BNY MELLON
iFlow
MACRO MORNING BRIEFING

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Fiscal Blockages Along Last Mile Of Inflation

Governments reluctant to use fiscal restraint to counter inflation

- Lack of fiscal consolidation remains a barrier to speedy declines in inflation
- Subsidy-focused industrial policy in developed markets a particular risk
- 'Safety flows' measured but JPY recovery remains in play

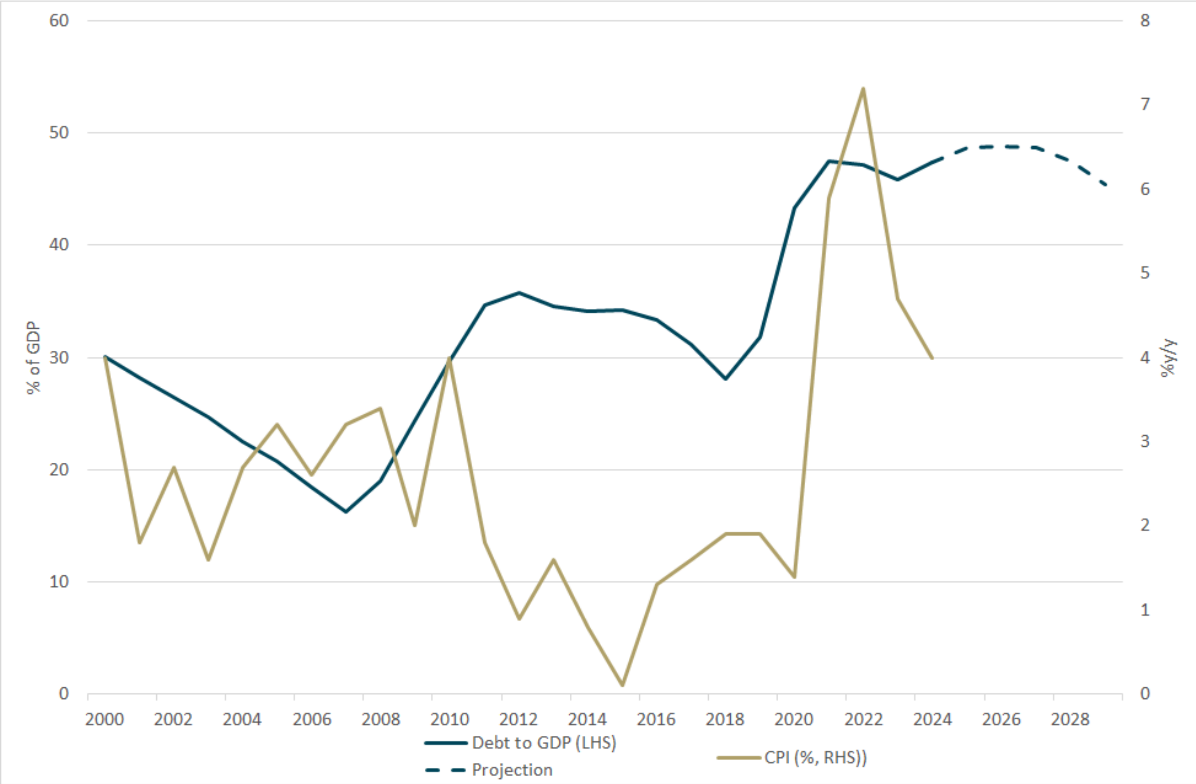
Fiscal contribution to inflation persistence in focus

For a relatively small economy, New Zealand sometimes can be quite prescient in identifying defining shifts in economic policy. In 1990, for example, the Reserve Bank of New Zealand became the first central bank to adopt an inflation-targeting mandate, which has since become monetary policy orthodoxy and will likely remain so for the immediate future. While there have been calls for inflation targets to be raised in acknowledgement of higher structural inflation, we agree with the view that such a step by any central bank would risk damaging credibility. Instead, we believe governments and central banks need to identify the drivers behind inflation persistence, especially through the wage channel.

This time, it was not the RBNZ but the Prime Minister of New Zealand, Christopher Luxon, who probably needed to say the unsaid. In an interview last week ahead of his new government's upcoming budget, and in the context of addressing the cost-of-living crisis, Luxon directly attributed higher inflation to "a huge amount of government spending", which "lifted interest rates and slowed the economy". Even when asked whether higher US inflation would threaten New Zealand inflation returning to target, Luxon pivoted immediately, noting that fiscal restraint and reducing "inefficient and wasteful government spending" would be the "way to support lowering inflation" and "bring those interest rates down".

