Fiscal Forward Guidance

70 – 30 November 2020

Key points

- The current EU fiscal surveillance framework is probably ill-suited to guide governments through their "exit strategy" from the ongoing extraordinary policy stimulus. We explore some solutions.
- For all the drama, even with a Free Trade Agreement agreed in the next few days, the UK will have chosen one of the most aggressive options which were available post-Brexit to shape its relationship with the EU.

We explore this week the possible "exit strategy" from the ongoing extraordinary fiscal and monetary stimulus. Drawing on Olivier Blanchard' recent research, we argue that the current EU fiscal surveillance framework may be ill-suited to guide governments through an optimal path for a fiscal consolidation which would ensure public debt sustainability while preserving the economic recovery. However, Blanchard's favoured solutions – moving to a discretionary assessment by the Commission with strong enforcement power or using the ECB's existing OMT framework – do not seem politically feasible to us, at least not without going first through a painful phase of volatility and tension on sovereign spreads. We continue to think that voluntary "fiscal forward guidance", i.e. ex ante commitments by governments to start tightening fiscal policy once certain numerical thresholds are met on the recovery (e.g. unemployment falling below a pre-set level) would offer enough visibility for the ECB to map their own normalization while minimizing the risks of market turmoil. There is no perfect system, if only because fiscal policy remains essentially the product of democratic decisions while monetary policy is a technocratic one, and we would expect quite a lot of noise on the route to exit, but the conversation at the institutional level needs to start before the pandemic emergency is over.

Meanwhile, as we write a deal has yet to be agreed between the UK and the EU. For all the drama around this "race against time" to provide some organized framework around the UK/EU economic relationship, the low-quality Free Trade Agreement which is being painfully negotiated would still be one of the worst arrangements among all those which were thinkable after Brexit. An FTA will be far from providing "frictionless trade" between the EU and the UK, which was the British government's initial objective immediately after the referendum. It would obviously be better for the UK – and to a lesser extent the EU – if a deal was struck, to avoid customs tariff being slapped (the extension of the UK tariffs on food imported to the UK could raise the overall consumer price level by 0.5% immediately), but even with an FTA the damage will be significant. We remain baffled that the negotiation is still hinging on fishing, which contributes 0.1% to the British GDP, while any attempt to secure the position of the UK financial services in the EU has been abandoned months ago (this industry contributes about 10%). Politics has its reasons, and its economic costs.

The devil's arithmetic

We have been arguing for a while now in Macrocast that the broad lines of an exit strategy from the current extraordinary quantum of policy support would need to be discussed before the pandemic crisis is fully resolved, to avoid market volatility if uncertainty on both monetary and fiscal policy beyond 2021 were to prevail. Far more distinguished economists than your humble servant are on the case – Olivier Blanchard probably is the first name to come to mind – but we want here to offer a few general ideas.

In the countries worst-hit by the pandemic crisis, or where governments have been the most forceful in their economic reaction, public debt will end up roughly 20% of GDP higher than re-Covid (that is the ball-park for the US or France for instance). If we ignore the debate on cancelling the fraction of public debt held by central banks (this would we illegal in the Euro area**), the first conceptual port of call to gauge future debt dynamics is the usual debt sustainability equation: given a certain initial level of debt, the primary balance (i.e. the public deficit excluding interest payments) which will stabilize the debt to GDP ratio depends on the difference between the interest rate and GDP growth**, the now ubiquitous "(i-g)". While this simple equation is very useful to build scenarios, it does not necessarily tell us what governments should do. High debt countries, at risk of a "sudden stop" in private investors' purchases of their sovereign debt, should probably do more than what (i-g) would suggest to improve their primary balance. This is the intellectual basis of the EU's enhanced fiscal surveillance framework, which imposes a larger quantum of fiscal consolidation to high debt countries, by reference to the EU's 60% reference.

However, **we have learned from the sovereign crisis of 2010-2013 that a "blind" normative approach can be counter-productive, because it ignores the interactions between the various parameters governing debt sustainability**. There is no such thing as a "given growth rate" or a "given interest rate". Their values are strongly dependent on the fiscal choices.

