Macro & FICC Research

Reflections

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New challenges for fiscal policymakers

When vaccinations lead to hope of a return to a more normal situation, COVID-19 crisis policies will be replaced by recovery policies. Historically large stimulus measures have eased the impact of the crisis but have also raised questions about how effective they are and how they can be phased out without pulling down growth. Public finances seem unlikely to deteriorate as much as feared, creating some respite. Meanwhile differences in fiscal stimulus doses are now contributing to greater divergences in GDP growth. The latest US rescue plan will help generate so much economic strength that we are already starting to see warnings about overheating risks. This makes analysing the effectiveness of different types of fiscal policy measures increasingly important. So far, central banks have been able to provide support by means of low key interest rates and asset purchases. As long as there is spare capacity and low inflation, no changes are expected on that front, but how long can it continue?

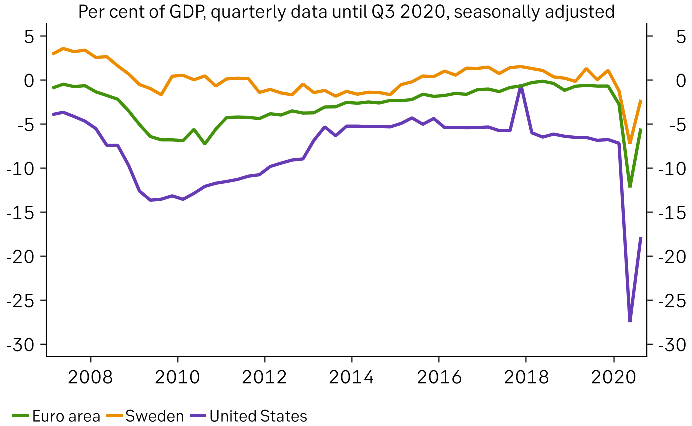
Håkan Frisén
Head of Economic Forecasting
+46 70 763 80 67
hakan.frisen@seb.se

Daniel Bergvall
Economist
+46 73 23 52 87
daniel.bergvall@seb.se

The magnitude of the fiscal stimulus measures that have been launched since the outbreak of the pandemic is unparalleled in peacetime. Fiscal policymakers have had to assume such heavy responsibility partly because central banks had already used up a lot of their ammunition. Fiscal policymakers also have greater potential to tailor their responses to the unique challenges created by the crisis. This applies, for example, to compensating households for large income losses or crafting special solutions for various sectors; something the blunter tools of monetary policy have difficulty handling. It is also clear that there is now greater tolerance for large budget deficits and rising public sector debt. This reduces the risk of early austerity measures of the kind implemented during the euro crisis a decade ago. There is also increasing "collaboration" between fiscal and monetary policymakers. The willingness of central banks to buy a large share of the increasing government bond supply is an important prerequisite for fiscal stimulus to work in practice.

Big differences in public sector deficits

Per cent of GDP, quarterly data until Q3 2020, seasonally adjusted



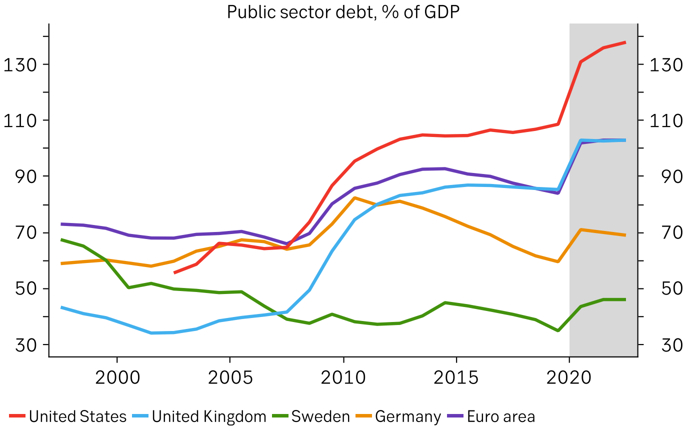
Source: International Monetary Fund (IMF), Macrobond, SEB

Budgets have not deteriorated as much as feared

Plunging GDP – combined with large-scale crisis responses – has put severe pressure on public sector finances. But in many countries, budget deterioration has been much milder than first indicated by the sum of the crisis responses that were announced. It seems likely that governments sometimes exaggerated the scope of their crisis packages, in order to show their determination. The economic downturn was not as deep as initially feared, which eased the cyclical strains on public finances. It is also likely that red tape and unappetising requirements made businesses less willing to take advantage of relief programmes. This has been especially clear in Sweden, where the 2020 budget deficit was only 3 per cent of GDP and where business sector organisations have criticised the "stinginess" of some relief programmes. Based on final budget figures, it is also clear that stimulus measures have been larger in the United States than in Western Europe. A large proportion of US stimulus responses has consisted of direct payments to households, naturally contributing to a high degree of utilisation.

