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Research & Strategy Insights

Fiscal Glitches

69 – 23 November 2020

Key points

- We look at "glitches" which impair fiscal policy in the US and the Euro area. We don't think the Republican "red line" on a quantum would constrain a decent emergency stimulus that much. How the funds would be allocated is the real issue. In Europe, we count on a "pain balance" unfavourable to Hungary and Poland to unlock the Recovery and Resilience Fund.

Exactly at the time central banks everywhere are acknowledging the centrality of fiscal policy in dealing with the economic consequences of the pandemic, governments are facing difficulties in implementing the next leg of their stimulus.

In the US, we are still waiting for Congress to design and pass an emergency package during the "lame duck" session. We don't think the Republican "red line" at USD500bn (2.5% of GDP) – which is probably only an initial negotiating position and may have been eased by Secretary Mnuchin's decision to "free up" some government money by terminating guarantees to little-used Fed facilities – would not constrain that much a decent emergency package. In our computations, assuming no further "covid wave" after the current one, extending the federal unemployment benefit schemes into the whole of 2021 would cost about USD200bn. Offsetting the estimated loss in states and municipalities' tax receipts over 2020 and 2021 – which could force an ill-timed fiscal tightening given the prevalence of "balanced budget" rules in a lot of these entities – would cost about USD320bn. True, a more ambitious medium-term programme to spur innovation would be welcome, but it could wait. We suspect that it is not so much the quantum which is blocking the negotiations but the allocation across "red" and "blue" states.

Meanwhile, the EU's Next Generation plan is again bogged down in the intricacies of the European institutional process. In fact, given the depth of the political implications of this package for the very nature of the EU project, we think that six months from first design as a Franco-German proposal to legislative (near) conclusion is short. Ultimately, the resolution of the current "Hungary/Poland vs everyone else" standoff may depend on a pure "pain balance". Even if circumventing a veto against the EU's multi annual financial framework would be complex for the other Europeans, it is possible, while the economic – and probably geopolitical – pain for the two Eastern countries would be significant. For this reason, we remain constructive.

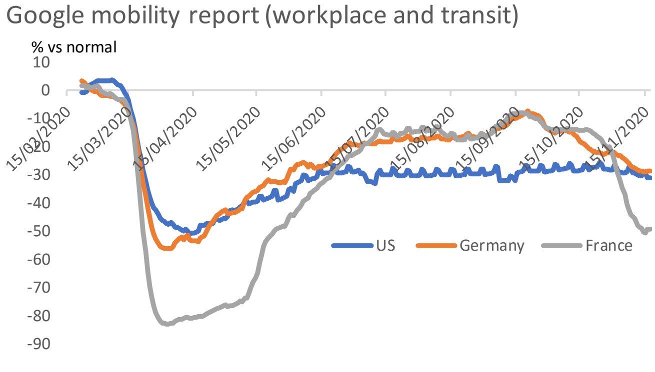
US: looking for some spare change

The latest data suggests that while the pandemic is getting back under control in Europe, it is still accelerating in the US, which has reached as of 21 November an infection rate of 677 per 100,000 over the last 14 days, up from 540 per 100,000 a week before, with still rising positivity and hospitalization rates. Assuming testing capacity is similar across the Atlantic, this is in line with the latest French numbers (667 per 100,000 for the infection rate) but there the decline is now significant (a peak was reached on 13 November at 919 per 100,000). Although therapeutic progress in treating Covid-19 has been significant, 7-day average mortality stood at 1486 per day at the end of last week in the US. This is still below the first wave's peak (above 2,000 throughout the last two weeks of April) but we must consider the usual lag between infections and mortality.

It seems that while some tentative relaxation in mobility-restrictive measures is likely in Europe before Christmas, this would be a massive risk in the US from a purely sanitary point of view. Last week we mentioned that more state by state restrictive measures were imminent, and indeed the states in lockdown now stand for more than 40% of the US GDP, double the rate seen on 15 November. The impact on mobility looks limited (see Exhibit 1) but there is lag in the availability of the Google reports (the last data point in Exhibit 1 is for 17 November). The bulk of the impact on activity is still ahead.

