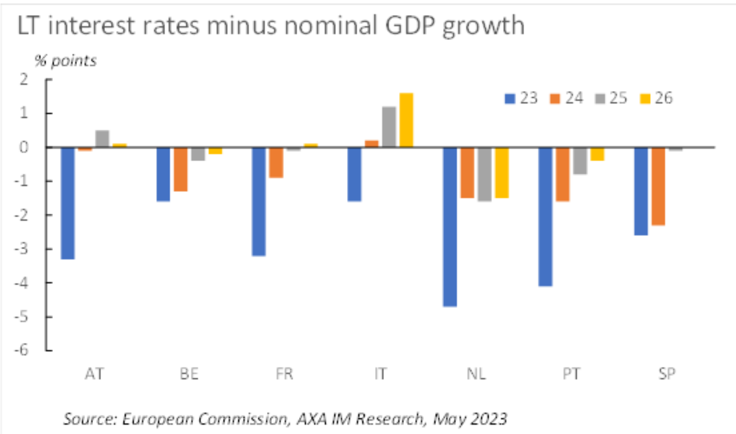
The P-stabs also allow us to check whether the new government plans would comply with the proposed framework for the debt criteria. The timeline of the fiscal-structural adjustment plans would be different than in the P-stabs since the "starting point" would probably be 2024 – given what we discussed above on the delays to the adoption of the new rules – but the current plans are already indicative of what governments intend to do.

Only two countries out of the "big 8" do not plan to have brought their public debt below the 2022 or 2023 level: Belgium and the Netherlands. The latter would be exempt from the rule since its debt ratio is already below 60%, by a significant margin (48.4% of GDP in 2022), but this would not apply to Belgium (105% of GDP in 2022). It is the only country in our sample whose current P-stab would not qualify for the proposed new fiscal surveillance framework and would thus be forced into adding more austerity from what is currently planned. But we note that in France and Italy the planned reduction in public debt is small (0.4% and 1.7% of GDP from 2023 to 2026 respectively), leaving only scarce margin for error. Note that our horizon for assessment – 2026 – was bound by the fact that this was the last year for which full data was provided by all countries. Once the new framework is enforced, countries will have four years (or even seven) from 2024 to deliver. In France for instance debt is planned to fall more clearly in 2027 (nearly 1% of GDP in on year).

Multi-year stability programmes are by nature heavy on assumptions. One however is crucial to assess the "room for manoeuvre" the governments may have if "things go badly," and that is the implied "i-g" dynamics. A debt trajectory is the result of the change in the primary balance and the difference between the interest rate (i) and the growth rate of nominal GDP (g). The more nominal GDP "outgrows" the interest rate, the more the debt to GDP ratio falls. Exhibit 3 suggests that with the notable exception of Italy, governments are clearly counting on a still substantial gap throughout the horizon of their programs (note that we took out Germany from our sample since the long-term interest rate assumption for 2024 and beyond, at 0.1%, looks suspiciously like a typo in the document).

Governments are counting on a "painless landing" of the European economy, with inflation gently falling back to 2% - but no return to the sub-par pace seen before the pandemic– without the ongoing monetary tightening triggering a nasty slowdown in economic activity (most P-stabs have GDP growth above potential for at least the next two years). Inflation normalisation would allow the ECB to gradually loosen its stance, contributing to keeping long-term interest rates in check. **Such a rosy scenario is of course possible but leaves very little protection against "accidents".**

Exhibit 3 – Looking into the debt stabilising dynamics



What also concerns us is the lack of consideration for the feedback effect on growth from a joint fiscal austerity drive in the Euro area. That most governments are planning to embark on a front-loaded fiscal adjustment is of course positive from a credibility point of view. As much as investors were ready to be tolerant to massive fiscal slippages during the pandemic, and later to deal with the immediate macro impact of the war in Ukraine, they would likely get nervous if the fiscal consolidation was constantly delayed. As necessary as it probably is, a planned multi-country tightening in fiscal policy in 2024 aof around 1% of GDP on average in the Euro area is unlikely to go through without any adverse impact on economic activity, coming just after the peak of the ongoing monetary tightening. Indeed, a recent paper published by the ECB in its latest economic bulletin (see link here), the authors suggested – using a suite of models – that the accumulated monetary tightening until May 2023 would reach its maximum impact on GDP growth in 2023 (4 percentage points relative to baseline for the average of the model outcomes). Note however that in this study, in 2024 the effect of the monetary tightening would still be significant (nearly 2 percentage points).

