Underlying Trends

Coordinated fiscal stimulus: the upcoming change in policy-mix?

ANNE-CHARLOTTE PARET, *Strategy and Economic Research*

Budgetary policy as an instrument of economic policy has not always been he rage. The criticism most often levelled against it is that it requires substantial budgetary leeway and lacks responsiveness (because it takes time to implement and benefits are felt only after some delay). Nonetheless, pushed by the IMF, the idea of budgetary stimulus has come back into vogue and goes by the name of "coordinated fiscal policy".

The accommodative monetary policies pursued by the major central banks are beginning to run out of steam and economic recovery remains subdued. Against this backdrop, the budgetary tool, which had been shelved since the eurozone crisis (leading to large-scale budget consolidation programmes) is coming under consideration once again as a potential solution. **Indeed, in today's environment, a fiscal package rolled out simultaneously in several countries could deliver a positive growth surprise, with an effect more pronounced than usual.** In fact, fiscal multipliers, which help quantify the impact of such a fiscal package on growth, have every reason to be higher in today's context[1]. First, the major central banks have created a protracted low interest rate environment (even though expectations are beginning to change in the United States). The effect of crowding out investment caused by rising interest rates, ordinarily expected subsequent to the deployment of fiscal stimulus measures, would therefore be lessened or indeed be totally absent today. Second, fiscal multipliers also depend on the structure of the budget expansion: spending increases should stimulate growth more than tax cuts do (as the latter are likely to be absorbed by firms and households). This holds even more if focusing on infrastructure expenditure or spending targeted to low-income households. Considering that quantitative easing measures have successfully relieved congestion in the supply of credit to businesses, tax cuts should less likely be absorbed by businesses for purposes other than investment. Finally, while such stimulus measures individually carry the disadvantage of being driven out by imports (for relatively open economies), the advantage of a coordinated strategy would be one of allowing countries to mutually benefit from stimulus measures deployed in foreign countries, thereby giving rise to a virtuous cycle. Hence, the IMF dictum: "The Whole Can Be Greater Than the Sum of its Parts".

That said, **is such an initiative foreseeable sometime in the next two years**? In the developed world, **Japan** is already implementing policy stimulus and is likely to pick up the pace in the event of an external shock or if growth struggles to recover (in particular, the VAT hike has been postponed again, and a new stimulus package announced in August).In the **United States**, the situation is uncertain. Although Donald Trump's program's relies on a wide range of tax cuts, his propositions will be curtailed by the Congress and the House of Representatives, where a majority against too heavy deficits should loom (even with a Republican majority). The impact of the fiscal policy will therefore depend: i) on the implementation of infrastructure expenditures and on the nature of the tax cuts ultimately voted (those targeting high income households stimulating consumption only to a lesser extent); ii) on the nature and scale of the expenditure cuts aimed to finance the lower tax burden. If the economy significantly slows, a stronger budgetary expansion would become necessary, partly because automatic stabilizers are relatively weaker in the United States (they contribute less to the smoothing of cyclical economic fluctuations). In the **Euro area**, the likelihood of a budgetary expansion appears remote. Albeit austerity measures are now a thing of the past and the European Commission has a more lenient attitude with respect to the budget recommendations[2] to follow, public debt ratios remain high and leave little fiscal space. This is especially so since cyclical factors should soon cease to contribute to the reduction of government deficits as the output gap gradually narrows. Moreover, following the Juncker Plan and the fiscal impulse provided by Germany (primarily in response to the influx of immigrants), it is not clear that Europe is prepared to propose a new sweeping budget plan. As to the BRICS, the likelihood of seeing any fiscal stimulus measures is also uneven. In **Brazil**, fiscal consolidation measures have been introduced to cope with an alarming rise in government debt (specifically, a cap on spending may be ratified by Parliament before the end of the year). In **South Africa**, fiscal policy is constrained by a debt ratio that has been on a rising trend for several years. **Russia** too has experienced an alarming rise in government debt (linked to the 2014-2015 decline in oil prices) leaving little budgetary for further expansion. In **India**, relatively strong growth and an ambitious deficit target (3% of GDP for 2018, versus 7% in 2015) does not point to any budgetary stimulus in the near term. On the other hand, in **China**, where the economy is transitioning to more sustainable growth, budgetary policy is providing some support to domestic demand. This trend should continue to avoid an overly sharp slowdown in growth (around 6.5% in 2017 compared to the anticipated 6.7% projected for 2016), with potentially non-negligible impacts for its trading partners (compared to a situation with no fiscal intervention).