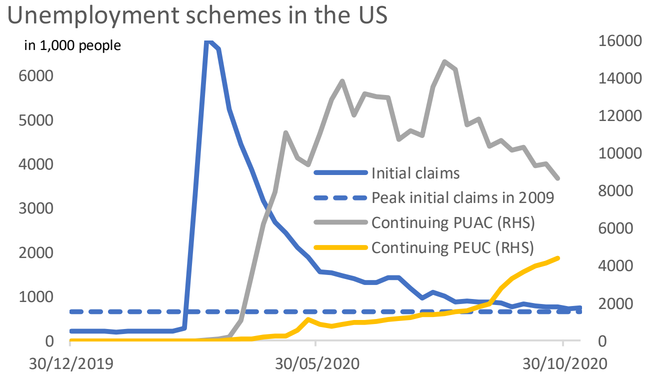
Economic agents are reacting before lockdowns are implemented. Retail sales in the US for October came out below expectations and was the weakest in six months. We know we may sound like a broken record, but the state of the US labour market is hardly consistent with robust consumer spending. Initial jobless claims remain slightly above the levels seen at the peak reached during the previous recession, in the first half of 2009 (see Exhibit 2), and we are concerned with the impact of the looming exhaustion of some of the key income-protecting aspects of the CARES act (Coronavirus Aid, Relief and Economic Security).

Exhibit 1 – US lockdowns not yet showing



Source: Google, AXA IM Research, November 2020

Exhibit 2 – We still focus on the labour market



Source: US Dpt of Labor, AXA IM Research, November 2020

Beyond the "checks" to families, the bulk of income support through the CARES act was channelled through three different schemes. First, the federal top-up of USD 600 per week for jobless workers; second the Pandemic Unemployment Assistance (PUA) which covers workers usually not protected by the states' unemployment benefit schemes (e.g. freelancers); third the Pandemic Emergency Unemployment Compensation (PEUC) which "takes over" state benefits for 13 weeks after they expire (after normally six months). The first scheme was terminated two months ago (the funds apportioned by Congress expired and the Federal Emergency Management Agency (FEMA) resources Trump then used by executive order were exhausted by the end of September). The two remaining schemes will expire at the end of December if no new stimulus package is voted by Congress during the lame-duck session.

There has been some decline in the number of Americans covered by PUA towards the end of the summer, but at the end of October (the latest produced by the Department of Labor) they were still 8,680.000. PEUC continues to grow, as it is a function of the stock of workers who were laid off during the first wave who haven't been re-hired and exhaust their "ordinary benefits". At the end of October, they were 4,380,000.

What would be the impact on the economy if this source of income were to disappear? The maths are relatively simple. PUA payments are calculated in reference to previous income, but they can't be smaller than half of the state's benefit. PEUC payments are equal to state's benefits. Based on an average "ordinary" benefit of USD1690 per month (it varies quite a lot across states), the two schemes would bring about an income support of c. USD15bn per month, or USD180bn per year, i.e. 0.8% of GDP. This is not negligible, and we would need to think of this dynamically. Indeed, the current covid wave is very likely to trigger another round of job loss which would make those schemes quite handy to cushion the blow on consumer spending.

We can look at this issue "the other round" though: the cost of extending such schemes into 2021 looks paltry relative to the plan currently pushed by the Democrats (USD2tn), so even the Republicans' red line (supposedly USD500bn) would provide plenty of space, even if taking into account a likely further deterioration in unemployment, targeting USD 200bn rather than 180bn would probably make sense. There are other aspects of the CARES act which expire at the end of the year which are not immediately costly to the US treasury but are impactful and would warrant an extension into 2021. Borrowers experiencing financial hardship due to the pandemic can obtain a forbearance of a total of 360 days on their loan payments (but the window for requesting such suspension of payments closes at the end of 2020 for some federally-backed mortgages). As of 8 November (latest available data), 5.47% of US mortgages were in forbearance (2.7 million home-owners). A "cliff" on mortgage payments occurring at the same time as a contraction in income support could quickly turn into a social disaster. Swiftly agreeing on a small deal in the coming weeks should then be consensual.

Moreover, by terminating the guarantees offered by the treasury on some of the little-used new facilities created by the Fed at the height of the market crisis during the first wave (initially USD450bn), Treasury Secretary Mnuchin has "freed up" some money, which should help convince fiscally-conservative Republican Senators to compromise. The Fed is probably right to lament the loss of some of its "precautionary weapons", but in the short run, and in the face of the ongoing "covid wave", it may make sense to divert this government money to actual fiscal spending with a likely high multiplier, rather than keep it parked to underpin small operations with – at least in the absence of another bout of financial turmoil – have little effect on the macroeconomic outlook.

