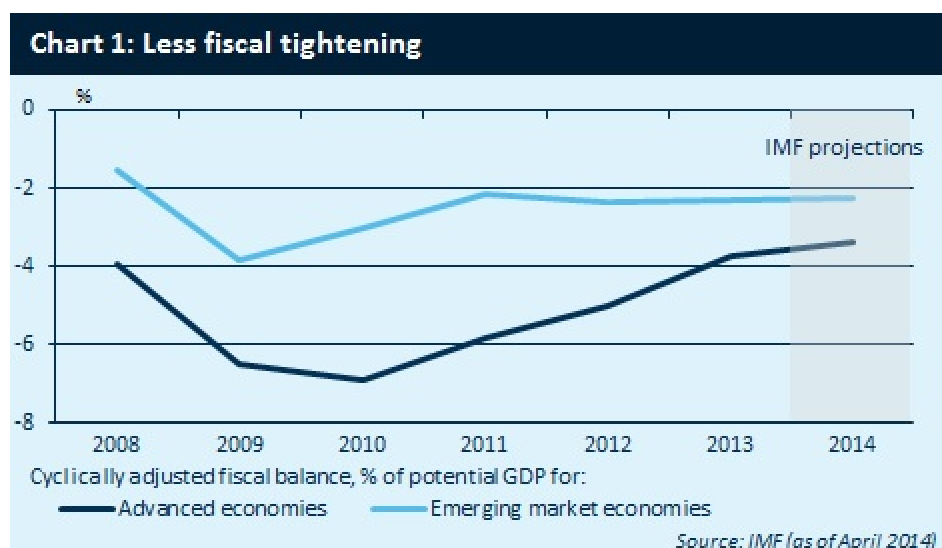
Standard Life Investments

# Weekly Economic Briefing
# Global Overview

## Let's get fiscal
**19 August 2014**

The aftermath of the global financial crisis saw national governments unleash a wave of fiscal stimulus. The IMF estimates that the global fiscal deficit in 2009 amounted to nearly 8% of global GDP, for the advanced economies this shortfall was closer to 10%. This stimulus, alongside unprecedented monetary action and financial sector intervention, meant that the financial crisis did not trigger a depression like that seen in the 1930s. However, the fiscal strategy since this nadir has been less cohesive. Despite weak recoveries, we have seen many governments implementing fiscal tightening. In some cases, this was motivated by concerns over growing sovereign indebtedness. Gross debt among the advanced economies has surged to 107% of GDP, from 80% in 2008. In the US, we have seen political manoeuvres trigger misguided and poorly planned fiscal adjustments. In some instances, tightening has been extremely costly. Evidence suggests that fiscal policy has a greater impact when there is significant slack in economies, financial systems are impaired and monetary policy is at or close to the zero lower bound. Parts of the Euro-zone periphery have felt the effects of these heightened fiscal multipliers. Aggressive fiscal tightening has led to large losses in output and welfare without fully delivering the expected improvement in public finances.

More recently, we have seen policymakers sensibly ease the pace of fiscal consolidation. The IMF expects cyclically adjusted budget deficits to be broadly unchanged in 2014 (see chart 1). With the US and UK enjoying relatively robust cyclical upturns, the focus should be on building credible medium-term consolidation programmes. In the Euro-zone, there is a strong likelihood that we will see further slippage on fiscal targets. While this should cushion demand, any loosening should be accompanied by structural reform to boost confidence that member states can generate the growth required to finance higher debt levels. With sovereign debt at astronomical levels in Japan, the focus should again be on structural reform, alongside further monetary stimulus. Finally, fiscal policy in China should focus on mitigating the effects of a structural slowdown in growth through measures which enhance a rebalancing of the economy.





### Contributors

**Authors:**
James McCann
Andrew Milligan
Govinda Finn

**Editors:**
Rachel Forshaw

**Chart Editor:**
Craig Hoyda

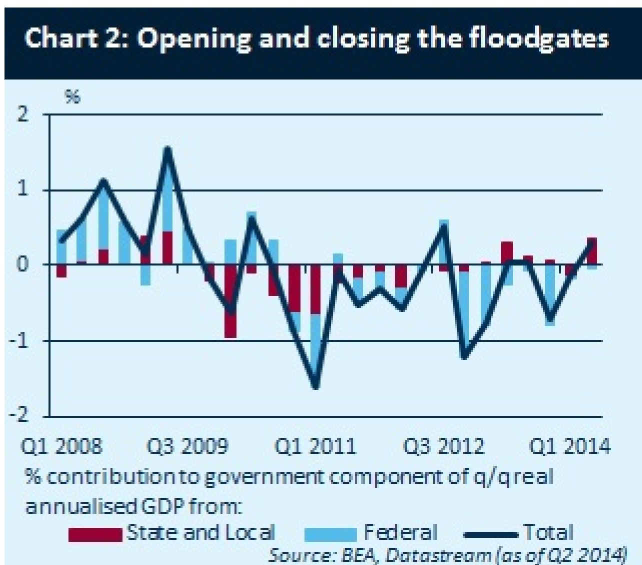
**Contact:**
Jeremy Lawson,
Chief Economist
jeremy_lawson@standardlife.com