Our current predicament can be summarized by three very simple equations:

(1) Fiscal balance = i (DEBT t-1) + structural balance + a. Output gap

The deficit here is broken down in (i) debt servicing costs, (ii) the structural balance, i.e. the discretionary part of the government's fiscal policy, such as changes in tax rates, (iii), the cyclical component which is the result of the automatic operation of public finances in reaction to changes in business conditions, here the output gap, i.e. the difference between actual GDP and where it should be it had continued to grow on trend. As an example, this third component would include the drop in tax receipts which will result from lower economic activity. The parameter "a" here stands for the sensitivity of public finances to the output gap. In Europe, "a" usually stands at c.0.5/0.6.

(2) Output gap = Exogenous shocks + b. Δ structural balance + c. Δ i

This is where endogeneity strikes. Equation 2 is a very simplified approach of course but ignoring for instance external shocks (i.e. a pandemic, or a drop in world demand), the current growth rate of an economy deviates from its trend according to the policy mix. A fiscal tightening (improvement in the structural balance) will depress GDP. A monetary loosening (reducing the interest rate) will lift GDP. The value of "b" is equal to the "fiscal multiplier". The value of "c" is the "monetary multiplier". This equation forms the basis of "counterproductive fiscal tightening". If the fiscal multiplier is high (e.g.=1), the GDP contraction it will trigger will raise the cyclical component of the deficit, so that the overall primary balance would improve by only half of the discretionary impulse. This could be offset by a monetary loosening, but this option may not be open if for instance the starting point for the interest rate is close to zero. Ultimately, public debt could continue to rise as the real interest rate increases, if deflation sets in as a result of the adverse shock to GDP, compounding the effect of the fiscal tightening.

(3) i= Δ Trend GDP + d. fiscal balance

This is another "endogeneity channel". In the long run, the real interest rate of any given economy should be equal to its trend GDP growth, but in the short run it is going to be affected by a risk premium, which in this simplified

equation is a function of the fiscal balance. Governments perceived by the market as too lax on their fiscal consolidation face a "punishment" in the form of higher interest rates, which will send their public debt ballooning.

The "right" approach thus for any country depends on the relative value of a, b, c and d. There is a consensus on the value of "a" only, and in any case, it is very likely that the value of b, c and to a higher degree d changes over time. Any private market practitioner will be familiar with the following point: sovereign risk premia are not linear. Most of the time, the market would get a sovereign "free pass" on its fiscal stance, until suddenly the attitude changes. This may not be triggered by actual fiscal decisions but quite often by a change in perception of the political landscape in the sovereign. The value of "d" can become so high as to trump any other consideration and force governments in "crash fiscal tightening".

For now, the probability of massive rise in sovereign funding rates such shock is limited by the ECB's involvement in keeping financial conditions favourable for any given level of the fiscal deficit, under the current "implicit yield control" approach which we think the ECB is now following. We would need to refine equation 3 to consider the behaviour of the central bank in specific conditions. An issue though is that we can't know for sure how long this "anti-crowding out" intervention will last. Prudence probably warrants designing an "all weather" framework for fiscal policy.

(3 bis) i= Δ Trend GDP + d. fiscal balance + e. "anti-crowding out" central bank intervention.

Fiscal forward guidance

Blanchard in his paper with Alvaro Leandro and Jeromin Zettelmeyer did not formalize it this way, but we don't think we would betray his thinking too much by asserting that it is the difficulty to simultaneously estimate a,b,c and d *ex ante* which made him conclude that the EU should get rid of its current normative numerical framework based on reference values (debt at 60% of GDP, fiscal deficits below 3% of GDP, minimum consolidation pace etc….) and move to a largely discretionary approach by the European Commission. It would fall upon the Commission to decide, based on non-numerical jointly agreed "fiscal standards" (such as "member states shall avoid excessive government deficits") whether there is a high probability of public debt becoming unsustainable in a member state. Among other inputs, the EC's assessment would take on board whether the ECB's likely to be able to help keep financial conditions in check.

