

Box 1.2: US macroeconomic policies and spillovers to the euro area

Uncertainties regarding future policy mix remain

Following the outcome of the US presidential elections in November 2016 there was a marked upturn in consumer and business sentiment, while financial markets also picked up in anticipation of a potential fiscal stimulus, substantive tax reform and other pro-growth elements of the new administration's policy agenda.

Six months after the elections, the administration's stance across a wide range of policy areas still remains subject to significant uncertainties. With respect to potential changes in the macroeconomic policy mix, initial expectations regarding the overall size of a fiscal stimulus have been scaled back, while its composition appears increasingly likely to comprise tax cuts rather than spending increases. Moreover, in terms of timing, the complexity of the legislative and budgetary process implies that any major fiscal or tax proposals are now unlikely to take effect during 2017.

Considerable policy uncertainty thus still surrounds this forecast round. A technical assumption has therefore been included in the baseline forecast for the US: a fiscal stimulus package amounting to 1% of GDP implemented in 2018 which is expected to provide a modest boost to growth.⁽¹⁾

This box goes further in discussing in more detail the likely impact of a range of fiscal stimulus scenarios on the US macroeconomic policy mix and growth outlook, as well as spillovers to the global and EU economy. It also presents simulations using the European Commission's QUEST model which, in addition to determining the quantitative impacts, provides insights into the channels via which spillovers are likely to emerge.

Current cyclical position of the US economy

The degree of remaining slack in the US economy is an important determinant of the impact of a fiscal stimulus. Following its recovery from the financial crisis, the economy's current expansion is now in its eighth year and the labour market appears to be closing in on full employment. Indeed, the unemployment rate remains at post-crisis lows of around 4½%, labour market participation has recovered modestly (against a strong secular downward trend), and employment growth has retained solid momentum in early-2017.

⁽¹⁾ This is revised down from a technical assumption of 1.3% of GDP (implemented over 2017-18) that was included in the Winter Forecast.

Price and wage pressures have continued to build gradually, with core inflation steadily approaching the Federal Reserve's 2% target. The combination of solid growth and rising prices has underpinned the continuation of monetary policy normalisation in December 2016 and March 2017 (cumulative 50 basis point rate increase), with further interest rate rises expected in the near term.

Overall, in abrupt contrast to the immediate post-crisis period, this points to an economy which is broadly performing at potential and with only limited remaining slack.⁽²⁾ As such, the growth effect of fiscal stimulus is likely to be relatively modest at this stage, while at the same time potentially generating upward pressure on prices, interest rates and the US dollar. In this constellation, a deterioration in net exports and tighter financing conditions would counteract to a large extent the demand-stimulus provided by an expansionary fiscal stance.

Qualitative assessment of stimulus and risks

Overall, even at the cycle's current advanced stage, it is reasonable to anticipate that a fiscal stimulus would still have a positive impact on US growth, which would also generate positive spillovers elsewhere. Nonetheless, and particularly given the role of the US in global trade and capital flows, as well as broader global economic trends (recovery across emerging markets, upturn in commodity prices), it should be noted that fiscal stimulus would also entail wider risks. These risks are not calibrated within the model's parameters and, if realised, would have potentially significant adverse spillovers to the global economy.

Principal among these risks is the upward pressure which stimulus is expected to exert on inflation and, as a consequence, on the ongoing process of monetary policy normalisation. A faster-than-expected tightening of monetary policy and higher yields on US debt may prompt a rotation of demand away from emerging market assets and, in the process, generate a potentially disruptive reversal of capital flows, downward pressure on

⁽²⁾ DG-ECFIN's estimates point to a neutral output gap for 2016 (0.0 pps.), with this expected to turn positive in the coming years as output grows slightly above potential. This contrasts with an estimated negative output gap of -3.5 pps. in 2009.

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emerging markets' (EMEs) currencies and turbulence across financial markets.

A tighter monetary policy stance combined with increased domestic demand is also likely to add further to US dollar (USD) appreciation. On the one hand, these dynamics should stimulate US import growth and provide positive spillovers to the global economy. However, large USD appreciation may also generate balance sheet pressures for economies with high levels of unhedged USD-denominated debt.