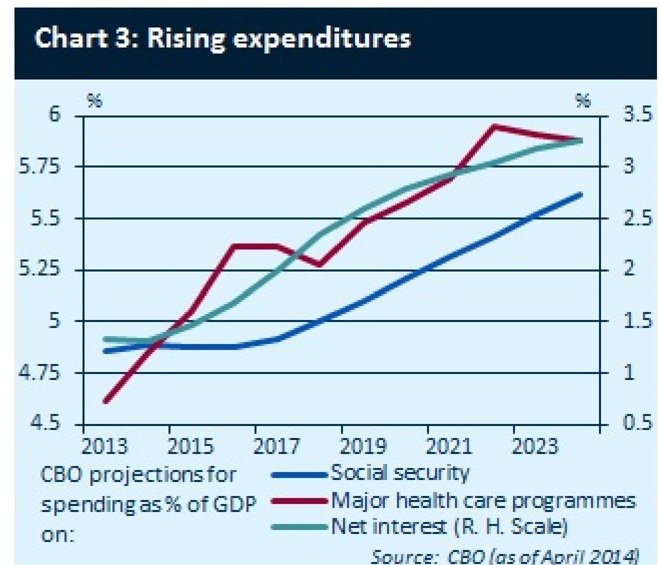
# US

## Fiscal bickering

The rebound in US activity, seen over the second quarter of this year, found support from an unexpected source. Government spending added 0.3 percentage points (pps) to the annualised growth rate, the largest contribution from the public sector since Q3 2012. State governments were responsible for this increase, with expenditure on investment and current consumption both rising over Q2. **A glance back at the pattern of fiscal expenditure since the crisis tells an interesting story** (see chart 2). The response to financial crisis was rapid and aggressive. Between 2008 and 2009 government consumption contributed on average 0.6pps to quarterly annualised growth rates, with Federal spending doing the hard lifting. It was a concerted attempt to support the economy through fiscal stimulus, alongside the impact of automatic stabilisers coming into effect. Given our better understanding of fiscal multipliers since the crisis, the impact of this stimulus on overall growth is likely to have been greater than the effect during normal times. Direct stimulus measures dovetailed with other policies, such as the Troubled Asset Relief Programme, which used the public sector balance sheet to strengthen the financial sector. However, the fiscal impulse started to fade thereafter. This was initially driven by cutbacks in state level spending, although the Federal government was not far behind. Between 2010 and 2013, government consumption subtracted on average 0.4pps from quarterly annualised growth. This represents a concerted switch away from stimulus, towards a consolidation of the public finances, even accounting for the fact that some of the reduction in spending can be attributed to a cyclical improvement in the economy.

The fiscal tightening implemented in the US between 2010 and 2013 did not represent coherent budgetary policy. Rather, the increasingly fractured political system triggered unintended and poorly planned short-term tightening. This began in the summer of 2012, when the prospective increase of the debt ceiling for Federal borrowing - usually a formality - became a political football. This was followed by the so-called fiscal cliff, in which policymakers bartered over how to deal with the simultaneous expiration of previous tax measures and imminent spending cuts. A last minute deal agreed to halt the majority of the tax increases; however, spending cuts were only delayed for a matter of months. Finally, the Federal government went into full shutdown in October 2013 as the debt ceiling issue reared its ugly head again. The good news is that these fiscal shenanigans look to have drawn to a close, since the US debt limit was increased without political standoff earlier this year. **The atmosphere around fiscal negotiations has clearly improved**, driven partly by polls suggesting that voters were not best pleased by the brinksmanship and gridlock of recent years. This is helpful. While US debt dynamics have deteriorated since the financial crisis, a short-term, politicised and uncertain fiscal policy has weighed on the US recovery. The focus must now turn towards a more orderly management of medium-term fiscal issues. With the US recovery proceeding, there should be an emphasis on consolidation of structural deficits and a gradual reduction in national debt. This challenge will be made more difficult by rising expenditure on social security and healthcare as the population ages, as well as on interest payments as rates eventually rise (see chart 3). **These issues require considered, long-term planning, as opposed to short-term politicking.**