While we agree with the substance of Blanchard's critique of the current fiscal surveillance framework, such approach would require a deep re-writing of the European Treaty, and we know how politically costly this would be. On top of the changes to the "assessment" component of the EC's surveillance framework, Blanchard et alii propose to significantly reinforce the "curative" component by either allowing the Commission to delay the adoption of a national budget which would not comply with its requested changes. This would likely require constitutional changes in a number of member states. We note that they propose an "appeal procedure" through the European council by qualified majority which could override the Commission's proposal. Still, this would mean that, on fiscal matters, national parliaments could be ultimately constrained by either a technocratic organization, operating under discretionary lines, or a coalition of foreign governments. Tough sell, including in the countries which are normally the best disposed towards fiscal discipline. Germany has its own national rules to constrain public debt – a constitutional "debt brake" – but the Constitutional Court in Karlsruhe is quite strict on any curtailment of the national parliament's rights when it comes to fiscal policy. Their other option (involving the European Court of Justice in forcing governments to comply) would in our opinion exceed by far what European citizens would accept in terms of meddling by judges into their fiscal affairs.

We are already dealing with a tough issue pertaining to national sovereignty of member states at the moment with the "rule of law" dispute, but at least in this case there is a "way out" without having to change the European Treaty (it would be tough but ultimately Poland and Hungary could be forced to give up on EU funds and the other Europeans can set up the Next Generation Programme outside the EU budget framework).

Blanchard is probably well aware of the institutional difficulties his proposal would entail. In a separate paper for the Peterson Institute, **he argued in favour of using the existing framework of cooperation between the ECB, the European Commission and the national governments by reviving the Outright Monetary Transaction (OMT) framework.** In this approach, the ECB would continue to provide "anti-crowding out" support on a case by case basis – instead of the indiscriminate current "carpet bombing" under the Pandemic Emergency Purchase Programme – in exchange for macroeconomic conditionality. Help – which could be withdrawn – would come with strings attached (in practice, a binding "programme" negotiated with and monitored by the European Commission and the European Stability Mechanism). **While we see the inner logic of this construct, we also have issues with its feasibility, at least not without significant market volatility.**

We fail to see what could push national governments towards any of the two solutions offered by Blanchard (change in the European Treaty or OMT) in a pre-emptive manner. Indeed, for quite some time, the level of capacity underutilization in the Euro area will be massive, maintaining inflation at a very slow pace, well below the ECB's target. In those circumstances, there cannot be much conflict between the ECB's pursuit of price stability and its "anti-crowding out action". Governments can probably count on some form of quantitative easing well after the end of the pandemic crisis. It is only if a conflict of objectives forced the ECB to normalize its monetary policy stance where some governments would need a "plan B" to keep financial conditions supportive. This would probably be quite messy. Political authorities would accept the political cost of requesting OMT support or engage in a Treaty change only if their funding costs have already risen substantially (note that the Treaty change route would probably be too slow to provide an efficient response anyway).We note as well that the ECB could legitimately consider that engaging in OMT on individual countries if the aggregate macro situation of the Euro area does not warrant such action could be seen as a threat to its independence.

This gets us to a conclusion which will probably be familiar to habitual readers of Macrocast: the workable solution does not lie in triggering existing emergency solutions such as the OMT or pursuing a time consuming and politically fraught Treaty change**. What we need is explicit cooperation between the central bank and governments well after the end of the pandemic crisis allowing a smooth, coordinated normalization of both monetary and fiscal policy based on a set of common indicators and explicit "cross-pollination" of both parties' reaction function**. In practice, governments would voluntarily commit *ex ante* to start fiscal tightening once the unemployment rate has fallen under a certain threshold, or other proxies of capacity underutilization, while the ECB would commit ex ante to take into account the quantum of fiscal tightening when calibrating the pace of its own normalization. Such "fiscal forward guidance" itself would be best achieved on a coordinated manner across member states, to take into account the spill-over effect (the fiscal stance of the large economies has an impact across the region, while "free riders" could jeopardize financial stability for all. Ultimately, the ECB would keep the upper hand, which would help keeping the markets on side, since it would tighten its monetary stance earlier than agreed should governments fail to deliver on their side of the bargain.

