THE TIME HAS COME FOR FISCAL POLICY TO ADJUST

Reflecting Jerome Powell's statement that it is time to adjust (i.e., loosen) monetary policy and subsequent action, it is also time to adjust fiscal policy in Europe and the United States, in the direction of tightening in both cases. This is a good time, given the context of monetary easing, falling inflation and positive economic growth. Even more than monetary easing, this fiscal consolidation must be gradual so as not to weigh too much on growth. Like the central banks that have been determined in their response to the inflationary shock, governments will have to show the same determination and perseverance in the coming fiscal consolidation efforts, given their necessity and significance.

The question of the need for fiscal consolidation is not new. The magnitude of fiscal imbalances that have accumulated over the years in numerous developed countries has already justified taking action for some time, to regain room for manoeuvre and ensure that public debt ratios remain sustainable. Nor is the issue of the difficulty of undertaking such consolidation a new one, with regard to the choice of measures and considering the negative economic impact. The purpose of this editorial is to outline the terms of this debate and to point out that now is a good time to consolidate, because the tightening of fiscal policy can take place in parallel with the easing of monetary policy that has already begun, allowing the former's negative effects on growth to be cushioned by the latter's positive effects.

AN ADJUSTMENT IS NEEDED WITHOUT FURTHER DELAY

There is no doubt about the need for budgetary consolidation in the light of the deteriorated state of public finances. Of course, the scale of the budgetary imbalances to be addressed varies from country to country. The US budget deficit is extremely large (8.4% of GDP in 2023) and the public debt ratio stands at 124%, up 16 points of GDP compared to 2019[1]. In Europe, behind the aggregate figures (fiscal deficit of 3.5% in 2023, public debt ratio of 83%, up 4 points compared to 2019), the picture is mixed. Some of the low achievers of yesterday are no longer so: Greece, Portugal and Ireland have large primary surpluses and their public debt ratios are falling sharply, while Spain's budget deficit is about to fall below 3%. These good results can be attributed to (imposed) fiscal consolidation efforts and currently stronger growth. On the other hand, eight countries – Belgium, France, Italy, Malta, Slovakia, Romania, Hungary, and Poland – are subject to an excessive deficit procedure by Brussels and face significant budgetary adjustments. The new rules on European budgetary governance certainly give a little more time and flexibility to make these adjustments, but the intention is precisely to strengthen the credibility of the requested budgetary discipline. For these countries and the United States as well, the problem is not so much the level of government debt ratios as their upward trajectory, which must at least be interrupted and stabilised. It is also essential to regain room for budgetary manoeuvres.

Fiscal consolidation should also help in reducing the significant tensions between monetary and fiscal policy that formed since the 2008 financial crisis. Bolhuis et al. (2024)[2] measure these tensions by the difference between the neutral rate of monetary policy and the same concept applied to fiscal policy[3]. This fiscal r* can be considered as a ceiling of the real interest rate above which the debt trajectory can become explosive. Yet, since the early 2000s, this fiscal r* has fallen sharply, more than the monetary r*. The gap between the two (monetary r* minus fiscal r*) has thus become less and less negative, to almost zero by the end of 2022, its highest level since the 1950s, in their sample of 16 advanced countries. The lower the neutral fiscal rate, the smaller the room for manoeuvre to run a fiscal deficit. Since historically such tensions in the policy mix tend to be followed by negative economic consequences, an adjustment of the policy mix is necessary to reduce them. Budget consolidation would contribute to this by raising the neutral budgetary rate.

