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Will budget deficits just push up inflation and bond yields?

Key points

- Budget deficits and public debt are on the rise in most countries. Fortunately, Australia is in a better position than most to increase public borrowing.
- Fears that soaring budget deficits will simply push up inflation and bond yields are likely to be misplaced in the short term. Increased public borrowing will be offset by increased private sector saving and reduced private borrowing as consumption and investment weaken.
- However, the key will be for governments to wind back their borrowing and debt as economic recovery kicks in.

Introduction

Many worry that the rise in budget deficits and public debt now underway in most countries, including Australia, will simply push up inflation and bond yields and, therefore, private sector borrowing rates. Partly reflecting these concerns, ten-year bond yields have increased from their lows early this year – rising from 2% to 2.8% in the US, from 3% to 3.9% in the UK and from 3.8% to 4.3% in Australia. This note looks at the key issues.

Rising budget deficits and public debt

Budget deficits are being pushed up by a combination of slowing economic growth (which reduces government revenue and boosts spending), governments buying private sector securities, and moves to increase spending and cut taxes to actively boost growth. Most major countries and regions will see their budget deficits increase sharply over the next few years.

Budget deficits and net public debt (% of GDP)

% GDP	Budget Deficit, %GDP			Net public debt, %GDP	
	2008 estimate	2009 forecast	Past peak since 1990	2008 estimate	Past peak since 1990
US	5.5	10.0	4.9 (1993)	48	55 (1993)
Euro area	2.0	5.0	5.7 (1993)	44	53 (1998)
UK	4.5	8.0	7.9 (1993)	38	44 (1998)
Japan	2.0	4.0	8.0 (2002)	87	now
OECD	3.5	6.0	4.9 (1993)	45	44 (1996)
China	-0.4	3.0	2.6 (2000)	25	n/a
Australia	0.5	3.0	5.5 (1992)	-4	26 (1995)

Source: OECD, IMF, AMP Capital Investors

This will push budget deficits in the US and UK above the extremes of the last 20 years, in terms of GDP. However, it should be noted the US budget deficit reached almost 30% of GDP during World War II The blow-out in public deficits will result in a sharp rise in both gross (and total) public sector debt and net debt (which nets off public holdings of securities such as foreign exchange reserves or holdings of private sector securities). The increase in gross debt will be larger than net debt because some of the public sector borrowing is being used to buy private sector securities in an effort to stabilise the financial system.

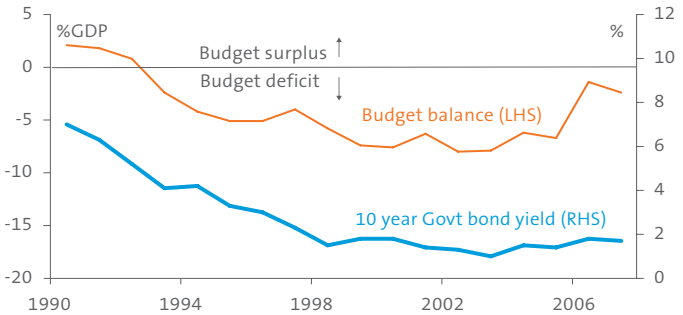
Given the severity of the downturn, net public debt in the US could rise by 20% to 30% of GDP over the next few years. Similar increases are possible in Europe and Japan. Such increases would push public debt levels above the extremes of the past 20 years.

Australia is clearly starting from a reasonably favourable position with no net public debt. The Federal Government's budget deficit projections and state budget deficits could push net public debt up to around 10% of GDP over the next few years. However, this would still be well below the 1995 peak of 26% of GDP and would also be well below other OECD countries, which are likely to have net public debt averaging around 65% of GDP within a few years.

Will deficit financing push up bond yields?

Every time there is a recession and public budgets shift into large deficits, there is concern this will boost inflation and the increased supply of bonds will boost bond yields. However, expanding budget deficits don't cause inflation or higher bond yields in economic downturns because they merely offset an increase in private savings as private consumption and investment are slashed. The Japanese experience in the 1990s was a classic example of this – the budget deficit and public debt blew out, but inflation turned into deflation and bond yields fell below 2%.