Of course, "free riding" would remain a problem. A small country could still break ranks and run a too lax fiscal policy without shifting average macroeconomic conditions in the region, making it difficult for the ECB to "retaliate". The "gentleman agreement" we describe is not flawless. We just believe it may be less institutionally complex than Blanchard's proposals.

Boldly they rode and well…

As another week ends without a political agreement on a Free Trade Agreement (FTA) between the UK and the EU which would shape the economic relationship between the two parties when the transition period stops on 1 January, 2021, we probably need to delve again into this issue.

The first point to underscore is that while observers are understandably fixated on whether a deal will be concluded in time for parliamentary endorsement by the end of this year, this may distract from the fact the FTA currently under discussion would provide only limited mitigation to the significant shock leaving the Single Market will wreck on the British economy. The assessment from the British government's own services is unambiguous. The UK Treasury in a document published in November 2018 estimated the cost of a mere FTA relative to the current situation (in practice

all the benefits of belonging to the EU until December 31st) to between 3.4% and 6.4% of GDP in the long run (15 years). No deal would push this down to a -6.3%/9% range. In other words**, the most pessimistic FTA scenario is as economically costly as the most optimistic "no deal" one.**

A common interpretation error is that an FTA could eliminate most of the logistical hurdles to bilateral trade. At least from the point of view of border control, this is wrong. To quote directly from the European Commission's Q&A on Brexit, *"in an FTA context, rules of origin and customs formalities will apply, all import will need to be comply with the rules of the importing party and will be subject to regulatory checks and controls for safety, health and other public policy purposes"*. The British side has already announced it would temporarily waive border controls after the end of the transition period even if an FTA is concluded, but such option is not open to the EU side. Indeed, controlling the Union's external borders is a condition of union membership. The test of the new border system conducted by the French customs last week triggered a 5k traffic jam on the British side. This does not bode well for "just in time" operational processes.

This does not mean we should be complacent about a "no deal" outcome. Failure to agree on an FTA, i.e. trading under World Trade Organization (WTO) rules, entails levying tariffs on both sides. The Brexiteers' claim during the campaign that the UK side could simply take them down to zero to cushion the inflationary shock never was realistic precisely because of a central tenet of international trade relations under the WTO: The Most Favoured Nation clause (MFN): countries can discriminate across importers only within the framework of a customs union or a free trade area**. Offering zero tariff on imports from the EU would have forced the UK to extend this courtesy to all their suppliers, which would jeopardize the competitiveness of many industries in the UK.**

The British government has unveiled a "UK General Tariff" (UKGT), which is overall less costly than the current EU external tariff (5.7% against 7.2%) but of course in case of no deal this UKGT would apply to imports from the EU (52% of the total), which are currently tariff free, which means that the net effect would be still be inflationary. The British government has been complaining for decades about the level of common customs duties on non-EU food imports, but British agriculture has been just as protected as their counterparts on the continent from global competition, and the UKGT maintains this level of protection (of course offset by the corresponding rise in custom duties that UK producers would pay to sell on the EU market in case of no deal). **Tariffs on food imports in the UKGT stand at about 15% of average. Since EU imports account for roughly 30% of all food consumed in the UK while food itself accounts for 10% of the British consumer price index basket, this could mechanically trigger an inflationary level shift of c.0.5%.** Given the structure of consumption across social groups, this would disproportionally hit the most vulnerable members of society, who are already the most at risk in the Covid-triggered recession.

"No deal" would also come up with various hassles which would make mobility between the UK and the EU significantly more complicated than today, even if even in case of an FTA, in any case freedom of circulation for workers has already disappeared. Your London-dwelling humble servant, proud owner of a British-born Australian shepherd, is particularly worried by the disappearance of the single "pet passport".