Luxon's comments evidently underplay the supply shocks which have driven inflation over the last few years, especially in labour markets. New Zealand's border control policies during the pandemic severely curtailed migrant labour, leaving the country with a severe shortfall when the restrictions were lifted. However, the unprecedent fiscal and monetary expansion during the pandemic had resulted in excess demand, which exacerbated labour supply issues – wage growth in 2023 easily hit record highs in the country's inflation targeting era. Exhibit #1 clearly shows co-movement between inflation in New Zealand and expansion in debt levels due to strong marginal fiscal expansion.

Exhibit #1: New Zealand Debt vs. CPI

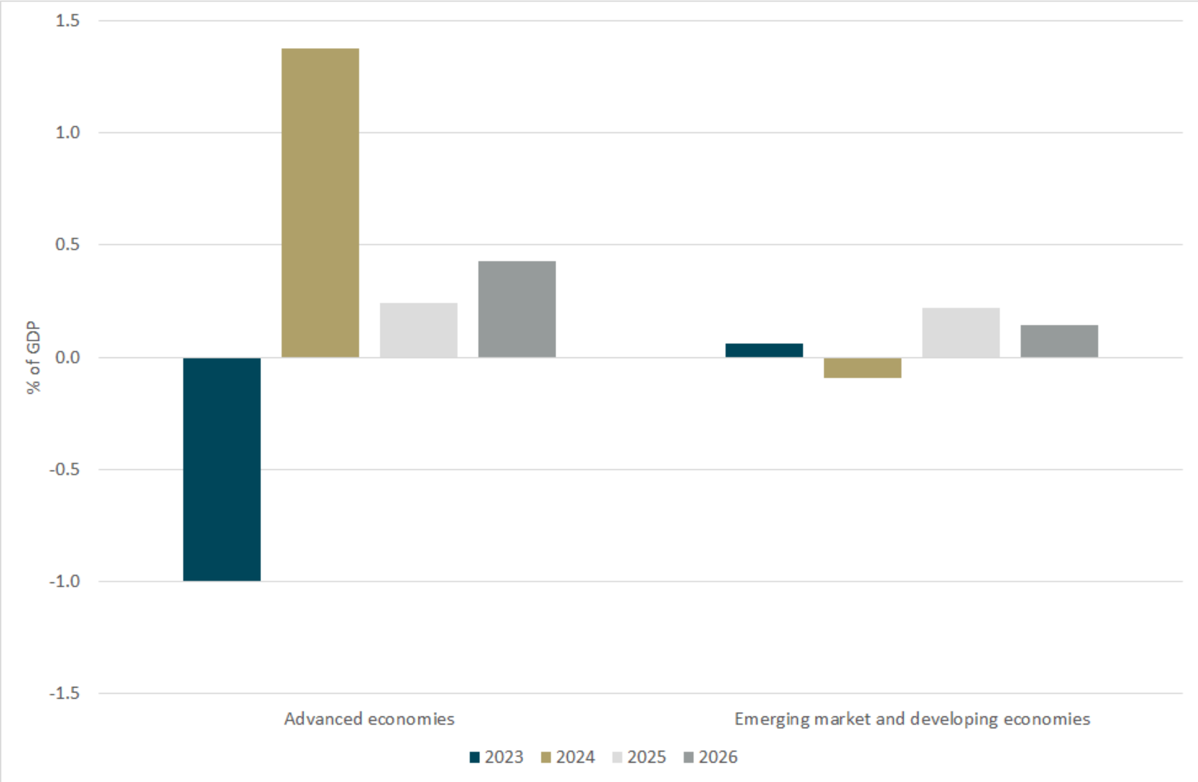


Source: Bloomberg, BNY Mellon

While many central banks have been urging fiscal restraint as they fight inflation, political necessities have taken precedence. Energy subsidies globally due to the supply shocks caused in 2022 and 2023 were another form of fiscal largesse augmenting demand and contributing to inflation/wage spirals. Due rising interest rates and bond market pressures, governments have broadly acknowledged that spending levels between 2020 and 2022 were simply unsustainable and unaffordable, even though at the time fiscal expansion was deemed necessary to avoid economic scarring.

The IMF's latest World Economic Outlook notes that although some modest tightening is expected in developed and emerging economies this year with improvements in primary fiscal balances (exhibit #2), fiscal restraint will ease in the next few years. Furthermore, due to higher interest rates, the IMF expects the share of interest payments of government revenue to continue rising. Therefore, the requisite level of improvement in countries' primary balances to bring down aggregate debt is well beyond current IMF projections.

