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Strengthening Monetary and Fiscal Interplay

G7 and Anglosphere central banks will welcome fiscal restraint

- Potential for US deficit reductions can create monetary policy space for the Fed
- RBNZ path this year continues to show spending cuts can complement easing
- Growth preservation still needed, which underscores US' productivity advantage

Prospect of greater fiscal restraint will affect G10 rate paths

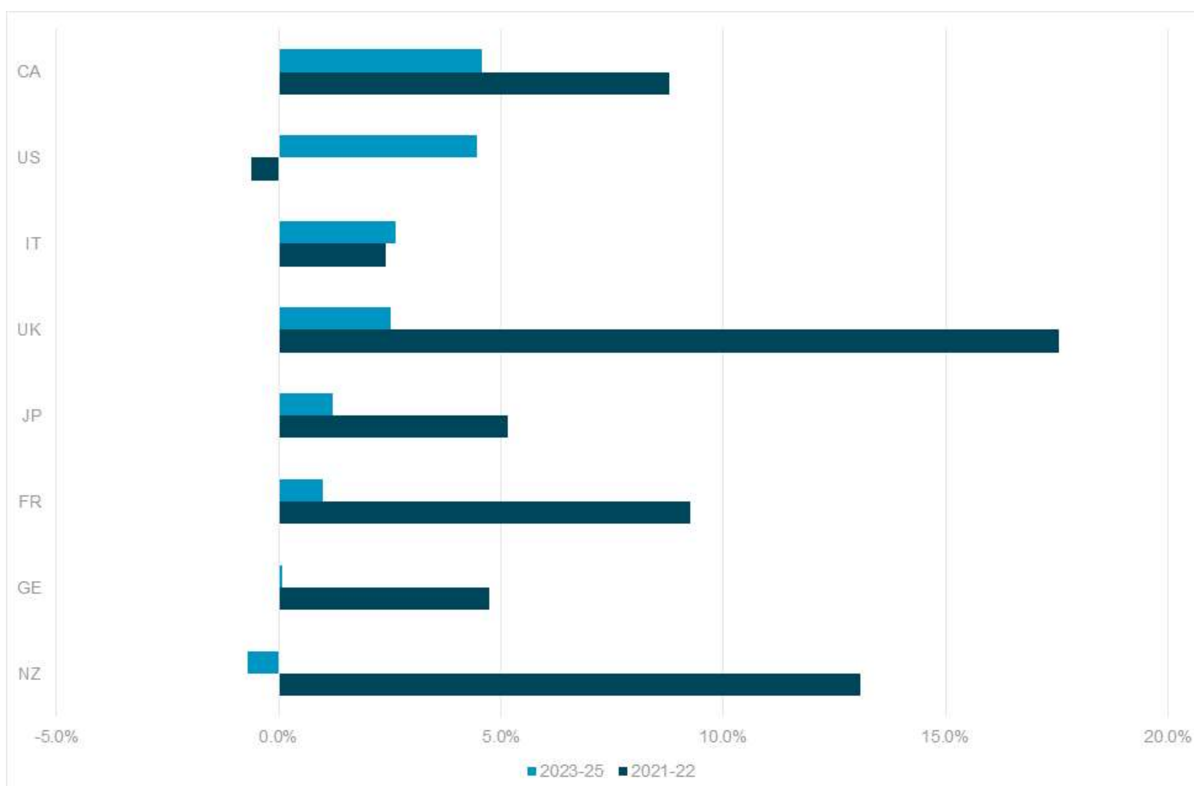
The RBNZ decision overnight marked another chapter in the central bank's standout performance in this year's global easing cycle. The government – now almost a year into its tenure – has broadly delivered on the fiscal side of the bargain and should serve as a benchmark for the rest of the world. We recently documented how Eastern European central banks are being frustrated by the lack of fiscal restraint, thereby contributing to pauses in their own easing cycles. More recently, the US curve has reacted to the prospect of fiscal restraint coming through, which would have implications not only for growth but also the structure of the US Treasury market. To be clear, fiscal restraint is not a silver bullet for policy optimality, and there are instances, such as in Germany and China, where the market believes that resources are being deployed neither efficiently nor sufficiently. Nevertheless, at least for Anglosphere central banks, we continue to see an urgent need for credible fiscal consolidation, and price action in the US Treasury market shows that even the prospect of a plan can help bring down long-term borrowing costs and create policy space for central banks.