As we write, the conclusion of the FTA seems to hinge essentially on fishing. We have already mentioned in Macrocast that focusing on an industry contributing less than 0.1% to the British GDP is quite bizarre. Of course, Brexiters would claim that this minuscule share reflects the "bad deal" the EU has been from the point of view of British fishermen. Actually, the low level of the UK quotas on fish caught in its own waters is a legacy of a British choice upon joining the EU in 1972 (at the time British vessels were more focused on the North Atlantic and left large swathes of the Channel and North Sea to EU competitors). Of course, having full fishing rights on their waters could allow UK operators to expand, but this would need to be balanced by (i) capacity constraints, since the current British fleet is not easily convertible to the species found in British waters and (ii) the fact that 2/3 of British fish exports go to the EU. If the price to pay to expand thanks to "no deal" is facing steep tariffs on the UK's main export market, we would seriously question the economic rationality of all this.

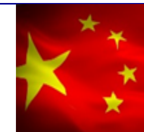
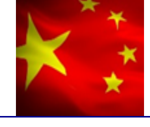
This probably gets us back to a familiar topic when discussing the post-Brexit relationship between the UK and the EU: it's been a long time since the debate has left the realm of economic rationality to locate itself firmly in the realm of politics. The big test in our view came when London gave up on trying to secure the position of the British financial

industry on the EU market, which would have entailed accepting "dynamic regulatory alignment" with a measure of "subservience" to Brussels. The British government chose to sacrifice the interests of an industry contributing 10% to UK GDP on the altar of sovereignty, in contrast fighting tooth and nail for one contributing 100 times less. As we write, the European Commission still hasn't announced whether it would grant UK-based financial firms' "equivalence", nor how it would work. Contrary to what we often read in the British press, "equivalence" is not offered "in bulk". The Commission would sift across the various asset classes and specific activities, probably granting "case by case" equivalence status, which in any case could be unilaterally revoked every 6 months. The Commission has already agreed to allow EU-based financial firms to clear their derivatives claims through British-based compensation houses, but this was firmly in the EU interest to avoid the financial market turmoil that forcing a complete reallocation could have triggered. It is not necessarily in the EU's interest to allow British-based financial firms' unfettered access to the European saving pool.

The prominence of national sovereignty over economic interest is a respectable choice, but the current British government is taking this to an extreme. We are tempted to draw a historical parallel which may be familiar to our British readers. 10 years after Ireland acceded to independence as a dominion, in 1932 the country engaged in a "trade war" with the UK, by far its main commercial partner, in the hope of fostering local industrial development but also as part of a general assertion of Irish nationalism which was to culminate with severing all remaining links with the UK in 1949 (for economic history buffs, the protectionist strategy was lauded by John Maynard Keynes. It may not have been his finest hour). The trade war with the UK itself was resolved in 1938, but the generic protectionist stance remained after WW2, and ended up as a remarkable failure, Ireland missing on much of the 1950s European economic revival which ultimately convinced the Irish government to embrace economic opening within the European integration framework in the 1970s. We note however **that even at the height of the tension between Dublin and London, Ireland remained in a de facto monetary union with the UK, the Irish punt being pegged 1:1 on sterling, giving up on any independent monetary policy**. Affirming national sovereignty did not go as far as to take risks with financial stability.

Of course, the relative position of the UK vis-à-vis the EU is quite different from that of the Irish free state vis-à-vis the UK in the inter-war period. Still, 4 years after the Brexit referendum, we are still baffled by the fact that even if a trade deal is struck next week, the UK is pursuing the most aggressive strategy it could have chosen from at the time.

We discussed before in Macrocast how such an aggressive stance was partly explained by an alternative encompassing economic strategy, big on government intervention, which was strongly pushed by Dominic Cummings, special advisor to Boris Johnson who has now left 10 Downing Street. **The "buccaneers" may have gone, but it remains to understand what is going to replace their strategy.** Beyond the immediate shock "no deal" would create, this would add to the sense the UK is drifting from mainstream, precisely at a time Boris Johnson seems to be tempted by a more "centrist approach". This sort of inconsistencies makes us hopeful a deal will be found in the next few days, but although this would allow us to put the "British question" on the back-burner for a moment while the world economy has frankly bigger fish to fry, we would remain quite cautious on the British economic trajectory for the years ahead.