Exhibit #2: IMF Fiscal Consolidation Expectations



Source: Bloomberg, BNY Mellon

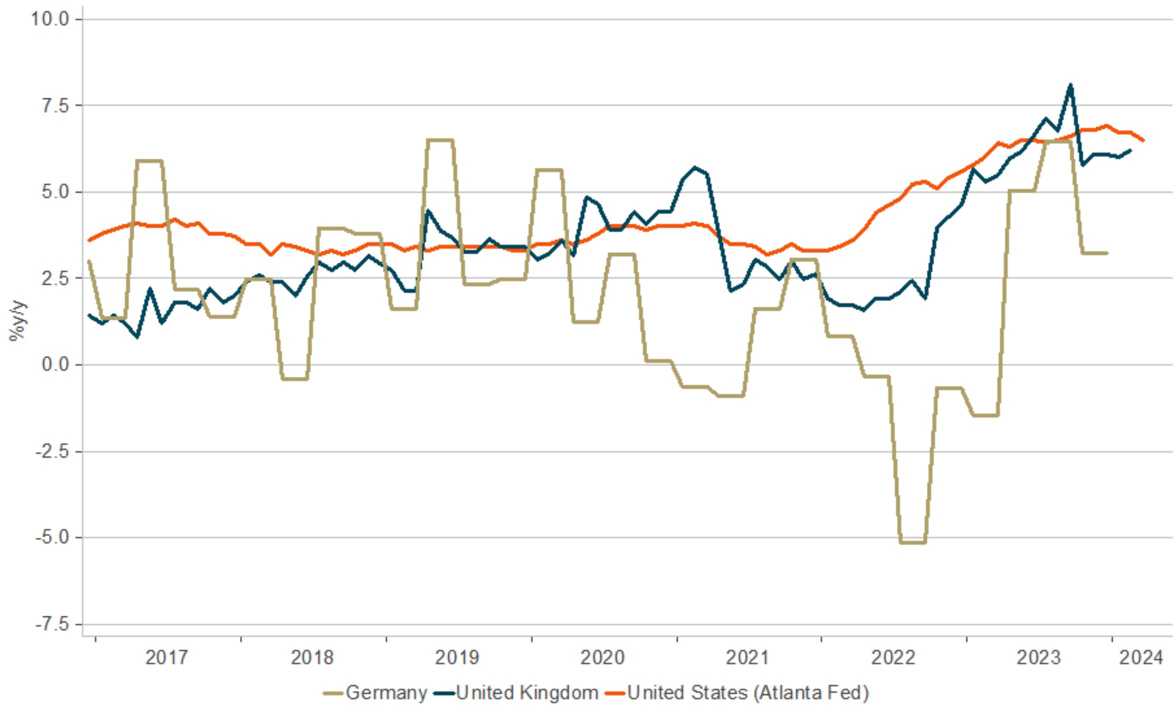
Prime Minister Luxon is correct that all governments can be more targeted in spending and avoid waste. Yet, there appears no political appetite for tough fiscal restraint in the form of spending cuts. Subsidies or price controls – as seen across Europe in 2022 – may limit inflation in headline components, but by then inflation expectations had already de-anchored and led to wage spirals. Coupled with labour shortages, higher real wages simply pushed demand elsewhere, leaving very large rate hikes the only viable instrument remaining. However, even as these short-term protective measures have softened, a new, structural inclination by governments towards subsidies as a part of industrial policy represents a new form of fiscal expansion which may present a new risk to inflation targets.

The European Union's Next-Generation EU programme, the US's Inflation Reduction Act and microchip industry subsidies, and China's current pivot towards 'high quality' growth all seek to restructure the world's largest economies towards highly productive and Green economies. On paper, such support should constitute government investment into new industries, and productivity growth will ultimately help to bring down inflation. However, so far there is scant evidence of such results, especially as most central banks continue to identify services wage growth as the main point of inflation persistence. China's current efforts may prove disinflationary globally, though the dynamics of Beijing's industrial policies in an external and domestic context are different from that of the US and European Union.

A key component of services wage inflation in developed nations remains in the public sectors. Policymakers have highlighted that this is a sector with relatively low productivity growth and, ceteris paribus, government borrowing to support wage growth is also less sensitive to interest rate increases because of captive investors. Exhibit #3 shows that while

US, UK and German public sector wage growth has declined from the highs, it remains well above pre-pandemic levels. The near-term political calendar renders it unlikely that public sector cuts will be on the agenda. We note that Christopher Luxon leads the newest government in major developed economies, having only been formed in November 2023. This means he has the lightest electoral burden. His political fortunes will likely be the canary in the coalmine for wider fiscal restraint. We believe governments need to actively adopt such stances – before it is imposed on them by bond markets.

