FISCAL CONSOLIDATION AND MONETARY POLICY

Stock markets look bright. In April, they again showed optimism. The S&P, the flagship index of the United States, recorded +1.46% during the month and since the beginning of the year the performance is 8.6%. More impressive was the Nasdaq, which appreciated by almost 17%, although it did not move in April. Even on this side of the Atlantic the rise of the indices does not disappoint. The Eurostoxx50 has been up 15% since the beginning of the year and in April it did not want to stop its run by registering a 1.1% increase. The most followed company in the world, Apple, valued at 169 usd on 28 April, is not far from its all-time highs around 180 usd at the end of 2021. On the contrary, digitalisation stocks, which were punished last year because they seemed to be discounting an overly happy future after the pandemic, have come back strongly.

The markets are becoming convinced that inflation is starting to fall and with it interest rates. The banking crisis, which has now partially receded, has also given the markets another gift: liquidity, instead of decreasing, increased in April for the first time since the beginning of the year, judging by the M2 money supply in the US (20.877 trillion usd), as well as in Switzerland. The banks' woes are helping the Federal Reserve: if lenders extend less credit, the economy will cool, helping to beat inflation, while loosening the grip on rates. After all, the signs of a slowdown are there. In the first quarter, US gross domestic product (GDP) grew by an annualised 1.1%, disappointing expectations of 1.9% and moving away from the previous quarter's 2.6%. Even the housing market, often the first to suffer the vagaries of the economic cycle, confirmed the difficulties: in March, home sales contracts fell 5.2% against expectations of a 0.5% increase. Despite these indications of cooling, the quarterly reports of major companies exceeded analysts' expectations.

All this has led the markets to believe that there will be clear signals at the next Federal Reserve meetings. Perhaps after a further +0.25%, Jerome Powell will go back on his statement that he does not intend to cut rates in 2023, hinting that instead he will have to make a major and quick turnaround in the second half of the year.

Five-year (forward) inflation expectations for both the dollar and the euro fell to 2.48% and 2.46%, respectively. The problem is that inflation in general tends to fall, but not 'core' inflation, which excludes energy and food prices (PCE, personal consumption expenditures): in the US it rose in March by 0.3% on a monthly basis to 4.6% annually. Rate futures do not register this divergence. Market projections already see three cuts of 0.25% each between September and December this year. Slightly different is the situation in the Eurozone, where instead the peak of rates is expected at the beginning of 2024 at around 4%, then dropping towards 3%. The picture painted by the stock exchanges looks like that of a soft landing and the financial markets have already decided to celebrate it.

The reality may be more complex. As Pierre-Olivier Gourinchas, an advisor to the International Monetary Fund (IMF), writes, "we are entering a dangerous phase during which economic growth remains low by historical standards, while financial risks increase, with inflation not yet having turned the corner".[1] According to the economist, as long as the financial system remains reasonably stable, monetary policy can continue its course while remaining firm on fighting inflation. But the fact that the recent banking crisis is helping to stop aggregate demand, mitigating the central banks' firmness, may bring yields down, restarting economic activity and thus inflation.

Stock market optimism is all about monetary policy, especially from the Federal Reserve. To maintain that 'region of stability' that allows financial assets to prosper, there is also fiscal policy. Before inflation became a threat again, monetary and fiscal policies walked hand in hand. In the past decade, nominal interest rates were at extremely low levels. While real interest rates never remained negative for so long. This allowed central banks'

[1] Pierre-Olivier Gourinchas, *World Economic Outlook, A Rocky Recovery*, International Monetary Fund, Aprile 2023, p. *xv*.

balance sheets to explode and government debts to reach record levels. Central banks were given the task of fighting inflation. But if they raise rates too fast, they undermine the resilience of fiscal policies: public debts, with inflation and without growth, are no longer sustainable.

This concern, in different ways, unites the two sides of the Atlantic. In the United States, a decision will soon have to be taken on raising the public debt ceiling to allow the financing of state activities, as well as on the major investment plans desired by the current presidency. The difficult compromise between Republicans and Democrats risks putting the brakes on Joe Biden's structural investment initiatives and thus on that support for demand which has so far managed to resist, at times astonishingly, even the turbo-charged rise in rates (+5% in fifteen months). Europe, which at the beginning of the first decade of the millennium went into crisis also because of the austerity imposed by Germany, has in the last two years set up the Next Generation EU. This is the first real joint debt programme in the history of the European integration process: EUR 807 billion to revive economies (especially those most in difficulty) by hooking them onto the energy and digital transition bandwagon. This initiative overlaps with that of individual states supporting demand and consumption with their debt. The ongoing revision of the stability pact is intended to bring back some of the rigour that the pandemic has pushed aside.

It is not certain that the 'sell in May and go away' also applies this year. A slowdown in fiscal policies parallel to the rate hike would push inflation down and be less sticky. The downside, however, would be a brake on growth. It would enter a spiral that would cancel out hopes of a soft landing and open the door to a serious recession. For Agustin Carstens, General Director of the Bank for International Settlements (the bank of the central bank's), 'higher interest rates would make fiscal consolidation more difficult; which would put pressure on monetary policy to remain accommodative for longer if growth remains subdued'. [2] This inevitable tension is likely to characterise the second half of 2023. The transition to the 'stability region'

[2] Augustin Carstens, "Monetary and fiscal policies as anchors of trust and stability", Discorso alla Columbia University, New York, 17 aprile 2023.

will not always be easy. Central banks will hold off on inflation and will not want to anticipate dangerous giveaways.

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