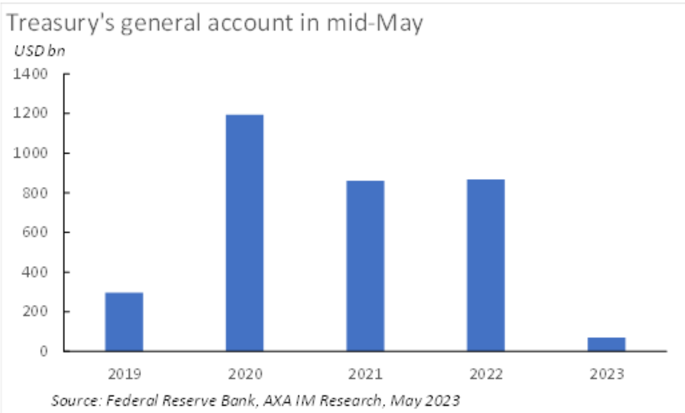
One of the key lessons of the Great Financial Crisis and the ensuing European sovereign crisis was that an internationally synchronized fiscal tightening could backfire, especially if mixed with a monetary normalisation, by depressing demand too much. The new EC proposals aim at tailoring the fiscal effort to each country's specific conditions, but when looking at what is currently planned, we should brace ourselves for a joint austerity turn across the Euro area.

Raise the ceiling, or else…

As we write these lines, no "white smoke" has yet come up over Capitol Hill. On Friday, the market was left with some optimistic overtones, even if Kevin McCarthy's choice of words (he was "hopeful" a deal could be struck) was more prudent than Biden's (he was "confident"). On Sunday night European time, all we knew was that Kevin McCarthy, after qualifying a call with Biden as "productive" announced they would meet on Monday. We still believe a deal is in the interest of both sides, given the stark consequences for the economy of a failure to agree, and a positive outcome remains our baseline, but of course we need to explore an adverse outcome.

As of last week, only $64 billion in cash remained in the Treasury account at the Federal Reserve (Fed°, less than 10% of the amount seen at the same period of the year in 2021 and 2022 (Exhibit 4). The Treasury has been communicating on 1 June as the date beyond which the current "extraordinary measures" would be exhausted and spending deferment would have to start in earnest (the X date). Janet Yellen on Sunday mentioned substantial corporate tax receipts due to hit the Treasury account by 15 June but expressed her nervousness as to the Treasury's cash flow until then. Deutsche Bank Research argued that if the Treasury can "survive" until 15 June, then it could probably hold on until 1 August, before being hit by big payments.

Exhibit 4 – Already scrapping the barrel



If the ceiling is not raised, Treasury will be allowed to issue new debt only up to the amount of securities being redeemed. This would suggest that there is no risk over the principal repayments of US federal bonds: the Treasury should still be able to "roll them over. But the whole part of the public spending that is not covered by tax receipts and thus had to funded by additional debt issuance – in other words the federal deficit, 5.8% of GDP in 2023 according to the May update by the independent Congressional Budget Office (CBO) – would have to be curtailed. Out of these 5.8% of GDP, roughly half is made up of interest payments (the primary deficit is forecast at 3.1% of GDP by the CBO). An inability to pay these interests would put the federal government into a technical default situation.