Debt will level out as growth accelerates

Public sector debt, % of GDP



Source: Macrobond, SEB

Wider differences in public sector debt

Nor does the rise in public sector debt appear to be as dramatic as we might have feared, but the situation has become more divergent in this respect as well. In Sweden, public sector debt appears unlikely to reach more than 40 per cent of GDP. But we should also take into account the effects of foreign exchange reserve management, with the Riksbank now replacing its borrowing via the National Debt Office with foreign currency purchased using newly created kronor. This will reduce the public debt ratio by about 5 percentage points in 2020–22. Despite unusually aggressive stimulus measures in Germany, that country is a long way from the debt ratio levels it reached during the global financial and euro crises. But in the United Kingdom, and in the euro area as a whole, government debt appears likely to surpass 100 per cent of GDP. US public sector debt is approaching 140 per cent of GDP. These debt increases will level off in the future, partly because crisis responses will be phased out as the economy improves. In addition, nominal GDP (the denominator in the debt ratio) will rebound sharply in 2021, after having fallen in 2020. If we look at the size of public sector interest payments, the picture is even more reassuring. Although the debt ratio is historically high in most countries, interest expenses as a share of GDP are often at record lows. In this respect, the Swedish figures stand out especially clearly. Due to both historically low debt and exceptionally low interest rates, public sector interest expense is equivalent to only 0.3 per cent of GDP. In the aftermath of the early 1990s financial crisis, it was well above 5 percent of GDP.

Public sector debt and gross interest burden
Per cent of GDP

	US	JP	IT	GE	SW
Debt, 1995	69	96	119	55	69
Interest expense, 1995	6.2	3.2	11.1	3.5	5.1
Debt, 2020	128	265	160	71	40
Interest expense, 2020	4.0	1.4	3.5	0.7	0.3

Source: Macrobond, SEB

Crisis responses are giving way to a new phase

The fog of the COVID-19 crisis is now beginning to lift, also increasing our ability to assess other consequences of the policies that countries have pursued. How the economy actually responds to stimulus measures depends largely on the course of the pandemic and what phase we are. Put simply, fiscal responses can be divided into three different phases; *crisis response policies, recovery policies and exit policies.* The task of crisis response policies is to ease the direct consequences to households and businesses in ways that contribute to social stability and minimise long-term detrimental effects on the economy. In a situation where shutdowns and restrictions are blocking consumption as well as production opportunities, the effectiveness of such policies will inevitably weaken. Due to the protracted course of the pandemic, we are still partly in this phase, although the vaccination roll-out and our increasing ability to keep the economy going in spite of restrictions means that the focus of attention will soon shift to recovery policies.

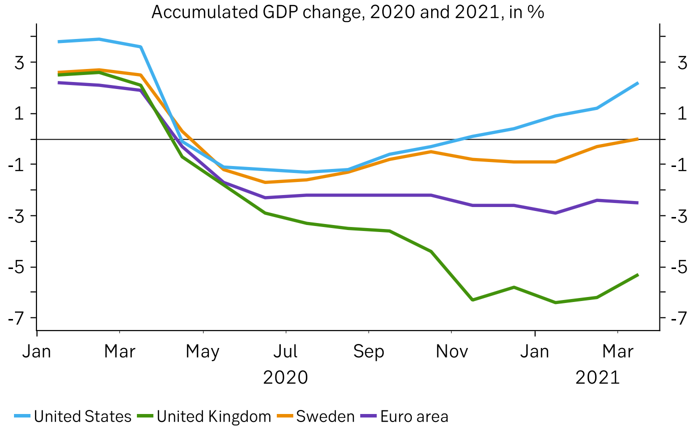
Extra powerful recovery policies

There are many indications that fiscal stimulus measures will be highly efficient in the next phase. Certain factors that hamper their efficiency are often pointed out, for example that households fear that public sector deficits will eventually lead to austerity measures in the form of reduced subsidies or higher taxes. This leads to increased savings to prepare for tougher times (the Ricardian equivalence theory). Another mechanism is that fiscal stimulus drives up interest rates in ways that crowd out private investment and, to some extent, consumption. Now that we can see that the increase in central government debt will not be as dramatic as feared, this diminishes the risk that higher precautionary savings will hamper future consumption. In addition, both governments and international organisations are signalling that the mistakes of the euro crisis – with its early budget consolidation measures – must be avoided. In practice, it is thus likely that the authorities will allow divergences from fiscal policy regulations for some time to come. We are seeing this in practice, with the European Union suspending the deficit and debt ratio requirements of its Stability Pact during the pandemic and discussing future revisions. The central banks, for their part, continue to show a willingness to maintain exceptionally low key interest rates and also generally help to hold down interest rates and bond yields by means of asset purchases.