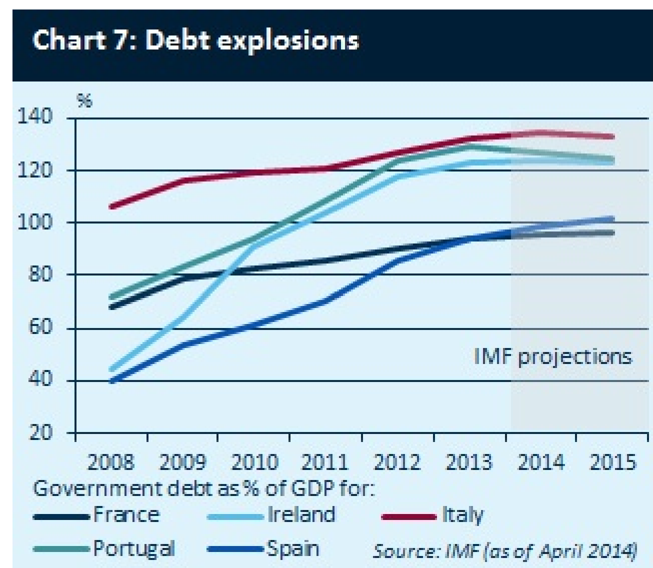



## Climbing debt mountains

**The Euro-zone provides an example of what happens when markets lose faith in the ability of countries to repay their fiscal commitments.** Greece, Portugal, Ireland and Cyprus all required government bailouts while Spain was forced to draw on EU funds to support its ailing banking sector. Elsewhere, it took the extraordinary commitment of the European Central Bank (ECB) to buy unlimited quantities of sovereign debt (upon certain conditionality) to calm financial markets. The immediate response to the deterioration in Euro-zone public finances was austerity. The cyclically adjusted budget deficit for the region fell from more than 5% of GDP in 2010 to 'just' 1.5% in 2013. This adjustment came at a significant cost to many countries, with fiscal multipliers almost certainly larger on account of weak demand, an impaired financial sector and an insufficient offset from monetary policy. The pace of adjustment has now eased, which should help growth, although **debt dynamics among many member states remain alarming. Italy provides a useful case study.**

Gross debt in Italy stands at some 133% of GDP and its financing needs amount to around 30% of GDP over this year and next. Before the crisis, Italy had managed to make some progress in reducing its debt burden through a combination of low interest rates on government debt, primary budget surpluses (excluding interest repayments) and firm nominal growth rates. While Italian bond yields have fallen to record lows on the back of implicit ECB support, Italy is struggling at present with the other two components. On the growth front, faith is being placed in the ability of the new Renzi Government to deliver much-needed structural reform. Italy continues to struggle with an anaemic potential growth rate and this weak real growth environment is exacerbated by stagnant inflation (see chart 6). There was some good news on the reform front last week, with the Italian Senate approving the Constitutional reform bill which will reduce the power of the upper house, streamline the political system and make future economic reform easier. This is just a first step, as the constitutional change requires three more votes, meaning that it will be some time before Italy can reap the rewards. While this represents a frustrating delay, **Renzi's strategy of reforming the political system first to facilitate deeper economic reform in the future looks to be right.** Hopefully, recent data from Italy - which showed another contraction in economic activity over Q2 - will remind policymakers of the urgency of this reform programme. However, with 10-year Italian bond yields at 2.67% there is little in the way of market pressure at present.

Weaker growth in the Euro-zone as a whole has raised the chance of slippage on this year's already less stringent fiscal targets. Indeed, the French finance minister has halved GDP growth forecasts and conceded that France will not meet its deficit target in 2014. **While fiscal slippage would help cushion the slowdown in activity, it must be accompanied by structural reform in order to convince markets that governments will be able to generate the growth to deal with these higher debt burdens.** Finally, more action should be carried out on the monetary stimulus side. An all-out QE programme would help support the nominal growth outlook in the Euro-zone, helping support the sustainability of the enormous level of debt in the currency union (see chart 7).

