

Listen to What Bond Markets Are Telling Us

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What is to be done? To find an answer, listen to the markets. They are saying: borrow and spend, please. Yet those who profess faith in the magic of the markets are most determined to ignore the cry. The fiscal skies are falling, they insist.



HSBC forecasts that the economies of high-income countries will now grow by 1.3 percent this year and 1.6 percent in 2012. Bond markets are at least as pessimistic: US 10-year Treasuries yielded 1.98 percent on Monday, their lowest for 60 years; German Bunds yielded 1.85 percent; even the UK could borrow at 2.5 percent. These yields are falling fast towards Japanese levels. Incredibly yields on index-linked bonds were close to zero in the US, 0.12 percent in Germany and 0.27 percent in the UK.

Are the markets mad? Yes, insist the wise folk: the biggest risk is not slump, as markets fear, but default. Yet if markets get the prices of such governments' bonds so wrong, why should one ever take them seriously?

The massive fiscal deficits of today, particularly in countries where huge financial crises occurred, are not the result of deliberate Keynesian stimulus: even in the US, the ill-targeted and inadequate stimulus amounted to less than 6 percent of gross domestic product or, at most, a fifth of the actual deficits over three years. The latter were largely the result of the crisis: governments let fiscal deficits rise, as the private sector savagely retrenched.

To have prevented this would have caused a catastrophe. As Richard Koo of Nomura Research has argued, fiscal deficits help the private sector deleverage. That is precisely what is happening in the US and UK. In the US, the household sector moved into financial surplus after house prices started to fall, while the business sector moved into surplus in the crisis. Foreigners are persistent suppliers of capital. This has left the government as borrower of last resort. The UK picture is not so different, except that the business sector has been in persistent surplus.

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So long as the private and foreign sectors run huge surpluses (despite the ultra-low interest rates), some governments must find it easy to borrow. The only question is: which governments? Investors seem to choose one safe haven per currency area: the US federal government in the dollar area; the UK government in the sterling area; and the German government in the euro zone. Meanwhile, among the currency areas, adjustment occurs far more via the exchange rates than through interest rates on safe-haven debts.

The larger the surpluses of the private sectors (and so the bigger the offsetting fiscal deficits), the faster the former can pay down their debts. Fiscal deficits are helpful, therefore, in a balance-sheet contraction, not because they return the economy swiftly to health, but because they promote the painfully slow healing.

One objection – laid out by Harvard's Kenneth Rogoff in the Financial Times in August – is that people will fear higher future taxes and save still more. I am unpersuaded: household savings have fallen in Japan. But there is a good answer: use cheap funds to raise future wealth and so improve the fiscal position in the long run. It is inconceivable that creditworthy governments would be unable to earn a return well above their negligible costs of borrowing, by investing in physical and human assets, on their own or together with the private sector. Equally, it is inconceivable that government borrowings designed to accelerate a reduction in the overhang of private debt, recapitalise banks and forestall an immediate collapse in spending cannot earn a return far above costs.

Another noteworthy objection – grounded in the seminal work of Prof Rogoff and Carmen Reinhart of the Peterson Institute for International Economics in Washington – is that growth slows sharply once public debt exceeds 90 percent of GDP. Yet this is a statistical relationship, not an iron law. In 1815, UK public debt was 260 percent of GDP. What followed? The industrial revolution.

What matters is how borrowing is used. In this case, moreover, we need to consider the alternatives. If the fiscal deficit is to be sharply reduced, the surpluses in the rest of the economy must also fall. The question is how that is to be compatible with rapid deleveraging and expanded spending. In my view, it cannot be. A more likely outcome, in present circumstances, is mass default, shrinking profits, damaged banks and a renewed slump. That is what would happen if today's contained depression ceased to be contained. The danger is particularly imminent in the euro zone. Much can be argued in response to the FT column by Wolfgang Schäuble, Germany's finance minister. But two points stand out. First, it is impossible for both governments and private sectors of deficit countries to pay down – as opposed to default on – their debt, without running external surpluses. What is Germany doing to accommodate such an external shift? Next to nothing. Second,

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inside a currency union, a big country with a structural current account surplus is nigh on compelled to finance counterpart deficits. If its private sector refuses to do so, the public sector must. Otherwise, its partners will default and their economies collapse, so damaging the exporting economy. At present the European Central Bank is offering much of the needed finance. Does Mr Schäuble actually want it to stop?

Contrary to conventional wisdom, fiscal policy is not exhausted. This is what Christine Lagarde, new managing director of the International Monetary Fund, argued at the Jackson Hole monetary conference last month. The need is to combine borrowing of cheap funds now with credible curbs on spending in the longer term. The need is no less for surplus countries with the ability to expand demand to do so.

It is becoming ever clearer that the developed world is making Japan's mistake of premature retrenchment during a balance-sheet depression, but on a more dangerous – far more global – scale. Conventional wisdom is that fiscal retrenchment will lead to resurgent investment and growth. An alternative wisdom is that suffering is good. The former is foolish. The latter is immoral.

Reconsidering fiscal policy is not all that is needed. Monetary policy still has an important role. So, too, do supply-side reforms, particularly changes in taxation that promote investment. So, not least, does global rebalancing. Yet now, in a world of excess saving, the last thing we need is for creditworthy governments to slash their borrowings. Markets are loudly saying exactly this. So listen.

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