For several meetings cycles, the RBNZ has stressed that the drop in public demand has contributed to its policy pivot. Earlier this year, we noted that this was only possible in New Zealand at the outset because the newly elected government was fulfilling its manifesto and had sufficient political capital to spend on consolidation. This means that New Zealand's comprehensive fiscal/monetary strategy cannot be replicated easily – for example France's new government is struggling to push through fiscal consolidation and the new UK government also pledged greater public investment as well as spending adjustments.

New Zealand's smaller and more flexible economy means execution is easier, but baselines also matter: New Zealand had one of the strongest fiscal expansions in response to the pandemic so there was already significant spare capacity to justify any meaningful fiscal impulse. The results are now clear: based on the OECD's estimates (Exhibit #1), the upcoming contraction is still expected to be light, but it will be the only Anglosphere and G7 economy with any form of aggregate public demand contraction at all. However, the mere fact

of contraction is generating a strong enough multiplier effect which is now being felt through the economy.

Exhibit #1: Public Demand Change, 2021-22 vs. 2023-25



Source: OECD, BNY

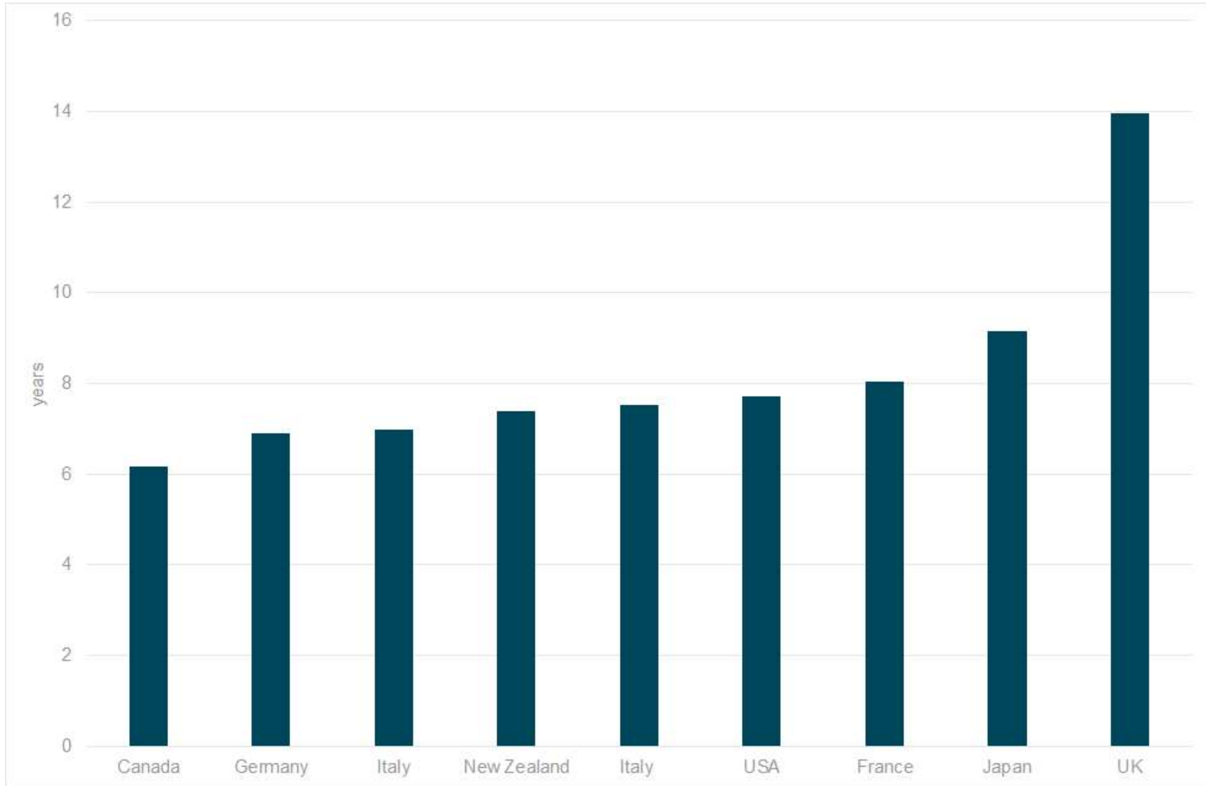
The RBNZ's record this year is broadly consistent with Bank of England (BoE) Monetary Policy Committee Member Catherine Mann's interpretation of "activist monetary policy." As opposed to BoE Governor Bailey's framework of a stepping up in rate cuts, Mann's view was to hold policy until downside risk to prices and expectations was confirmed, and then cut very aggressively to limit further demand scarring in the economy. If this is going to be the approach globally, we note that investors should be cautious in their front-end strategies. Fiscal contraction tends to flatten curves initially, but if central banks begin to front-load easing through their policy horizon (which normally is around three years), the pricing of terminal rates (at neutral or otherwise) can come through much earlier than expected. This is somewhat different to a meeting-by-meeting approach where every meeting is