Country/Region	What we focused on last week	What we will focus on this week
	• FOMC minutes suggest Committee will provide balance sheet guidance "fairly soon" • GSA initiates transition for President-elect Biden. Biden announces Yellen as Tsy Sec • GDP unrevised at 33.1% (ann) Q3 • H'hold data soft into Q4, inc income -0.7% (Oct), initial claims up and sentiment down • Strong house price growth in Sept.	• Virus development, as restrictions rise and case numbers appear to plateau • November payrolls report to gauge pace of employment recovery – and any slowdown • ISM manufacturing and non-manufacturing index • Vehicle sales for Nov broader gauge of conf • Fed's Beige Book
	• November Flash PMIs fell to a 6-month low, with German manufacturing sector still showing resilience • Germany's 16 states have agreed to extend current lockdown until 20 December • Decline in Nov consumer confidence has been confirmed. Services sentiment is down to -17.3 while in industry it remains stable	• Look for details of the European Commission survey, in particular production and demand expectations • Flash inflation should be flat (cons:-0.3%) • Oct euro area retail sales may rise a bit as restrictions started at the end of the month (cons: +0.3% mom / 2.6%yoy) • Oct unemployment rate should rise slightly
	• Chx Sunak delivers spending review. Material deterioration in public finances to 19% deficit and 105% debt in 2020-21 • OBR f'casts GDP -11.3% 2020, -5.5% & 6.6% • Govt announces return to 3 Tier system after lockdown ends on 2 Dec. • Oxford/AZ +ve prelims, UK has 100mn doses	• Difficult to see UK-EU trade deal if not announced this week • Virus developments, signs of falling new case load, but still elevated • Mortgage approvals and lending for Oct, house prices Nov show solid housing mkt • Final PMI estimates for November
	• November CPI Tokyo is down to -0.7%yoy after -0.5%. Core CPI is flat at -0.3% • The government announced the suspension of the "Go to" campaign in order to restrain virus circulation in Japan. Bars/restaurants remain open but with reduced hours	• Industrial production is likely to rise in Oct but it doesn't include Nov headwinds • Oct unemployment rate should be stable • November consumer confidence should decline following the return of restrictions • Nov services PMI is likely to decline
	• The State Council vows to maintain financial stability and zero tolerance toward fraudulent issuance in relation to the recent SOE defaults	• The PMIs to show continued robust expansion in manufacturing and services activities
	• BOK kept policy rate unchanged at 0.5%, while also hinting no signs of near-term policy action • Korea's first 20-day export growth rose by 11.1%, maintaining the overall resilience • Mexico Q3 GDP +12.1%qoq driven by the secondary sector recovery (+21.7%qoq). Banxico sees output gap closing by 2022, inflation converging by 2H2021. Mid-month CPI print was lower; November inflation print could be a potential trigger for policy easing	• Central bank meetings: Poland (expect on hold) • South Africa double downgrade on debt rating by Moody's and Fitch • Q3 GDP Brazil, Poland • Nov PMIs for Asia to suggest overall improving macro-momentum • Nov PMIs likely weaker as pandemic restriction imposed (Poland, Czech Republic, Russia) and monetary policy tightened (Turkey)

Upcoming events		
	US :	Mon: Chicago PMI (Nov); Tue: Mfg PMI (final, Nov), ISM mfg index (Nov); Thu: Serv PMI (final, Nov), ISM non-mfg index (Nov); Fri: Non-farm payrolls (Nov), Unemploy (Nov), TB (Oct)
	Euro Area:	Mon: Ge HICP (prel., Nov); Tue: EA HICP (prel., Nov); Wed: Unemp (Oct); Thu: EA comp&serv PMI (final, Nov); Fri: Ge new mfg orders (Nov)
	UK:	Mon: Mortgage approv (Oct); Tue: Mfg PMI (final, Nov); Thu: Comp&serv PMI (final, Nov); Fri: Constru PMI (Nov), SMMT new car registrations
	China:	Mon: Unemp (Oct); Tue: Mfg PMI (final, Nov)
	Japan:	Tue: Caixin mfg PMI (final); Thu: Caixin serv PMI (final)

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