Global fiscal policy: a material change in tone

Global Macro Outlook, September 2016

This inaugural monthly outlook accompanies the launch of the BlackRock Macro GPS, a continuously updated indicator incorporating big data signals that provides a timely handle on the economic growth outlook. This month, we also assess the potential for fiscal easing in key economies. Highlights:

- The tone on fiscal policy is changing: as monetary easing reaches its limits, major economies are moving away from austerity. There is never a case for reckless fiscal spending, in our view. But productivity-enhancing fiscal expansion, such as infrastructure investment, now is likely to be more effective than usual.

- Infrastructure spending features in the US presidential campaign. Japan and Canada have pushed ahead with public investment. The UK appears set to temper its fiscal consolidation. The shift to fiscal policy could mark a regime change for bonds and other assets. Long-term yields should rise on fiscal expansion, but central banks still have the intent and ability to limit any unwanted yield rises.

GPS: low, but not that slow

Our BlackRock Macro GPS indicates the global recovery grinds on with no signs of Brexit contagion. It implies modest growth ahead for G7 GDP, albeit with upside to consensus expectations. See how the green line (GPS) is hovering above the grey line (consensus) in the chart below. UK data since the vote, including PMI surveys, have been resilient. This suggests a new government, decisive monetary stimulus and a weaker currency prevented a sharper confidence shock. Our UK GPS implies no immediate downgrade, but its big data signals now point to more weakness. We see the UK’s structural adjustments leading to a protracted and gradual growth decline.

Upside to economic consensus forecasts
BlackRock Macro GPS, 2015-2016

Sources: BlackRock Investment Institute and Consensus Economics, September 2016. Notes: The GPS shows where the 12-month consensus GDP forecast may stand in three months’ time. Consensus forecasts are measured by Consensus Economics.
Shift in tone
Investors have zeroed in on whether fiscal policy will play a greater role in lifting growth and inflation at a time when economies are still very policy-dependent. The case for fiscal expansion is hardly new. Beyond continual disappointments in global growth, the need for public investment is stark. The average age of US public infrastructure is the highest since at least 1950. See the chart below. Demographics are not the only aging problem major economies face.

Fiscal policy must take the baton from central banks, we believe. Not only are central banks reaching limits with rates testing the lower bound, but the lack of fiscal support may undermine the effectiveness of monetary easing, as argued in a 2016 paper by Nobel Prize-winner Chris Sims. Without the public and private sector taking advantage of easy financial conditions, low rates hurt savers and foster deflationary forces. Consider the Japan experience: Its push to improve its fiscal health via a higher sales tax dulled the impact of the Bank of Japan’s stimulus.

More governments are now looking at fiscal support, and the focus on austerity has faded. The International Monetary Fund (IMF) has become a bigger champion of fiscal expansion, while the G20 committed in September to “greater policy co-ordination and deploying more growth-friendly fiscal policy”. This is unlikely to equate to an immediate acceleration in growth, and some big developing countries such as Brazil are tightening their belts. Still, the shift away from austerity and the acknowledgement of the need for fiscal and monetary co-ordination matter for financial markets.

Malign neglect
Average age of US fixed assets, 1950-2015

Gauging the fiscal kick
We do not advocate reckless fiscal expansion and favour measures that have a positive impact on long-term growth. That said, how effective is fiscal expansion? An increase in the budget deficit tends to boost overall activity by about the same amount (in dollar terms). This implies a fiscal multiplier close to 1, as the baseline in the chart above shows. But the multiplier varies over the economic cycle. It tends to be higher during recessions or when short-term rates are near zero. When an economy runs near full capacity, the multiplier tends to be lower because government spending can ‘crowd out’ private investment by competing for scarce resources.

Yet this is not your usual environment. Monetary policy is constrained, and the usual distinctions between ‘recession’ and ‘expansion’ may not map as clearly onto the current landscape. We believe fiscal policy should be more effective, and thus the multiplier higher than the historical average.