Taking the ebbs and flows of tax receipts, enough non-interest payments would have to be deferred to ensure that the Treasury account has enough money to meet the coupon payments. This is the mechanism through which **the debt ceiling in a recession-making machine even if it does not trigger a debt default.** Illustratively, in a – very extreme – scenario in which the stand-off would last for an entire year, nearly 6% of GDP worth of ordinary public expenditure (e.g., wages, supplies) would have to be deferred to make space for interest payments and to comply with the impossibility to issue more debt than what is redeemed. Even if we assume a low multiplier level, this would likely cause a contraction of GDP of more than 3%. Of course, all this is a function of time. If the deferment only lasts a few days or a few weeks, the macro impact would be relatively small. Yet, beyond the mechanical impact of curtailing public expenditure, its mere announcement would likely have a strong adverse effect on household and business confidence, probably precipitating a contraction in GDP which we think is in any case looming.

But **the assumption that the Treasury will be able to roll over the expiring debt is not so obvious.** In the transcript of the emergency meeting held by the Fed in October 2013 (see the link here) to discuss their potential response to a previous episode of the debt ceiling drama, this was a key focus of the conversation. It is indeed possible to imagine a situation in which the Treasury would lose its access to the market: no one would want to participate to the auctions of federal bills and notes any more, for fear of being caught up in the Treasury's cash-flow difficulties. This would quickly trigger a situation of actual default – the amount of ordinary expenditure to defer to generate enough cash without the support of debt roll-over would probably make it impossible to maintain a decent level of government operation – and this is "terra incognita" from a financial stability point of view: what would happen, for example, to the derivative transactions collateralized by US Treasury bonds? What would individual savers sitting on money market funds full of short-term US bills decide to do?

Given these profound systemic risks, **in this "very adverse scenario," we think the Fed would have no other option but to act massively to support the federal government.** A way to avoid a disruption of the Treasury's market access would be to make it plain to the primary dealers that the Fed stands ready to bear the bond risk by buying back the bonds purchased at the auctions within minutes of the close of the operation. In terms of monetary policy, this would be tantamount to a return to QE, but in this case and in the face of an impending recession, we do not think the Fed would hesitate for very long.

However, we do not think that the Fed – with its usual arsenal – could do much to deal with the deferment of non-interest expenditure by the Treasury. Baroque solutions are regularly mentioned, such as the Treasury minting a coin with a huge value, against which the Fed could credit the Treasury's account (a blatant "printing press" debt monetization), or the idea that Biden could invoke the 14th amendment on the sanctity of the federal debt – taken in the context of the end of the Civil War – to order the Treasury to continue to issue above the ceiling. We suspect both solutions would trigger lawsuits: the market would be hanging on the Supreme Court's final decision.

Overall, **we do not see how, if the negotiations fail, the US could avoid, at best, an adverse shock to growth through spending deferment - the intensity of which would vary according to the duration of the political conflict.** We also fail to see how rating agencies could afford not to revise down their rating of the US federal debt, if only to be consistent with the 2011 decision. Assuming this does not morph into a full-blown financial crisis, what could be reaction of the markets?

In 2013, the conflict on the debt ceiling was compounded by a proper budgetary dispute which triggered a partial government shutdown on 1 October (to be precise, spending had to be deferred not because the ceiling had been hit but because there was no Congress authorisation to spend). The "X date" at the time according to the Treasury was 17 October. In the two weeks between the beginning of the partial shutdown and the X date – and the last-minute deal on 16 October – T-bills starting trading with a significant premium, but with no contagion to long-term interest rates (Exhibit 5). The deal brought peace on the short end of the curve but did not lift the dollar exchange rate much – at least not enough to offset the previous losses). In 2011, once the deal was struck, long-term interest rates fell despite the rating downgrade (Exhibit 6).