Exhibit #3: Public Sector Wage Growth

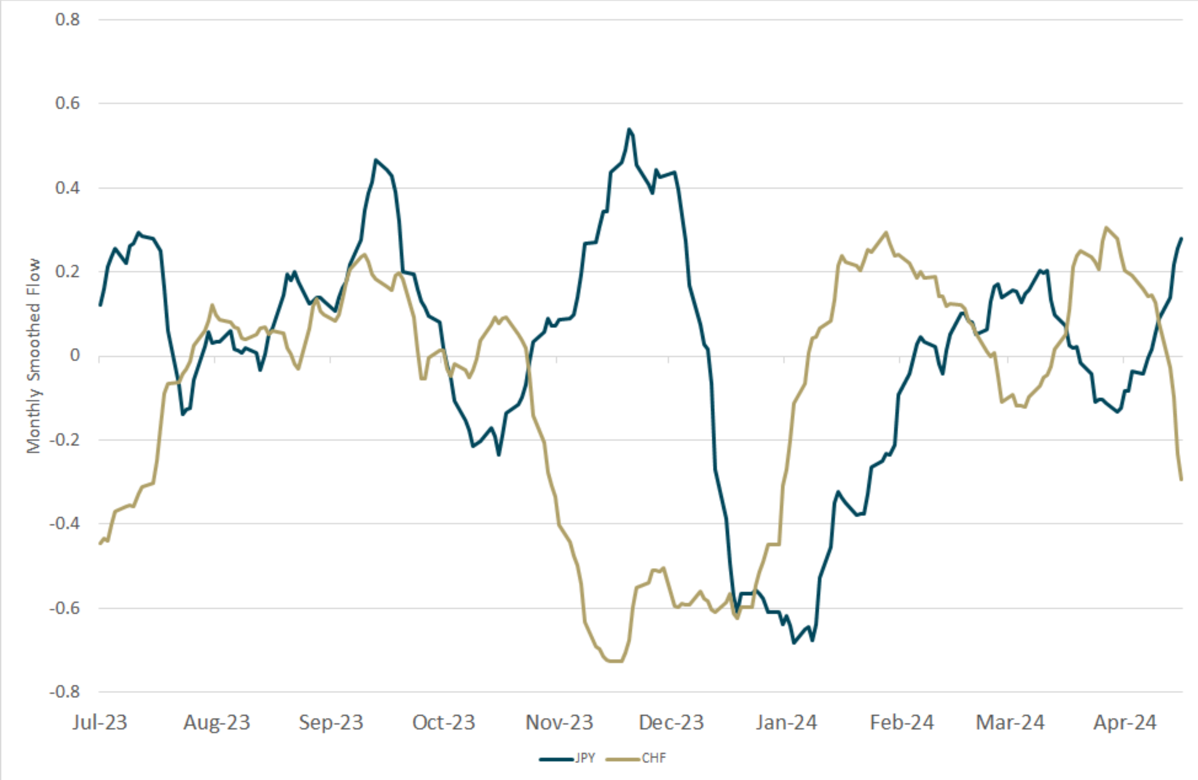


Source: Macrobond, BNY Mellon

The durability of risk appetite will remain in focus this week. For now, it appears that severe geopolitical escalation has been averted, but equity markets face questions over valuations for the first time in months. The tech-led rally in global stocks – especially in the US – has stalled amid more cautious guidance by leading tech companies. If risk continues to falter, diversification will likely move up the agenda, in which case the dollar could struggle upon rotation in a market heavily overweight US assets. So-called safe havens may still be sought in any case as geopolitical woes are likely to be a market factor for the long haul.

We have identified the yen and Swiss franc as potential beneficiaries from safety interest, but iFlow indicates only the former benefitting strongly. Recent buying (exhibit #4) has pushed JPY holdings back into positive territory as extreme valuations and associated intervention risks have sharply curtailed risk:reward in JPY-funded carry trades – many of which were clearly affected by the events of late last week. We doubt the Bank of Japan's decision this coming Friday will have as strong an impact. But with its every upcoming policy decision 'live', it is difficult to envisage a lower bar for major re-rating in the JPY.

Exhibit #4: Smoothed Flow, JPY vs. CHF



Source: iFlow, BNY Mellon

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