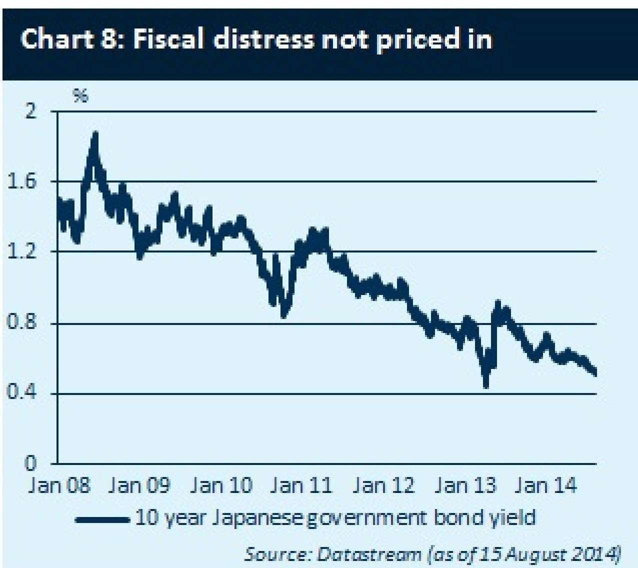


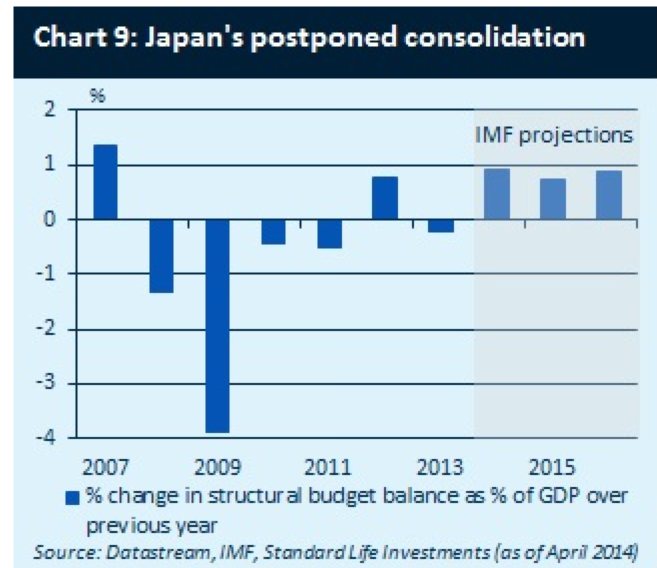
## Japan's sinking feeling

Japan has long been considered a fiscal Titanic. Yet, despite the country's public debt-to-GDP ratio reaching nearly 230% and its cyclically adjusted primary deficit standing at more than 9%, **predictions of imminent fiscal calamity have repeatedly fallen wide of the mark.** One explanation for this is that the country has been sustained by domestic institutional investors who have chosen to ignore Japan's fiscal plight in favour of the attractive real yields available from government bonds in a deflationary environment (see chart 8). Unfortunately, the recent shift in inflationary pressures raises serious question marks over such analysis. With real yields now negative, why has there not been a more aggressive sell-off in the market? One explanation is that bond holders do not believe the Bank of Japan can succeed in its task and that Abenomics is doomed to failure. However, another explanation is that **while investor returns are indeed being squeezed in the short term, this is being counteracted by an improving fiscal outlook for Japan in the longer term.**

Let us consider this latter idea in more detail. According to the Ministry of Finance, while the government is on track to achieve its target of halving its primary deficit to nominal GDP by fiscal year (FY) 2015, its 2020 target of a primary fiscal surplus is not attainable. So why should market participants give the government a better chance of meeting its fiscal target than it gives itself? The first thing to point out is that, while the policies of the Abe regime appear to be primarily focused on an exit from deflation, they have had some important fiscal consequences too. Stronger economic growth in FY2013 has helped raise tax revenues to ¥47 trillion, its highest level for five years. Perhaps more importantly, the 2013 figure was significantly higher than the government's initial estimate of ¥43.1 trillion, the fourth consecutive year that actual receipts have exceeded estimates. **Given this track record, it may be easy to see why investors are upbeat about further positive fiscal surprises.**

Of course, tax receipts are only part of the equation, and there is evidence that fiscal expenditure is also on the rise. For FY2014, fiscal expenditure is expected to reach ¥74.4 trillion, a third consecutive annual increase since falling to ¥68.4 trillion in FY2012. This upward trend is not expected to reverse any time soon as Japan's ageing population adds to a social security bill that already accounts for more than 40% of primary balance expenses. To tackle this problem, the National Council on Social Security System Reform has proposed sweeping reforms of the country's social security provision. However, will this be enough to push Japan onto a more sustainable fiscal trajectory? Market pricing may signal greater confidence in Japan's fiscal consolidation efforts but Japan remains a worrying outlier in terms of fiscal sustainability. According to the IMF, Japan has the world's largest consolidation requirement (close to 16% of GDP, in order to reach a primary surplus of about 7% of GDP). Perhaps more worryingly, while Japan has long targeted a more aggressive improvement in its fiscal deficit, its ability to deliver tangible progress is poor, with Japan's structural budget only seeing one year of improvement since 2008 (see chart 9). **More haste, Mr Abe!**



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