Exhibit 5 – FX did not recover quickly after the deal

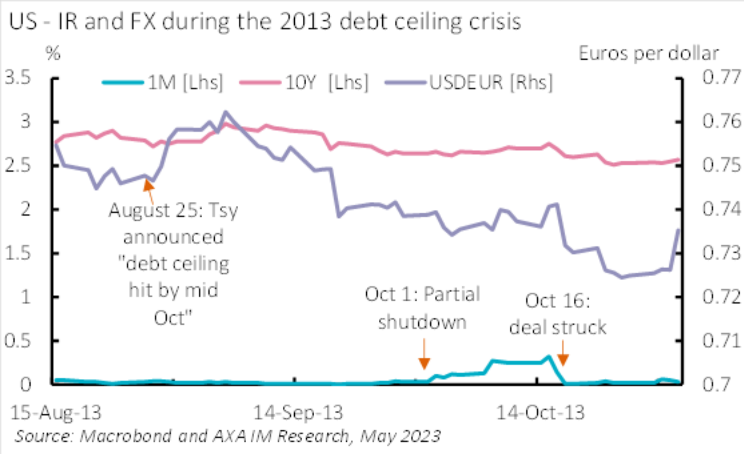
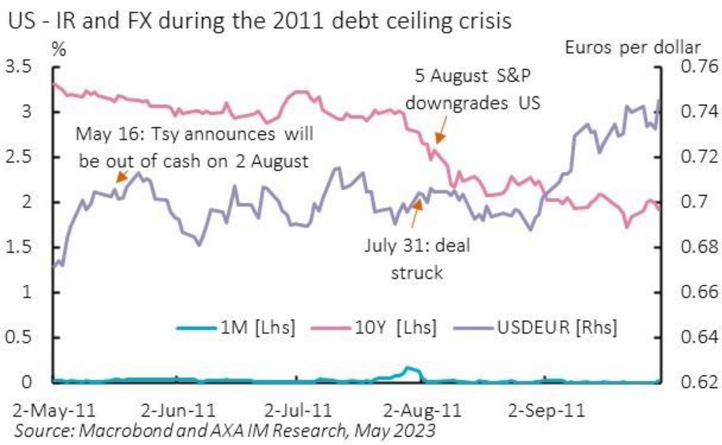


Exhibit 6 – 10-year yields fell after the rating downgrade



We suspect that these market reactions can be explained by investors' expectations on future policies. A spending deferment – much like a shutdown – is an adverse shock on growth which should normally reduce inflationary pressure and trigger a monetary loosening. In 2011, President Obama had to concede a significant austerity turn in exchange for a deal on debt, which would be consistent with lower long-term yields. This remains key in our view**. As long as the market would believe that hitting the debt ceiling would be a very short event adding to its already strong conviction that the Fed will have to reverse its policy stance in the second half of this year, possibly because the fiscal leg of economic policy will have to turn to austerity, the bond market reaction may be mild**. We would however expect the equity market to struggle, as well as the dollar exchange rate. Yet, this "mild landing" from a long-term yield point of view may still require massive immediate quantitative action from the Fed to stop the situation from morphing into a major, global systemic crisis. **Conversely, if a deal was struck quickly, the market would have to brace itself for massive treasury issuance to rebuild its cash reserves**, this time without support from the Fed which would maintain its quantitative tightening stance.

Maybe more fundamentally, we are concerned by the fact that fiscal policy has become hostage to what seems to be an intractable political conflict. Fiscal rectitude has not always been a central matter in the US ideological divide. Even if Democrats are more supportive of government spending than Republicans, it is Bill Clinton who presided over the last federal budget surplus. These matters are now so politically charged that **policy circles are losing track of what IS the real issue: the fact that, without decisive action in the next few years it will be very difficult to keep public debt under control in the US**, as our colleague David Page discussed in a recent note (see link here). Such an effort would call for a large measure of bi-partisanship – since it is doubtful that spending o-r tax alone will be able to do the trick – which now looks extraordinarily far from reach.