Central banks would welcome fiscal help to meet inflation targets. The US Federal Reserve is signalling a tolerance for above-target inflation - despite its tightening stance. There is also fiscal space thanks to low bond yields cutting debt servicing costs. Since early 2015, Congressional Budget Office downward revisions of projected US interest costs over the next decade have totalled $1.4 trillion.
Jingling the public purse
Fiscal spending targeted at productivity-enhancing projects limits ‘crowding out’ effects by lifting both an economy’s total supply and demand, we believe. This is key at a time markets worry about protracted stagnation. Globally coordinated stimulus delivers more bang for the buck than isolated efforts, as shown by the 2008-2009 experience.

Low investment and productivity have also squeezed output gaps by depressing potential growth. See Productivity Slowdown Puzzle of January 2016. Output gaps could widen again if fiscal action supports investment in productive capacity.

Fiscal expansion will take time to materialise. Yet the signals are clear, and economists are upgrading their forecasts. See the chart below.

Plans and proposals for increased fiscal spending abound. Both US presidential candidates have proposed bigger fiscal spending. Hillary Clinton’s 1.3% of GDP per year of spending would be offset by higher taxes, while Donald Trump’s tax cuts could total more than 5% of GDP per year, according to campaign materials and analysis by the Committee for a Responsible Federal Budget and Tax Policy Center. These figures are shrouded in uncertainty; the new president will likely face hurdles in Congress.

Japan has rolled out stimulus worth 5.6% of GDP, but much consists of loans and guarantees. Ministry of Finance figures point to a spending dollop of 1.5% of GDP.

Fiscal spending avant-garde
Forecasts for government spending growth, 2015-2016

Bye bye austerity
DM fiscal contributions to world GDP, 2004-2018

Canada has launched a C$26 billion (1.3% of GDP) expansion over the next two years. And the new UK government has suggested a reset to the previous austerity policy, with a first budget plan set for Nov. 23. Stimulus may come from a value-added tax rate cut and accelerated infrastructure spending.

To be sure, the eurozone’s Stability and Growth Pact limits the room for fiscal expansion. The threat of sanctions on Spain and Portugal for breaching limits this year shows a reluctance to allow bigger budget deficits. Germany and the Netherlands have the most scope to lift spending but are unlikely to do so. China’s projected fiscal deficit has increased a bit, but other emerging markets (EMs), especially commodity producers, are cutting back.

We estimate that these expansionary plans in isolation (and excluding China and other EMs) could provide a cumulative boost of around 0.3% to world GDP over the next two years. Using more optimistic assumptions about the fiscal multiplier effect and spending plans, we could see this rising to 0.7%.

We see the various fiscal expansion measures leading to rising primary structural budget deficits in the developed world, particularly in the US. We do not expect a big jump, to be sure. But a return to rising deficits would mark a sea change. As the chart above shows, we see the shift to bigger fiscal spending among G7 economies now making a small contribution to global growth rather than subtracting from it, as the IMF still forecasts.
Impact on bonds, FX and equities

What does more fiscal spending mean for markets? Fiscal expansion should lift long-term bond yields as growth and inflation expectations rise and deficit spending increases the net supply of sovereign bonds. The median impact of a 1 percentage point deterioration in the fiscal balance can lead to a 0.4-0.5 percentage point lift in long-term bond yields, according to academic studies such as Fiscal Policy and the Term Structure of Interest Rates.

We believe the impact will be more muted in the current environment. Weak productivity and other structural headwinds mean neutral real policy rates are likely much lower than they have been historically. Demand for perceived high-quality assets such US Treasury bonds remains high.

One reason is that global savings outstrip investment. And central banks still have the intent and ability to limit any increases in long-term bond yields through quantitative easing. Fiscal expansion can lead to FX appreciation via, for example, higher growth expectations, according to a 2014 academic study Effects of Fiscal Shocks in a Globalized World.

Yet we see little fallout on currencies for now due to the muted change in bond yields. Equities likely will receive mild support from stronger overall demand, with distinct impacts for some industries.

Bottom line: We note an important change in tone among policymakers, away from austerity and toward fiscal spending. Even if the short-term growth implications are limited, this shift matters. The focus on fiscal expansion is likely just beginning.