REVERSING THE DEBT ROLES

AS GOVERNMENT BORROWING RISES AND CORPORATE DEBT STARTS TO FALL, **GILES KEATING** OF CREDIT SUISSE FIRST BOSTON LOOKS AT HOW IT IS LIKELY TO AFFECT THE WORLD'S ECONOMIES.

For half a decade, shrinking government bond supply has been a crucial part of the global financial landscape, almost everywhere bar Japan. In the US, there has been outright repayment of public debt on a large scale, because the US Federal Government ran large surpluses. In Europe, public deficits have been reduced significantly. The result has been to push investors into private sector equities and debt, providing powerful underpinning to corporate capital-raisers.

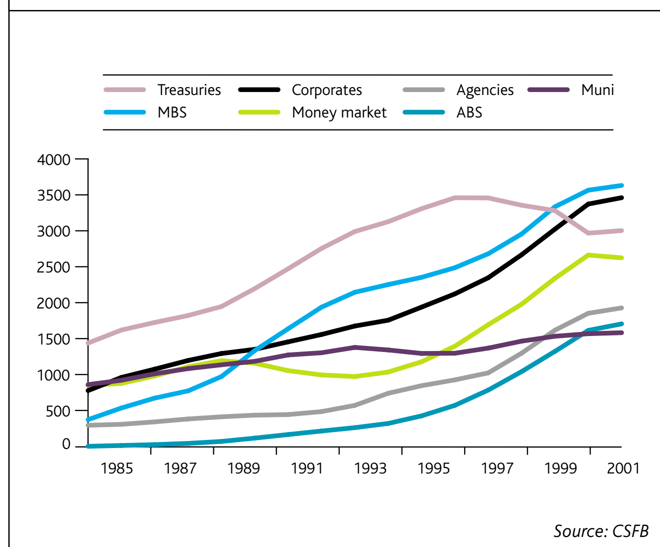
All this is now changing. Government deficits are on the increase again, both to counter recession and to fund the response to the new terrorist threat. The US Federal surplus looks set to disappear by the end of 2002, while euro area governments are suddenly finding that the Maastricht ceiling of 3% on the deficit to GDP ratio is threatening to bite again. Investors will, once again, find increasing supplies of government bonds offering renewed competition to corporate capital-raisers.

FEDERAL GOVERNMENT BORROWING. In the US, over the past few years, there has been a crossover as the Federal Government has reduced the amount of debt outstanding, while consumer borrowing for housing has moved up strongly – illustrated by the rise in mortgage-backed securities (MBS). Corporate borrowing has done the same, until this year. The next two years, in both the real economy and in the financial markets, should reflect the process of switching back again. We expect Federal Government borrowing to start rising, while the corporate sector should start reducing its own borrowing (see *Figure 1*).

Is this a good or a bad development? The answer depends crucially on whether the increased government activity is a purely temporary, cyclical phenomenon, or whether it persists into the expected economic upswing. And on whether we are simply seeing a macroeconomic fiscal effect, or whether we are returning to an era of intervention and 'big government'. If the first, then bond yields will be able to fall and there will be no crowding out of private investment. If the second, then bond yields, sooner or later, will move up sharply, damaging equity valuations and restraining private investment.

Over the short term, the fiscal expansions are unequivocally good news. They come at a time when output gaps (unemployed people and equipment) are increasing sharply, and when private sector demands for capital (other than to cover short-term involuntary inventory holdings) are weakening. It is helpful and good short-term Keynesian demand management for governments to fill those gaps by borrowing to fund tax cuts or temporary spending.

FIGURE 1
DEBT CROSSOVER



Source: CSFB

The stimulus is large. Details could still change, but taking this year and the next together, the discretionary effect will probably reach at least 1.5% of GDP in the US, 2% in the UK, and approaching 0.5% in the euro area.

The deterioration of headline budget positions would be greater, as tax revenues fall during the recession. Of course, monetary policy is being eased as well. Yet, it is difficult to see these policy moves by themselves as inflationary. Even with the benefit of this policy stimulus, we expect the existing global output gap to widen

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further throughout next year, as global growth, though rising, remains below potential.

The fiscal and monetary expansion matters a lot for bond yields, if it signals a fundamental change in the structure of the economy, and in the priorities of politicians. The Cold War era was characterised by government sanction for corporate oligopolies, and corporate acquiescence in labour union power. The aim was to protect jobs and foster the technology needed for national security in sectors such as aerospace. Central banks were subservient to this structure, giving a strong inflationary bias. By contrast, the liberal economic environment of the past two decades has allowed central banks to act tough without significantly damaging output, giving a powerful disinflationary bias.

ECONOMIC COMPROMISES. Despite the economically liberal leaning of most of the Bush administration, it may have to make compromises to support the war against terrorism. Intervention and increased government spending may emerge in some parts of the economy. The tension is already visible in the aid given to airlines, but resisted for other sectors. Compromises of this type would probably not be unwelcome to the euro area's left-of-centre governments. The risk is that the result would be a reversion, at least part of the way, to the inflationary Cold War economic structure.

Fortunately, there is a powerful force in the opposite direction. For the war against terrorism to achieve more than transient successes, requires that the international coalition be broadened and deepened. Governments in coalition countries need to be helped to create thriving economies, to counter the disruptions of war and to minimise the dangers of social unrest. Help will also be needed in Afghanistan itself, and in countries receiving refugees, who will likely number in millions. Cash aid will play a role, but a more powerful and durable solution would involve trade.

The problem for the OECD nations is that to offer effective free trade to these regions, major disruption would be caused to domestic farming. This is because farm trade, in contrast to manufacturing, has been largely excluded from the trade liberalisation rounds of the past 50 years and is heavily protected in most key industrial nations. Average manufacturing tariffs on imports into the richer countries now stand at 1.5%, versus 15.6% for agriculture. To a lesser extent, a similar situation exists in textiles. Yet, it is agriculture and textiles that are the two key sectors for the poorer nations, and unless they are liberalised any trade progress will be largely ineffective for them.

POLITICAL REMEDY. A political solution is in principle possible: open up world agricultural trade and compensate the farming communities of the US, Europe and Japan using money from taxes on services and manufacturing. Ultimately, it should be possible to reverse those tax rises, once the overall gain from trade boosts GDP. This may appear politically unattractive, but if the alternative is to raise taxes anyway, to pay for massive aid, it may yet become feasible. A liberalising agenda of this type would foster low inflation and high productivity.

Bond investors are therefore faced with two broad longer-term political scenarios, each with radically different inflation implications: a return towards the Cold War intervention model, or a bold move forward to radically reform world trade. Although current events give some clues, the eventual direction will not become truly clear for several years. Faced with such great uncertainty, investors will probably focus mainly on shorter-term macro influences, while demanding some risk premium for structural uncertainty.

This suggests that, given the scale and continued widening of the global output gap, recent declines in long-term real yields can be sustained and perhaps go further, for a while. Sub-4% 10-year yields in the US appear sustainable during the deepest part of the recession. This is irrespective of the fact that within a reduced overall demand for capital, the proportion taken by governments rises sharply relative to that taken by the private sector. But the uncertainty will stop yields falling even more radically, despite global deflationary pressure. And if the 'big government' scenario starts to become more likely, with governments unwilling to retreat as the economy picks up, then yields could rise again very sharply.

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MERRY CHRISTMAS

As with last year, we have decided to donate a sum of money to charity. The charity chosen this year is CRISIS. Everyone at the Association wishes members, students, suppliers, customers and friends a very happy Christmas and New Year.
Please note our office will be closed from 5pm on Friday 21st December, reopening on Wednesday 2nd January 2002.