live but subject to data confirmation. The RBNZ is not the only central bank with this approach, as the Riksbank and Swiss National Bank look set to reach neutral or even sub-neutral levels within the next six months, and at a time when the market is still uncertain about the Fed's path and the ECB only recently adopted a more assertive approach. We can see that there has been a significant narrowing in expectations for the extent of easing next year in New Zealand, and even with a clear dovish outlook by the central bank over the past two quarters, expectations for end-2025 rates have increased by close to 50bp since September, only falling back recently. For a small, open economy such as New Zealand, reflation expectations in China and the US have played a role, but aggressive current easing can also help generate domestically based inflation. Admittedly, policy transmission will be faster in smaller economies such as New Zealand, Switzerland and Sweden, but the "activist" approach as defined by Catherine Mann is just as valid for G7 names in managing forward expectations after disinflation trends are confirmed.

Exhibit #2: New Zealand End-2025 vs. End-2024 Spread

Source: Bloomberg, BNY

Another narrative coming through the US in a fiscal context is "terming out" issuance in Treasury securities. There will be clear implications for the US front end and as the "price" of T-bills and US cash equivalents is still seen as the benchmark for the risk-free rate (for more details, please refer to this week's Short Thoughts). However, anchoring long-end financing, especially at advantageous rates, is particularly pertinent for governments to finance long-term investment. This is what the global economy is asking of for Germany and China to boost growth. However, simply having an advantageous maturity profile is no guarantee of growth or debt sustainability. The UK has by far the most extended maturity profile in the G7 and Anglosphere economies. However, its debt profile has come under heavy scrutiny this year and realised borrowing has overshot the Debt Management Office (DMO) forecast significantly. Without credible fiscal policy to anchor yields, "terming out" could prove costly over time as debt servicing costs crowd out investment capacity.