THIS IS A GOOD TIME TO ADJUST

An important facilitating factor: the evolution of the famous r-g gap appears to be favourable for such fiscal consolidation efforts. As already noted in a previous publication[4] – and underlined by the Bank of France with respect to France and true for other countries – "The upcoming period of gradual recovery and monetary easing is not unfavourable to the necessary fiscal consolidation needed to bring public debt under control."[5] In other words, this is the right time to implement a measured countercyclical fiscal adjustment. The negative effects of fiscal consolidation on activity will be mitigated by the positive effects of policy rate cuts. The recovery in the Eurozone would be limited, but not prevented, while in the United States, if there is fiscal consolidation – which does not seem to be in the air – it would participate opportunely in the slowdown of the economy, which remains dynamic in many respects[6]. It seems to us that it is not common for the evolution of the policy mix to appear so adapted to economic conditions. One might wish for an even more favourable outcome if there were explicit consultation and coordination of the joint action by monetary and fiscal authorities.

1 AMECO data.
2 Mind the gap: Gauging fiscal-monetary tensions through fiscal r-star | CEPR, 29 September 2024 ; Fiscal R-Star: Fiscal-Monetary Tensions and Implications for Policy (imf.org), 9 August 2024.
3 Fiscal r* is the real interest rate that stabilises a country's debt-to-GDP ratio given its primary deficit path when output is growing at its potential and inflation is at target. When fiscal and monetary r* are equal, policymakers can simultaneously stabilise debt and keep inflation at the target.
4 Eco Perspectives 3rd quarter 2024– Economic Research – BNP Paribas, Editorial | Economic outlook in the face of uncertain election outcomes (bnpparibas.com), 2 July 2024.
5 Macroeconomic projections – June 2024 | Banque de France (banque-france.fr), 11 June 2024.
6 For an overview of our baseline scenario, see Soft landing in sight, but don't unbuckle seat belts yet (bnpparibas.com), 30 September 2024. For a more detailed view of the economic situation and outlook in the large and some small OECD countries as well as in China, please refer to the various texts in this issue of *EcoPerspectives*.

GRADUALISM AND TARGETING ARE NEEDED

There are plenty of reasons to tackle current fiscal imbalances. There is also a consensus on the need to tackle them gradually. It is a question of demonstrating proportionate budgetary rigour and not of implementing an austerity policy so as not to repeat the mistakes of the early 2010s forced march during the European sovereign debt crisis. This is one of the messages put forward by the OECD, which in its latest economic outlook advocates for a return to fiscal discipline (the sooner the better) but not a return to austerity[7].

What is at stake is the means of carrying out budgetary consolidation, which levers will be activated in terms of tax increases and spending savings and cuts, knowing that it is not possible not use one of the two. The challenge is to identify and implement the most effective measures to reduce the deficit quickly and sustainably with the least economic, social, and environmental damage in the short and long term. In Europe, in particular, one way to minimise the negative impact on growth could be to implement measures that can unlock the still significant household savings surplus. Without going so far as to talk about growth-supportive consolidation, the idea is to have as credible a consolidation strategy as possible to ensure that households are as Ricardian as possible, i.e., draw on their savings at present by anticipating tomorrow's tax cuts. It is a difficult task and a balancing act for governments, but their fiscal adjustment programmes can be judged against these different criteria.

In conclusion, although this issue of budgetary consolidation concerns many countries, only Europe seems ready to commit itself resolutely to it, which is to be welcomed. The United States is facing huge fiscal imbalances that do not give the impression of being under control. Moreover, neither presidential candidate has a clear desire to engage on fiscal consolidation. US fiscal policy risks remaining accommodative rather than becoming restrictive, and this is an issue. US growth would be supported, more or less depending on the candidate, but does it really need such a support (apart from the one already provided by lower interest rates) at the cost of further weakening public finances and increasing the risk of financial stress. This concern is also true for China, which recently announced a major fiscal stimulus for its economy. This support is certainly necessary, but it must not obscure the fact that the country is also confronted, even if a priori to a lesser extent than the United States or Europe, with significant budgetary imbalances (Chinese statistics are lacking in readability and transparency).

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7 OECD presses governments on fiscal discipline, 'but not austerity' (ft.com), 25 September 2024 ; OECD Economic Outlook, Interim Report September 2024 | OECD, 25 septembre 2024.