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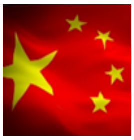
Country/Region	What we focused on last week	What we will focus on in next weeks
	• President Biden and Congressional leaders expressed optimism on finding a compromise over the debt ceiling before 1 June, boosting market confidence • Empire & Philly Fed surveys (May) diverge, the former falling sharply. Both remain around recession levels. • Retail sales (Apr) rise solidly, buoyed by car sales • Existing home sales (Apr) -3.2%mom • Jobless claims retreat to 242k from 264k, but fraudulent claims (MA) make data unreliable	• FOMC minutes (May) watched for any participants likely to vote for further hikes • Personal spending (Apr) to gauge real consumer spend, after strong value sales last week • PCE inflation (Apr) headline could rise, core should dip to 4.5% from 4.6% • Durable goods (Apr) for signs of Q2 investment fall • U Mich (May, f) to see if preliminary rise in 5-10y inflation expectations to 3.2% is revised lower
	• Euro area March industrial production felt markedly by 4.1%mom. The decline is exacerbated by Irish volatile date (-26.3%mom) • Eurozone “flash” Q1 GDP confirmed at +0.1%qoq • Eurozone “flash” Q1 employment growth at +0.6%qoq • Eurozone “final” April HICP headline at 7.0%yoy and core inflation at 5.6%yoy	• Flash Services and manufacturing PMIs for Eurozone, France and Germany (May). Focus on the strength of services and divergence with Mfg sector • German Ifo (May) • French business climate and consumer confidence (May) • German GDP details (Q1)
	• Jobs growth remained strong (up 182k in Q1), but payrolls point to sharp slowing declining by 135k in Apr. U/rate rose to 3.9% as workers returned to LM • Bailey, Ramsden and Broadbent spoke at Treasury Select Cttee on QT – signalled pace of QT could rise • GfK cons conf (May) up to -27, highest in over 1 year	• CPI inflation (Apr) expected to drop sharply as energy base effects drop out (cons 8.2%yoy) • UK public finances (Apr) to kick off FY23 data • Flash PMIs (May) • Retail sales (Apr) expected to rebound following May drop and benefits uplift
	• Q1 GDP up 0.4%qoq as domestic demand continues to recover, with consumption up 0.6%qoq • Exports (Apr) picked up following Q1 slump • Price momentum remains strong. Core CPI inflation (ex-fresh food and energy) rose to 4.1% in Apr – highest since 1981. Headline inflation stands at 3.5%	• Flash PMIs (May) • Reuters Tankan Index (May) • Tokyo CPI (May) to be watched closely for clues on evolution of nationwide inflation. Core CPI (ex-fresh food) expected to moderate to 3.3% from 3.5%.
	• April activity data came below market expectations with some loss seen in the recovery momentum. Sequential growth saw broad-based weakness but over a year ago prints were pushed up due to a high base effect	• 1-year and 5-year loan prime rates to be released
	• CB: Mexico (11.25%) & Philippines (6.25%) kept rates unchanged • Q1 GDP (%yoy) picked up in Colombia (3.0%) & Thailand (2.7%) and eased in Romania (2.3%). Conversely, GDP contracted in Chile (-0.6%), Hungary (-0.9%) & Poland (-0.2%)	• CB: Korea (3.50%), Hungary (13.0%), Indonesia (5.75%) & Turkey (8.50%) to stay on hold. South Africa is expected to hike +25bps to 8.0% • CPI (April): Malaysia, Singapore & South Africa • Industrial production (April): Poland, Singapore, & Taiwan

Upcoming events	US:	Tue: Services & Manf. PMI (May), New home sales (Apr); Wed: FOMC minutes; Thu: GDP (1Q S), Core PCE (1Q S), Weekly jobless claims (20 May), Pending home sales (Apr); Fri: Durable goods orders (Apr), PCE & core PCE (Apr), Personal income & spending (Apr), Goods trade balance (Apr), Wholesale inventories (Apr), Michigan consumer sentiment (May)
	Euro Area:	Mon: EU20 Consumer conf. (May); Tue: EU20 Composite, Services & Manf. PMI (May), Ge & Fr Services & Manf. PMI (May); Wed: Ge IfO business climate indx (May); Thu: Ge GDP (Q1), Fr Insee manf. confidence (May); Fri: Fr Insee consumer confidence (May), It ISTAT business & consumer conf. (May)
	UK:	Tue: PSNB (Apr), Composite, Services & Manf. PMIs (May); Wed: CPI (Apr), CPIH (Apr), RPI (Apr), PPI input & output (Apr), CBI Industrial trends survey (May); Thu: CBI Distributive Trades survey (May); Fri: Retail sales (Apr)
	Japan	Mon: Primary ‘core’ machinery orders (Mar); Tue: Manf. PMI (May)
	China:	Mon: Loan Prime rate (May)

Our Research is available online: www.axa-im.com/investment-institute