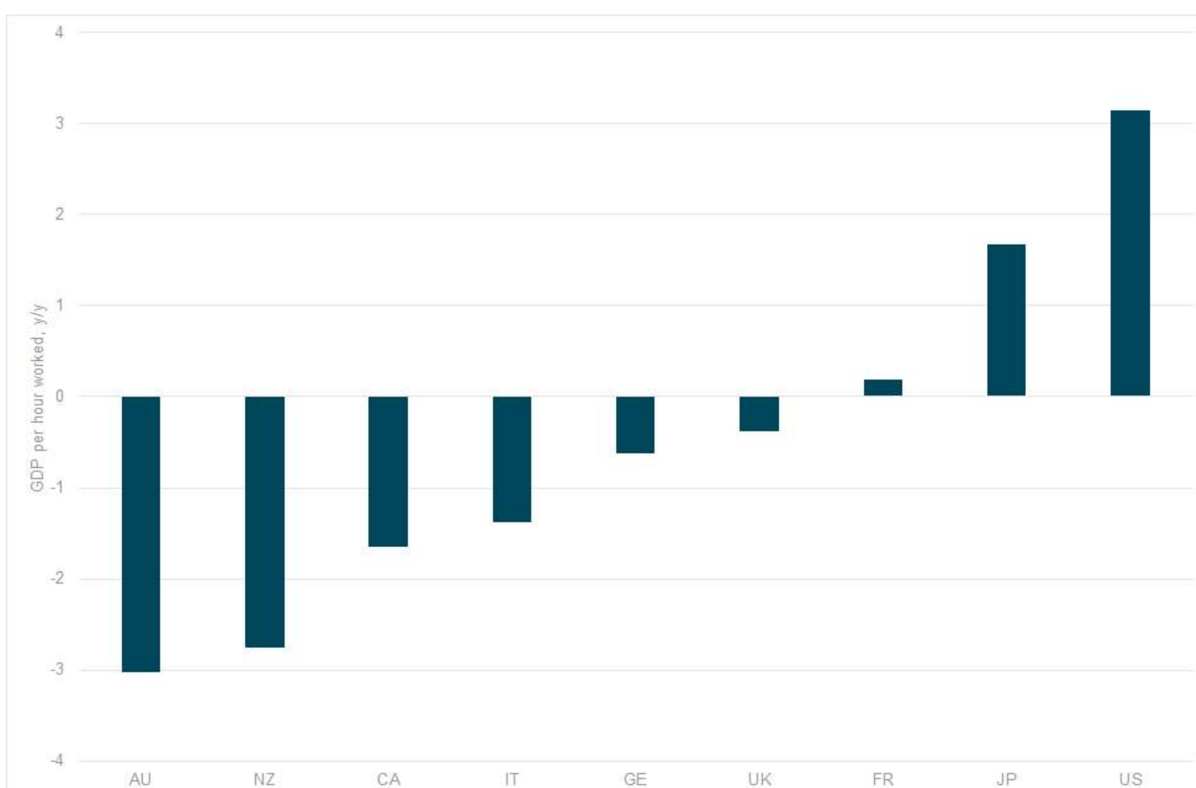
Exhibit #3: Debt Maturity Profiles



Source: Bloomberg, various DMOs, BNY

To strike the right balance, a credible fiscal plan must be accompanied by a credible growth plan, which is what new and incoming administrations are striving for. While there is a clear consensus that achieving escape velocity in growth is a necessary condition for debt sustainability, the market is clearly inclined to reward meaningful fiscal easing upfront. This explains the behaviour in the US curve at the beginning of the week, and the general performance of bond markets in emerging or frontier markets such as Argentina. In contrast, the UK is much more of an outlier where, even with a debt profile that is already "termed out," the government has struggled to anchor long-dated bond yields. The severe lack of productivity growth is the main hindrance in this respect, and the market's lack of confidence in the UK's ability to boost productivity has shifted the burden of fiscal adjustment onto spending cuts. In contrast, small economies and emerging economies with good demographic profiles can generate faster productivity gains, while the US has a natural advantage (Exhibit #4) in this respect due to the strength of its technology sector. The bottom line is that the fiscal-monetary interplay is gaining in prominence, and as always, where the US leads up ahead, the rest of the world will likely follow.

Exhibit #4: Productivity Growth (2023)



Source: OECD, BNY

Please direct questions or comments to: iflow@bny.com

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