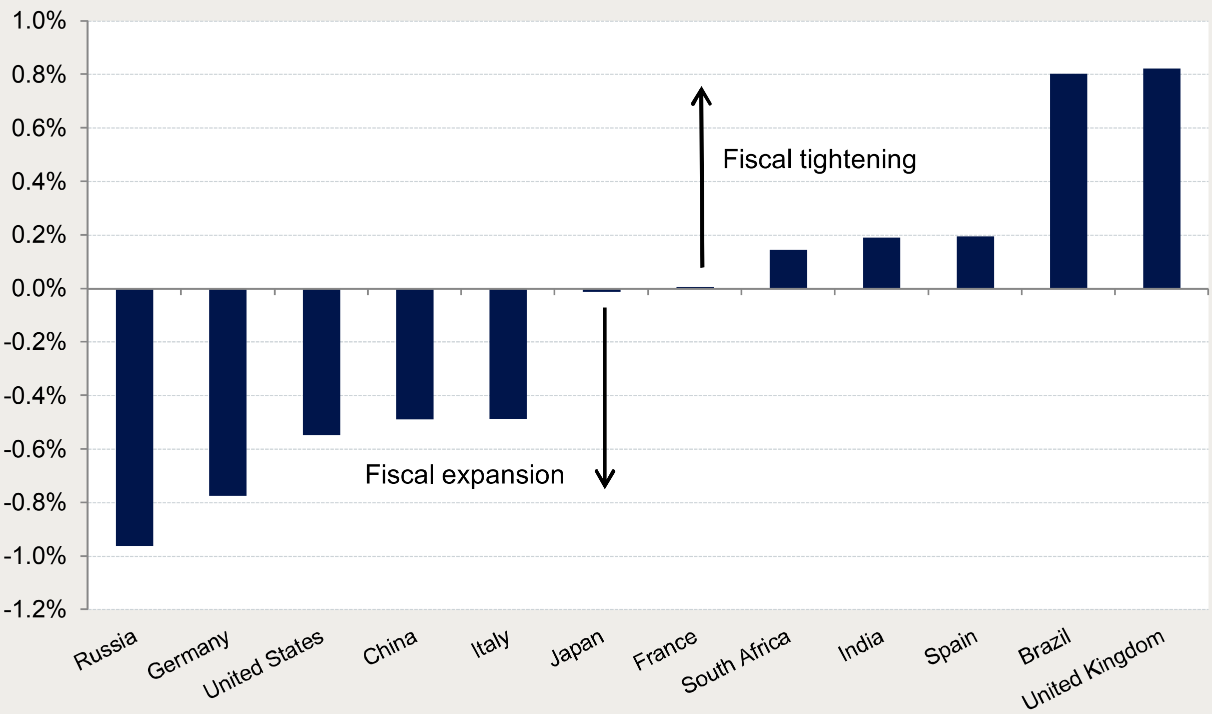
The simultaneous introduction of expansionary fiscal policies at the international level could produce results beyond the usual expectations against the current backdrop (because of the durable low interest rate environment and because positive spillovers are likely to reinforce each other, should coordinated deployment occur). Moreover, their financing would be eased by central banks' quantitative easing (in particular BoJ and ECB). Nevertheless, such coordination would hinge on both the removal of political uncertainties (evolution of

[1] *For more details on fiscal multipliers' determinants, see "Fiscal Multipliers: Size, Determinants and Use in Macroeconomic Projections", IMF, September 2014.*

[2] *In August, Portugal and Spain avoided the sanctions they were facing due to their budget slippage.*

bipartisan compromises at the American Congress, results of the upcoming elections in Europe and emergence of political consensus supporting such a stimulus package in the eurozone) and the future outlook for growth. The emergence of such a situation would be more likely in case of a significant negative shock. **Assuming such a stimulus has the intended effect on growth, it could even benefit to countries public debt dynamics via a positive "buoyant growth - low interest rate" mix.** It would help debt trends in countries where interest rates are exceptionally low, especially those enjoying a safe haven reputation (United States, core European countries and Japan), which is shielding sovereign interest rates even more against a potential rise. Finally, in these countries, inflationary pressures, which traditionally form the counterpart to budget stimulus, would be, for once, quite welcome.

2016 structural adjustment (IMF estimates)



Note: The structural adjustment is the change in structural balance (expressed in percentage of potential GDP). It corresponds to the reduction in general government deficit which is due neither to the effects of the economic cycle nor to one-offs. Estimates of structural balance can differ, namely due to the difference in the estimation of the output gap and temporary one-offs in revenue and expenditure items.

Source: IMF World Economic Outlook (October 2016), Amundi Research

Amundi
ASSET MANAGEMENT
RESEARCH STRATEGY & ANALYSIS

Amundi Research Center

Top-down
Asset Allocation
Bottom-up
Corporate Bonds
Fixed Income

Foreign Exchange
Money Markets
Equities

Find out more about Amundi research team

research-center.amundi.com

Monetary Policies
Forecasts
Investment Strategies
Quant
Emerging Markets
Sovereign Bonds
Private Equity
Real Estate
High Yield

Contributors

AMELI-RENANI ABBAS, *EMG Debt Strategy – London*
AINOUZ VALENTINE, *Credit Strategy – Paris*
BERTONCINI SERGIO, *Credit Strategy – Milan*
DE BRAY YASMINE, *Equity Research – Paris*
BUTLER RICHARD, *Credit Research – Paris*
BOROWSKI DIDIER, *Economic Research – Paris*
DRUT BASTIEN, *FX and Fixed Income Strategy – Paris*
FORTES ROBERTA, *Strategy and Economic Research – Paris*
GEORGES DELPHINE, *Multi-Asset Strategy – Paris*
HERVÉ KARINE, *Economic Research – Paris*
ITHURBIDE PHILIPPE, *Global Head of Research – Paris*
JI MO, *Economic Research – Hong Kong*
LAPEYRE THOMAS, *Equity Research – Paris*
LETORT VALÉRIE, *FX and Fixed Income Strategy – Paris*
MARTIN EMMANUEL, *Equity Research – Paris*
MIJOT ÉRIC, *Equity Strategy – Paris*
PARET ANNE-CHARLOTTE, *Strategy and Economic Research – Paris*
PERRIER TRISTAN, *Economic Research – Paris*
WANE IBRA, *Equity Strategy – Paris*
YOSHINO AKIO, *Economic Research – Tokyo*

Editor

ITHURBIDE PHILIPPE, *Global Head of Research – Paris*

Deputy-Editors

BOROWSKI DIDIER, *Economic Research – Paris*
BUTLER RICHARD, *Credit Research – Paris*
MIJOT ÉRIC, *Equity Strategy – Paris*
JI MO, *Economic Research – Hong Kong*
TAILLEPIED STÉPHANE, *Equity Research – Paris*

Conception & production

BERGER PIA, *Research, Strategy & Analysis – Paris*
PONCET BENOIT, *Research, Strategy & Analysis – Paris*