Green elements justify aggressive spending

Continued aggressive fiscal stimulus measures and divergences from normal frameworks are now also being given legitimacy in other ways. The authorities emphasise that these actions are structurally important and improve the supply side of the economy; in addition, they include green elements that contribute to greater sustainability. In the US, the Biden administration's next fiscal package will focus on investments in infrastructure, the environment and digitisation, but also on measures that the administration hopes can improve the utilisation of human capital, such as spending on education and expanded childcare. The recovery package that the European Union approved last year – Next Generation EU (NGEU) – has a similar focus. NGEU will not primarily cover COVID-related expenses but will instead go towards investments for the future in structurally vital areas such as the environment, digitisation, job creation and growth – areas that may easily be neglected in national crisis-focused budgets. The package totals EUR 750 billion (just over 6 per cent of euro area GDP), of which EUR 360 billion consists of loans and EUR 390 billion grants. It also contains redistributive mechanisms that will focus especially on the countries that have been worst affected by the pandemic crisis. Italy, for example, will receive more than 10 per cent of its GDP in allocations, if borrowing limits are fully utilised.

Consensus forecast on various dates
Accumulated GDP change, 2020 and 2021, in %



Source: <Property Source not found.>, Macrobond, SEB

Rapid US recovery will change the playing field

During the most acute phases of the COVID-19 crisis, most countries took steps they considered necessary, regardless of the state of their public finances. When it comes to future recovery policies, we will see bigger differences. For example, Germany and the Nordic countries – with their stronger balance sheets – have significant scope to provide more support, and for longer. Although the US is now approaching public debt levels that are high both in a historical and international perspective, the special position of the dollar will still allow a large degree of freedom. But even if the US has no direct fiscal constraints, cyclical issues are now becoming relevant to what is appropriate fiscal policy. The US economy has recently shown unexpectedly strong performance, especially in light of continued widespread COVID-19 transmission. In addition, President Joe Biden's new American Rescue Plan, which is equivalent to more than 8 per cent of GDP in 2021, has now become law. All in all, this has recently contributed to a significant upward adjustment of American GDP forecasts. SEB now predicts that GDP will grow by 6.5 per cent this year and 4.0 per cent in 2022. In the February issue of *Nordic Outlook*, our estimates were 4.5 and 3.5 per cent, respectively. The new forecast implies that full-year 2022 GDP will be 7 per cent above pre-crisis GDP in 2019, which is actually slightly above the previous trend. Although our basic view is that this will not necessarily lead to any serious inflationary pressures, it is clear that exit policies are now starting to look clearly divergent and that the gap between the US and Western Europe will widen.

Large but manageable stimulus measures

In February's *Nordic Outlook*, we discussed various ways of quantifying fiscal stimulus. At the beginning of the pandemic, it was important to try to quickly summarise all the programmes announced by governments and central banks. As we begin to see what actual budgetary impacts these measures may have, the focus will be more on established metrics of fiscal policy direction. The change in cyclically adjusted net lending is the most common "top-down approach". The idea behind this approach is that the budget changes not due to shifts in economic activity should be defined as policy-determined. In this way, we avoid becoming dependent on interpreting hard-to-analyse lists of measures by different countries. On the other hand, this method is based on uncertain estimates of the output gap and the cyclical sensitivity of public sector finances. Measured in this way, stimulus measures in 2020 amounted to 5 per cent of GDP in the 37 countries of the Organisation for Economic Cooperation and Development (OECD). Since change is measured between years, it is natural that countries with the largest stimulus measures in 2020 will find it hard to avoid fiscal tightening in the future. US fiscal policy will be slightly expansionary this year, since the large 2021 "rescue plan" was on par with the large-scale crisis responses enacted in 2020. Partly due to the relatively cautious Swedish crisis response in 2020, on the other hand, a stimulus effect is likely to be recorded in Sweden this year as well. Overall, fiscal policies in the OECD countries look set to be fairly neutral in 2021, while a fiscal tightening seems inevitable in 2022.