Why is it so difficult then to get an emergency deal then? The biggest bone of contention is on support to states and municipalities. According to Brookings, the pandemic will reduce the states and local tax receipts by more than USD300bn in 2020 and 2021. 46 states operate some sort of "deficit ban", of which 33 have over time opted for the most stringent forms according to an index computed by the Urban Institute. In those states, the only way to deal with such a shortfall will be to cut spending. This could trigger a fiscal tightening of 1.5% of GDP. "Red" and "blue" states should be equally interested in getting more support from the federal government. The "only" problem – as often – is the allocation formula. The fiscal stimulus package proposed by the House – which is still the starting point for the Democrats in this negotiation – allocated the funds to the states mostly according to the local unemployment rate. This would favour the Democratic strongholds. Conversely, if they were apportioned according to poverty rates, then the rural states of the South, held by Republicans, would win.

To make a long story short, given the projected supply-side restrictions to the US economy it would make sense to implement another fiscal stimulus, and USD500bn – 2.5% of GDP – would be a decent amount, covering the looming income shock triggered by the CARES expiring and avoiding a state and local tightening. A second package would probably be welcome in 2021 to deal with long term structural issues, in particular the deterioration in US infrastructures and the Green transition, but in terms of cyclical stabilization USD500bn would already provide significant help. Consequently**, the issue is not necessarily the quantitative red line defended by the Republicans, but the precise design of the measures**. Democrats and Republicans would both lose in a failure to find a deal, and this makes us ultimately constructive on its chances, but an acceleration in the talks is needed. The clock is ticking.

Meanwhile, Europe is still rehearsing Hamilton

It might be depressing to see the Recovery and Resilience Fund (RRF) still bogged down in political and institutional controversy six months after being first mooted as a Franco-German initiative in late spring, but given the issues at

stake, we would argue that six months is actually a short time. Indeed, if this new scheme is to be Europe's "Hamiltonian moment", resistance was always to be expected given the profound political implications this seemingly horribly technocratic framework will have. Fundamental questions need to be raised and addressed. The strength of the opposition to the scheme is testament to its game-changing potential. If the price to pay for the beginning of fiscal federalization, and by extension the federalization of the EU itself, is a showdown with some member states, so be it.

The current standoff – this time pitting Hungary, Poland and Slovenia against all the others – is the third one since last summer, and each of these standoffs has been a crucial test of the very nature of the European project.

Overcoming the resistance of the "frugals" to debt mutualisation was the first one. This went far beyond the usual and caricatural opposition between stingy Dutch and spendthrift Italians. The root of the problem was whether economic policies dealing with a symmetric shock hitting the entirety of the EU should be designed from the sole point of view of contributing to the welfare of European citizens wherever they are in the Union without jeopardizing the underlying position of the public finances of the member state they happen to live in, even at the risk of rewarding bad policy records. The "frugals", concerned with transfers allowing spendthrift countries to continue running unsustainable policies, advocated strong conditionality and favoured loans. The "mutualists" argued that in this instance financial transfers were the only way to help without adding to the burden of the most fragile countries. A compromise ultimately emerged, but essentially, the measures funded by the RRF will be assessed on their own merits in each country, irrespective of their policy record. True, each member state will have to explain to the European Commission how the transfers they will receive from the EU will contribute to healing the scars of the pandemic and send their growth trajectory on a better footing, but the overlap with the other surveillance schemes put in place by Brussels is minimal. In our understanding, there is no conflation of the fiscal rulebook with the RRF.

The second standoff arose last month when the European Parliament threatened to torpedo the EU's multi-annual financial framework (MFF) – on which the RRF hinges – if the rules preventing member states from straying from "rule of law" principles were not strengthened. What was at stake there was the balance of power within the EU's institutions. Since the Great Recession of 2008-2009, the EU has been increasingly operating as an inter-governmental organization, making the European Council prominent, side-lining the more "federal" institutions (the Commission and the European Parliament). The most obvious example of this is the European Stability Mechanism, which together with the ECB "saved" the Euro area during the peripheral sovereign crisis but was set up outside the EU legal framework, as a separate international treaty between member states. The RRF, although it was designed by national leaders, is fully embedded in the EU's budget framework, which offered the Parliament a unique occasion to re-assert itself. Indeed, the European parliament (EP) has the power to reject the budget. Historically, "Consenting to tax" has always been the root of the gradual extension of parliamentary power beyond strictly financial matters. **The European parliament has just done what every parliament has in the past on their way to democratize institutions: use what was originally a highly technical issue to send a political message.**