Table 1:
USD denominated debt in emerging markets (gross)

	2016-Q3	
	Trillion USD	y-o-y % change
Total emerging market economies, of which:	3.6	0.6
Africa and Middle East	0.6	15.7
Emerging Asia and Pacific	1.6	-4.3
Emerging Europe	0.5	-5.2
Latin America and Caribbean	0.9	4.4

Source: Bank for International Settlements (BIS)

Finally, in the context of sustained political attention being directed towards US bilateral trade relationships, fiscal stimulus is likely to contribute to a further widening in the US trade and current account deficits. Aside from more general concerns regarding global imbalances, there is a risk that these dynamics generate additional momentum for protectionist measures which would entail negative consequences for both US and global growth. In that vein, adverse spillovers for the wider global economy stemming from each of the risks outlined are likely to further reduce the already-modest positive impacts of stimulus on the US economy.

Range of fiscal stimulus scenarios

In light of the continued uncertainty surrounding a potential fiscal stimulus package in the US, the baseline forecast continues to incorporate a technical assumption (1% of GDP implemented in 2018), while two additional scenarios have been simulated covering the period 2018-2022:

Scenario 1 (2.0% of GDP): an exclusively tax-based stimulus package, with two-thirds directed to corporate income taxes and one-third to personal income taxes.⁽³⁾

Scenario 2 (2.5% of GDP): a stimulus package of 2.0% of GDP comprised of tax cuts for corporate

⁽³⁾ On 26 April the administration released its proposals for tax reform, including substantial reductions in statutory rates for both personal and corporate incomes. These proposals are set to undergo further examination over the coming months.

and personal incomes (two-thirds and one-third, respectively), plus an additional 0.5% of GDP in public infrastructure spending.⁽⁴⁾

For the purposes of the model all stimulus measures are implemented in the first quarter of 2018, and it is assumed that these measures are deficit-financed (i.e. no offsetting measures are implemented elsewhere). Monetary policy is also assumed to follow the Taylor rule, implying that interest rates are responsive to the upward price pressures generated by stimulus.

Impact of stimulus on the US economy

The dynamics underpinning the US economy's response to fiscal stimulus are highly similar under each scenario, with the model's results varying primarily due to the scale of the stimulus. Overall, tax cuts contribute to a pick-up in domestic demand, added to further by increased public investment in Scenario 2. However, this is somewhat offset by higher interest rates (driven by rising prices) and the drag produced by falling external demand (driven by US dollar appreciation). Across each scenario there is a positive, albeit moderate, impact on the aggregate US economy. This is consistent with the advanced stage of the current cycle and implied low fiscal multipliers.

Table 2:
Impact of stimulus on US GDP*

	2018	2019	2020	2021	2022
Scenario 1 (2.0% of GDP)	0.3	0.5	0.6	0.7	0.8
Scenario 2 (2.5% of GDP)	0.6	0.8	0.9	1.1	1.2

* Deviations from steady-state.

Initially, lower personal income taxes provide a modest boost to private consumption. Meanwhile, falling corporate income taxes generate a much larger increase in business fixed investment, while higher infrastructure spending generates similar dynamics on the public side.⁽⁵⁾ This is augmented by a further modest tightening of labour market conditions which, due to the fact that labour market is already close to full employment, is principally driven by higher wage growth rather than increased employment.

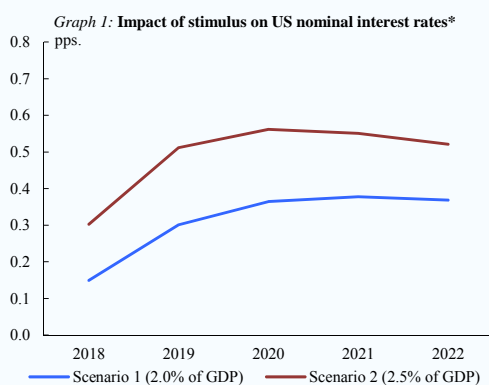
⁽⁴⁾ Proposals for increasing infrastructure investment also include tax-based incentives for private investors, although there are concerns regarding their potential for only limited additionality.

⁽⁵⁾ Increased public investment under Scenario 2 results in some crowding out of private investment in the form of higher interest rates, with private investment thus marginally lower than in Scenario 1. However, economic growth at the aggregate level is higher.

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The price level also rises in response to higher domestic demand and wage growth, in turn generating upward pressure on interest rates. The resulting tightening of financing conditions dampens growth in domestic private consumption and investment, with the scale of this effect increasing in tandem with the size of the stimulus package assumed.