Fiscal stimulus impulse

Change in structural budget deficit, per cent of GDP.
Plus signs mean a stimulus effect, negative the opposite

	2020	2021	2022	2020-22
OECD	5.0	-0.5	-2.0	2.5
United States	6.0	0.5	-3.0	3.5
Japan	5.5	-3.0	-1.5	1.0
Euro area	3.0	0.5	-1.5	2.0
Germany	4.5	-1.0	-1.0	2.5
United Kingdom	7.0	-3.0	-2.0	2.0
Sweden	2.0	0.5	-0.5	2.0

Source: OECD, SEB

Policy mix important to effectiveness

It may also be important to specify how various measures affect economic activity. One way is to estimate so-called implicit multipliers for different types of measures. A multiplier larger than 1 means that actual impact on the economy is greater than the initial budgetary burden. This is usually because the measure triggers a chain of economic activities. A low multiplier may, for example, be due to the effect being weakened by increased savings or rising imports. For small economies with large foreign trade, such as Sweden, the issue of import leakage is especially important, while the size of the savings leakage is more relevant to US conditions, for example. Tax cuts for high-income earners are a typical example in which the multiplier is weakened by increased savings. On the other hand, measures that lead to greater purchasing power for low-income earners or spending on public sector investments and core business activities have a high multiplier. If you want to achieve a high short-term growth effect, this analysis is an important tool when designing the policy mix. However, multipliers are also dependent on macro conditions such as the economic situation and general optimism. They are also affected by the sustainability of public sector finances and their interaction with monetary policy (as discussed earlier), which can make the estimates uncertain.

US stimulus measures also benefit other countries

Given its large stimulus measures and rapidly shrinking output gap, multiplier analysis is the most interesting for the United States. Olivier Blanchard, former chief economist of the International Monetary Fund (IMF), recently highlighted overheating risks based on the size of the multipliers, citing earlier studies that show very large uncertainty intervals. But since conditions are now favourable, he concludes that we are more likely to end up at the upper end of estimation ranges, increasing the risks of overheating. In this context, it is interesting to consider spill-over effects between different economies. One OECD calculation indicates that the 2021 US stimulus package – just over 8 percent of GDP – will boost US growth by 3 to 4 per cent over the next year. In addition to the dampening effect of increased savings, import leakage will also benefit growth in other countries. For example, Canada will see about a 1 per cent boost in growth and the euro area about 0.5 per cent. The discussion about import leakage thus also accentuates the importance of coordinated efforts that may lower the risk of anyone getting a free ride.

The risks and opportunities of exit policies

To avoid making economic actors nervous, governments and central banks have held off on discussing the shape of the policy normalisation that must come sooner or later. But soon it will be time to make fiscal policy decisions about 2022, which will be a crucial year for exit strategies. It is difficult to ignore the fact that fiscal policy will generally be moving in a tightening direction by then. For example, the UK has already announced tax hikes to strengthen public finances but active measures will not be introduced until 2023. Our assessment is that fiscal tightening will not exceed 2 per cent of GDP in the OECD as a whole, following a 5 per cent stimulus in 2020 and a neutral direction in 2021. It will be natural not to maintain the same stimulus level in 2022, when private income generation is starting to pick up speed. In the euro area and elsewhere, a lack of fiscal manoeuvring room will also force tighter policies. In the US, there are instead clear cyclical motives for a shift in this direction, since the economy will have a high level of resource utilisation by then.

Dramatic upturn in the US household savings ratio

How the economy is actually affected will also depend on previous stimulus measures. In many countries, household saving has soared, with incomes rising due to fiscal stimulus measures while consumption opportunities have been restricted in certain areas. The United States stands out in this regard. In 2020, real household purchasing power appears to have increased by 6 per cent, while consumption fell by 4 per cent. This pushed the household savings ratio from 7.5 to more than 16 per cent of income. This year, income will continue to increase at almost the same rate, while new stimulus measures of the same magnitude as in 2020 are combined with strong underlying growth in wages and employment. We estimate that in 2021, consumption will rise somewhat faster than income, which means that savings will remain at an elevated level. This, in turn, will provide resilience in 2022. Although there are likely to be further US stimulus measures in 2022, some decline in household purchasing power can probably not be avoided after the exceptional increase in 2020 and 2021. However, this will be partly because tax increases on both companies and high-income earners will fund aggressive public sector investments. These have a low multiplier effect on households, as discussed above, thereby easing their negative effect on consumption, which we believe will show a robust increase in 2022 as well.