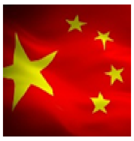
There again, a compromise had to be crafted with the Council on 5 November. Since the EP can reject the budget as a whole but cannot amend it, MEPs found themselves in the uncomfortable position of having to kill the EU's main crisis fighting tool in the middle of the second wave of the pandemic on a point of principle. The EP had to concede an important point to the Council. In the initial parliamentary view, it would take a qualified majority of the Council to *reject* a financial sanction proposal from the Commission – a member state under surveillance would have to find many allies to fight Brussels. The EP had to accept that it would take a qualified majority to *endorse* the sanction proposal, thus making it necessary for Northern states which are usually in the lead on rule of law issues to find many allies to go after the delinquents. Still, the EP managed to impose a fairly far-reaching mechanism. In the Council's initial proposal, EU intervention was supposed to be triggered only when it could be proved that a rule of law breach in a member state had a *direct* effect on the EU's financial position (e.g. corruption involving mismanagement of structural funds). It has been extended to systemic aspects. An article was added listing examples of cases, such as threatening the independence of the judiciary, or failing to correct arbitrary decisions and limiting legal remedies.

It was therefore perhaps unsurprising that, despite this compromise, Hungary and Poland would reject the 5 November deal, which gets us to the third standoff. Again, the issue at stake lies at the very heart of the European project. If the RRF is the Union's "Hamiltonian moment", then the member states must accept the circularity between economic federalization and political convergence. The EU is not "just" an economic project based on free trade with a single competition rulebook sprinkled with some limited structural funds to address potential economic divergence. It is a political project based on certain key principles unambiguously stated in article 2 of the European Treaty: *"The Union is founded on the values of respect for human dignity, freedom, democracy, equality, the rule of law and respect for human rights, including the rights of persons belonging to minorities. These values are common to the Member States in a society in which pluralism, non-discrimination, tolerance, justice, solidarity and equality between women and men prevail".* The EU is a package, without any possibility to pick and choose. What was missing was an enforcement mechanism. This is what the Council, pushed by parliament, has set out to create.

Where do we stand now? Hungary and Poland are threatening to block the MFF which will govern the annual budgets of the EU until 2027 by vetoing the decision on the Union's own resources (unanimity is needed at the Council). The room for manoeuvre for the German presidency of the Union is quite limited because any further watering down of the "rule of law" mechanism to get Hungary and Poland on board would probably meet fierce resistance in parliament after the concessions it has already accepted. A solution is all the harder to find that after the "pure" European validation process, national parliaments will have to give their consent. There is a possibility that one of these legislatures would decide to reject a compromise their government would have reluctantly supported at the last minute (there is a fair number of minority governments in Europe at the moment, in particular in Northern countries such as Sweden and Denmark).

So ultimately, the fate of the of the Next Generation Pact is likely to hinge on pure "pain balance". If the Eastern countries maintain their veto until the end, what will happen? Day to day operations of the EU would continue by merely replicating the previous budget allocations, but no new spending could be implemented. This would make it impossible to distribute the RRF funds through the normal EU mechanisms, but also any new programmes under the "ordinary" structural funds. According to calculations by Goldman Sachs, this would result in a net loss for Poland equivalent to 25% of its 2019 GDP (spread over the next seven years), and 15% for Hungary. Definitely not negligible. Still, fragile countries such as Italy and Spain would also be net losers. There is an option though: replicating for the RRF the approach used for the European Stability Mechanism and take it out of the normal legal framework of the EU. This would be complex, since a new institution would have to be created, and the Europeans would miss the opportunity to strengthen the EU's budget own resources, and time would be wasted, but it is not impossible. We thus think that Poland and Hungary do not have the upper hand in this dispute and should accept any cosmetic compromise Berlin will offer them. Another issue facing Warsaw and Budapest is that they have lost a crucial support in Donald Trump. Hungary is not allergic to some rapprochement with Russia – the country is building a new nuclear plant with Russian support and is planning to test the Covid vaccine developed by Moscow – but Poland certainly is. Being isolated from both the EU and potentially the new US administration may be another problem to consider for the two Eastern states.

