GLOBAL ECONOMICS UPDATE

How much is fiscal policy supporting activity?

- **With lingering pandemic and energy support measures coming to a close and governments returning one eye to previous fiscal targets, fiscal policy will tighten a little in advanced economies over the coming years. This will contribute to slower growth. But since budget deficits seem set to remain larger than before the pandemic, fiscal policy will still be relatively supportive, making central banks' jobs of returning inflation to targets more challenging.**

- Fiscal policy was loosened significantly across advanced economies in 2020-2021, as governments introduced various support measures for households and corporates during the pandemic. Additional support packages were later rolled out across Europe, and to a lesser extent in Japan, to help offset some of the impacts from soaring energy prices following Russia's invasion of Ukraine in 2022. But most of the support related to the pandemic has now ended. And although energy support measures in Europe have not yet fully rolled off, spending on these has decreased, not least because energy prices themselves – most notably European natural gas – have fallen sharply from their peaks last year.

- **Lower government spending and higher tax revenues due to a combination of recoveries in GDP and high inflation have paved the way for government budget deficits to narrow significantly since 2020.** (See Chart 1.) On average, headline budget deficits have shrunk by about 7%-pts since 2020 across major DMs. Deficits are now closer to their pre-pandemic levels in the US and Japan than in the euro-zone or UK reflecting the severity of the energy crisis in Europe.

- **But even taking into account the improvements in budget balances, deficits remain larger than they were before the pandemic in all major DMs.** And if we look at structural budget balances – which are adjusted to account for where economies are in the business cycle – there has been less of an improvement since the pandemic and policy clearly remains supportive. The structural deficit stood at 5.2% of GDP on average across the G7 in 2022 compared to only 3.8% in 2019. (See Chart 2.)

Chart 1: Headline Government Budget Balance (% of GDP)

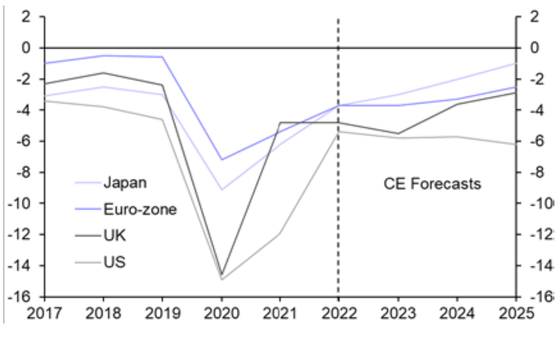
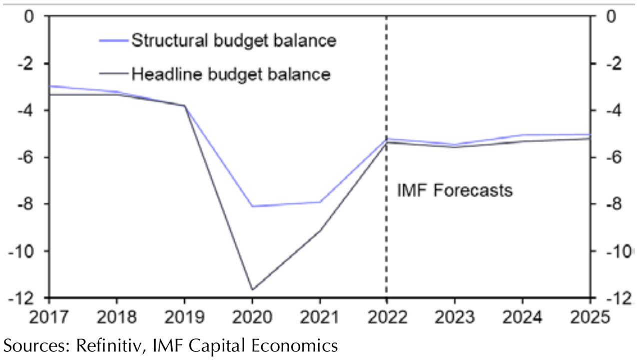


Chart 2: G7 Average Budget Balances (% of GDP)



Sources: Refinitiv, IMF Capital Economics

- Ideally, fiscal policy should be countercyclical, serving to support activity when private sector demand is too weak and temper it when demand is overheating. This is always difficult for governments to judge and given the particular uncertainty now about both the strength of private sector demand and the level of the output gap, it is almost impossible to ascertain how supportive policy truly is. **Nonetheless, the relatively large structural deficits suggest that fiscal policy is probably still supporting demand, which could be another factor explaining the recent resilience in activity and inflation in advanced economies.**

- The question now is how supportive fiscal policy will be going forwards. **In general, governments look set to tighten policy somewhat over the next few years, as pandemic and energy support measures aren't extended and governments in countries with fiscal rules rein in spending in a nod to ultimately achieving**

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their targets. Accordingly, we think that with the exception of the US, budget balances will narrow further in major DMs over the next three years, which will contribute to slower growth.