Plenty of room for fiscal stimulus in Sweden

The situation in Sweden contrasts with that of the US in some ways. Direct relief to households has been limited during the COVID-19 crisis, partly because the existing social benefit system provides greater basic security even without active measures. But overall purchasing power fell slightly in 2020. Since the decline in consumption was still of the same order of magnitude as in the US, this resulted in a slower savings upturn. In 2021 we believe the savings ratio will continue to rise as a sharp increase in income is combined with a fairly modest increase in consumption, with restrictions continuing to block many activities for a relatively large part of the year. Measured as a full-year average, a large increase in consumption is thus not likely to be recorded until 2022, when GDP growth is also expected to culminate at close to 5 per cent. Due to relatively modest stimulus measures in 2020, combined with low public sector debt, Sweden will have an unusually large degree of freedom in formulating its exit policy. A relatively high unemployment rate and long-term collective pay agreements at fairly low levels mean that there is also cyclical room for stimulus. We can also note growing criticism that the government is not doing enough in the climate field. Although Sweden's existing fiscal framework does not impose any formal restrictions during the crisis itself, it has nevertheless probably contributed to more prudent fiscal policies than in other countries. However, the crisis has revealed shortcomings in Swedish society, and it would probably not be hard to mobilise a political majority in favour of major spending in such fields as health care, emergency preparedness, digitisation and green investments, even if this might mean not fulfilling budget targets. However, no formal changes to the fiscal policy framework are likely to be relevant until 2026 when the next review will take place in accordance with the agreement. At that time, it will be possible to create additional fiscal manoeuvring room by putting more emphasis on the "debt anchor" than on the budget target.

Central banks will provide continued support...

Constructive interaction between fiscal and monetary policymakers has contributed to the success of crisis policies. Large government budget deficits and increased debt have not created greater concerns, because of clear signals from central banks that they are prepared to provide support in the form of low key interest rates and asset purchases (quantitative easing, QE) during the foreseeable future. This favourable situation arose because central banks realise that fiscal policymakers have better tools for dealing with the crisis, but perhaps especially because central banks actually have a lot of room to help. A long period of difficulty in reaching their inflation targets has created a credibility problem that central banks must make an effort to eliminate. This is one important reason why the US Federal Reserve (Fed) is now prepared to allow inflation a bit above target for some time, thus actually testing how far unemployment can be pushed down. The inflationary impulses now on the way due to rising commodity prices and problems on the supply side of the economy – for example with regard to transport – are hardly enough to change expectations or persuade the central banks to change their minds. Nor do we believe that the downsides of loose monetary policies, in the form of widening wealth gaps, will make central banks more cautious in the near future.

...but this support will not be unlimited

Central banks have definitely not given up their fundamental task of guaranteeing stable monetary value. Sometimes we may get the impression that tendencies towards "printing money to fund public sector deficits" might indicate an underlying decline in the independence of central banks, forcing them to follow the lead of governments. If inflation expectations should actually take off in such a way that they are de-anchored from the inflation target, we would end up with serious problems regardless of how the central banks handle such a situation. Our main view is that there are strong disinflationary forces even in a medium-term perspective and that the probability of derailed inflation expectations is thus quite small, but the risks of central banks "playing with inflation fire" cannot be ignored. It is hard to say when this will affect monetary policy, but as the post-pandemic recovery achieves a firmer footing and resource utilisation is normalised, the balance between the advantages and disadvantages of sticking to ultra-loose policy guidance will change. Tendencies towards price and wage increases will then have to be taken much more seriously than the premature inflation impulses we foresee in the near future. It will then become increasingly important for central banks to underscore their independence and their basic task of maintaining price stability. The differences between the economic situation in the US and Western Europe are, of course, very important. In the US, we can see that the Fed is now tolerating some surges in Treasury bond yields, while leading economists are beginning to warn that overall stimulus measures are becoming too strong. In the euro area, the European Central Bank (ECB) will probably have to be available for quite some time to help sustain a tentative recovery. It is also important to deal with divergent conditions. So far it has been possible to keep yield spreads between countries in the euro area from soaring, which had previously been a clear sign of systemic stress. There is reason to hope that the more flexible approach to the euro area regulatory framework that has characterised COVID-19 crisis management will have a lasting impact. But at the same time, it would be naive to think that underlying tensions have disappeared. A clear example of this is Bundesbank Governor Jens Weidmann's recent statement that the extraordinary measures and policy interpretations necessitated by the crisis must be phased out as we move towards normal times. The ECB will continue to struggle with internal conflicts in terms of finding the right balance between alleviating stress symptoms and meanwhile maintaining restrictions and incentives that encourage fiscal responsibility at the national level.