We still have a bit of time. Technically we were not counting on much disbursement from the RRF in the first half of 2021 anyway. Still, confidence matters. So far, EU countries have been more guarded than the US on the quantum of fiscal support they have opposed to the pandemic. According to the latest computations of Bruegel, only Germany has come close to the US effort (8.3% of GDP excluding the deferrals/guarantees, against 9.1%, the others usually standing at about half of that). Doubts on the advent of mutualisation may explain some of this reluctance.

Country/Region	What we focused on last week	What we will focus on this week
	• US has record number of new Covid cases, States increase restrictions • Biden wins Georgia recount, Trump team continues to block transition and assert impropriety despite producing no evidence • Retail sales were soft in Oct, Empire & Phil Fed surveys fell in Nov, jobless claims rose • Housing market continues robust growth • Fed Mnuchin	• Further restrictions to dampen virus spread • Transition progression for Biden team • Development of Treasury decision to end Fed lending and use funds for stimulus • FOMC meeting minutes • October income and spending figures to highlight impact of fading fiscal support • GDP revisions to Q3 estimate
	• EU SURE programme disbursed additional €14bn to member states, after €17bn in October • Spanish government extended the state loan guarantee programme until 21 June, moratorium on insolvencies until 21 March • Hungary and Poland vowed to veto the EU budget, disagreeing with the rule of law	• November Flash PMIs, European Commission surveys and German IFO to give insight on lockdown 2.0 impact • President Macron to unveil the post-lockdown strategy, providing the healthcare situation allows it after 1 December • Watch for developments on the EU budget front
	• Brexit negotiations make no progress, EU prepares for no deal as real deadline looms • Oct retail sales surprise to upside, +1.2% pre-empting lockdown. Sharp Nov fall expected • CPI Inflation rose to 0.7% in Oct (from 0.5%) • PM Johnson announces £16bn defence spending, £12bn green investment	• Chancellor to deliver 1-yr Spending Review, OBR forecast update • UK-EU trade negotiations breakthrough • Continued slowdown in virus spread • Government expected to announce post-lock down measures • PMI preliminary estimates for Nov.
	• GDP rebounded by +5%qoq after -8.2%. Consumption and exports recovered while investment remains the laggard. • Oct exports rose to -0.2%yoy from -4.9% • Oct CPI declined to -0.4%, new core at -0.2% • Nov. flash manuf PMI is down to 48.3 (48.7)	• November CPI Tokyo is expected to remain in negative territory, closed to -0.6%. It remains a good proxy of nationwide level • Further details on the 3rd supplementary budget, focusing on demand stimulus may be unveiled
	• The signing of RCEP creates the world's largest trading bloc and strengthens Asia's economic integration • China's economic recovery continues with October data showing broad-based improvement across sectors	• Onshore bond market awaits more information from the recently defaulted issuers and the authorities' response
	• As expected, Turkey bank hiked one-week repo rate by 475bp, to 15% to be used for financing operations. BI cut rates by another 25bps, BOT on hold • Russia's IP drop -5.9%yoy in Oct. driven by mineral extraction output -8.8%yoy • India retail inflation remains above RBI targets (4%±2%) at 7.6%yoy in October. Elevated food prices (+11.1%yoy) pressurize the headline level price	• Central bank meeting: South Korea • Q3 GDP for Mexico and India • BOK meeting and first 20-day export growth • Mid-month CPI Inflation in Brazil and Mexico (Nov.)

Upcoming events	US:	Mon: Mfg, serv PMI (prel., Nov); Tue: Conference Board cons conf (Nov); Wed: GDP(2nd est., Q3), Core PCE price index (Oct), Goods TB (Oct), Wholesale inventories (Oct), New home sales (Oct)
	Euro Area:	EA Comp, mfg, serv PMI (prel., Nov), Ge, Fr mfg, serv PMI (prel., Nov); Tue: Ge GDP (final, Q3); Thu: EA M3 money supply (Oct); Fri: EA Cons & busi conf (Nov), Fr GDP (final, Q3)
	UK:	Mon: Comp, mfg, serv PMI (prel., Nov); Tue: CBI Distributive Trades Survey (Nov); Wed: Chancellor Suank announces one-year Spending Review
	Japan:	Thu: Lending index (final, Sep)
	China:	Fri: Industrial profits (Oct)

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