- But again, we think that deficits will generally remain larger than pre-pandemic levels. In the case of headline budget deficits, this will be partly due to the fact that mild recessions will reduce tax revenues and high interest rates will push up debt interest expenditure, offsetting some of the falls in government spending as energy support measures are withdrawn. But it's not just rising interest costs which are keeping deficits historically large. We expect primary budget deficits to also remain relatively high across major DMs, at least over the coming year. (See Chart 3.) **So on balance, even accounting for the projected narrowing in government deficits, policy looks set to remain more supportive of demand than it had been in the years leading up to the pandemic. Accordingly, fiscal policy will do little to help inflation to return to 2% targets in advanced economies.**

- **The outlook differs slightly across advanced economies.** In the euro-zone, although we forecast the primary deficit to narrow from 1.9% of GDP in 2022 to only 0.5% in 2025 as EU fiscal rules are re-introduced and help to impose some fiscal discipline, fiscal policy can hardly be classified as "tight". That's because we still expect the primary balance to be in deficit by 2025, whereas it was in surplus in 2019. (For more details of the euro-zone's fiscal outlook see here.) Meanwhile, although the primary deficit is already back around its pre-pandemic level in the US, we don't expect it to narrow much (if at all) by 2025. This is because even accounting for the modest fiscal tightening set out in the debt ceiling deal, which finally drew the student loans moratorium to a close, discretionary spending looks set to *increase*. **Accordingly, fiscal policy will be more supportive of *growth* in the US than elsewhere over the next few years.**

- The combination of higher interest payments, weak GDP growth and the fact that governments will be running relatively large primary budget deficits over the coming years means that, with the exception of Japan, we expect debt-to-GDP ratios in DMs to be higher than they were in 2019 in five years' time. In the euro-zone and UK, debt ratios will only inch down, while in the US we expect the ratio to rise further. (See Chart 4.)

- **The upshot is that with primary deficits still projected to be larger than they were before the pandemic, fiscal policy will probably remain a bit too supportive of demand in advanced economies over the coming years. Not only will this make it harder for central banks to return inflation to targets in the near term, but if deficits remain permanently larger, then long-term interest rates may need to remain higher as well.**

Chart 3: Primary Budget Balance (% of GDP)

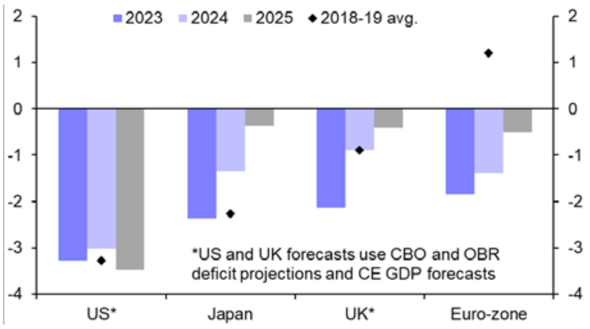
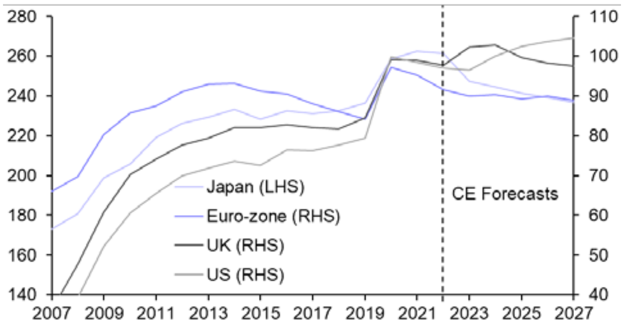


Chart 4: Government Debt (% of GDP)



Sources: Refinitiv, IMF, OBR, CBO, Capital Economics

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