On the external side, increased domestic demand and the anticipation of higher interest rates drives USD appreciation of over 1% in nominal effective terms, before reversing in subsequent years as import demand rises. This has material impacts on the competitiveness of US exports, and the contraction in export volumes remains persistent throughout the horizon. In addition, lower prices (in USD terms) and increased domestic demand support growth in imports, ensuring a decline in net exports which weighs on GDP growth.

In line with the deterioration in the competitiveness of US exports and the rise in import demand from the stimulus package, the trade and current account balance deteriorate slightly in each scenario. This occurs primarily during the latter years of the horizon as, for the purposes of the trade and current account balance, initially the price effects of USD appreciation offset the deterioration in net export volumes. The initial USD appreciation reverses in subsequent years, resulting in a modest widening of the US trade (0.3 pps.) and current account (0.1 pps.) deficits by 2022.

In terms of fiscal dynamics, stimulus also produces a persistent deterioration in the US fiscal balance across each scenario, resulting in a material rise in the debt-to-GDP ratio (8.2-10.0% of GDP) by 2022 relative to the baseline. This adds to pre-existing concerns regarding the medium- and longer-term fiscal sustainability in the US.

Spillovers to euro area and global economy

Given the relatively modest impacts on overall US GDP growth, spillovers to the euro area and the global economy (in terms of economic growth) are expected to be similarly modest. The principal channels through which spillovers emerge are: (i) the positive impacts of increased US import demand; and (ii) higher import prices in the euro area and global economy (also due to USD appreciation) which weigh on private consumption and investment. As noted, however, the model captures solely the impact of fiscal stimulus on headline economic growth and its subcomponents, rather than the wider impacts on, for example, capital flows, balance sheets or confidence. These spillovers (both positive and negative) may be pronounced and their impacts could have significant effects on economic growth also.

In the case of the euro area, the euro's depreciation against the US dollar and increased US import demand provides a small boost to export growth throughout the horizon. However, this is offset by the weight which higher import prices exert on domestic demand via weaker private consumption and investment growth. Overall, depending on the scenario analysed, there is either a neutral or small positive impact to euro area GDP growth initially, turning marginally negative in future years due to higher inflation weighing on domestic demand.

The rest of the world (ROW) responds to fiscal stimulus in a highly similar manner. USD appreciation provides a modest impetus to exports, while higher import prices exert downward pressure on domestic demand components. Fundamentally, however, as ROW is less open to trade than the euro area, these effects are somewhat less pronounced, and the aggregate results find a neutral net effect in each scenario.

Table 3:
Impact of stimulus on euro area and RoW GDP*

		2018	2019	2020	2021	2022
Scenario 1 (2.0% of GDP)	EA	0.0	-0.1	-0.1	-0.1	-0.1
	RoW	0.0	0.0	0.0	0.0	0.0
Scenario 2 (2.5% of GDP)	EA	0.1	0.0	-0.1	-0.1	-0.1
	RoW	0.0	0.0	0.0	0.0	0.0

* Deviations from steady-state.

Conclusion and wider policy context

It is important to note that the results presented are illustrative and serve to show the dynamics via which a fiscal stimulus package is expected to impact on the US economy and elsewhere. Overall, as anticipated, the impacts on US economic growth are expected to be positive but limited, resulting in

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only marginal spillovers for the remainder of the global economy. Of course, this also reflects the relatively moderate size of the stimulus package simulated, particularly when compared with initial post-election expectations and the administration's recently presented tax reform proposals. A larger fiscal stimulus than considered here would entail larger impacts on US economic growth. Equally, however, a potentially difficult budgetary negotiation process could result in stimulus which is more moderate.⁽⁶⁾

Beyond the effects captured by the model, there could be significant spillovers emerging via financial (rising US interest rates, reversal of capital flows), foreign exchange (balance sheet stresses) or trade policy (rising protectionism) channels. These risks coincide with wider economic trends globally following a prolonged period of weakness, and their materialisation would present significant headwinds to the present tentative recovery.

⁽⁶⁾ Simulations carried out by the World Bank find that the cumulative increase in US GDP after two years from lowering corporate income taxes from 35% to 15% amounts to 0.9-1.3 pps.; and, separately, lowering average personal income taxes by 2.5% would raise GDP by 0.4-0.6 pps. The IMF estimates that a fiscal stimulus package of 2% of GDP over 2018-19 would raise GDP by 0.5-1.0% by 2021, depending on whether these measures were directed towards high or low productivity areas.