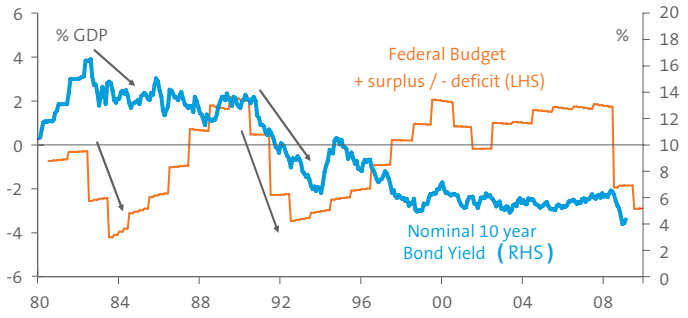
Japanese bond yields fell in the 1990s despite the budget blowout



Source: OECD, Bloomberg, AMP Capital Investors

The same has been evident in Australia. The below chart indicates that bond yields fell during the early 1980s and early 1990s recessions, despite a blow-out in the budget deficit at the time.

Aust bond yields normally fall when budget deficits blow out during recession

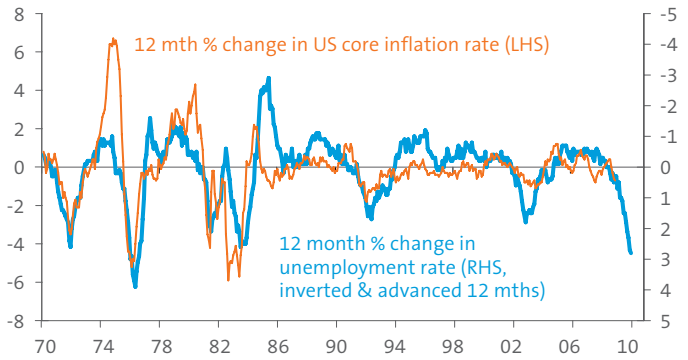


Source: OCED, Bloomberg, AMP Capital Investors

The next year or so is unlikely to be an exception. For the following reasons, **the impact of the global economic slump will more than offset greater bond issuance in determining bond yields**.

First, the period ahead is likely to see a sharp fall in underlying inflation rates, both globally and in Australia, as the recession leads to excess capacity. This, in turn, combines with weak raw material prices to put downward pressure on inflation. For example, the rise in US unemployment is pointing to a very sharp fall in US inflation.

The rise in unemployment points to a big fall in US inflation



Source: Thomson Financial, AMP Capital Investors

Similarly, if our predictions are correct and the unemployment rate in Australia rises to 7% by year-end, this will also drive a sharp fall in underlying inflation locally.

Falling inflation will hold down inflationary expectations and ensure that short-term interest rates remain low for a lengthy period. Both factors will ensure that bond yields stay low, despite increased public borrowing.

Second, increased private sector savings will more than offset the increase in public sector borrowing. For example, the US budget deficit looks like being boosted by 5% of GDP over the next year. However, household savings are likely to rise, possibly by around 5% of GDP, and it is likely that borrowing in the corporate sector will fall by around 3% of GDP. As such, increased private sector savings will likely offset increased public sector borrowing, ensuring plenty of funds will be available to buy government bonds

Likewise in Australia, an increase in public borrowing equivalent to 3% or 4% of GDP will be offset by increased household savings (which may amount to 4% of GDP [1]) and reduced corporate borrowing as business investment falls. This increase in private sector savings will likely mean there will be ample funding for an increase in public borrowing. In fact, over the year ahead households will save a big chunk of the payments they receive from the government, which will ultimately be recycled into buying government bonds. This also means there will be enough domestic sources of increased savings to fund public sector borrowing without having to worry about relying on increased offshore borrowing, including from China.

For these reasons, we are not particularly concerned about rising budget deficits and public debt pushing up inflation and bond yields. In fact, the more likely scenario is that bond yields remain low. They may even revisit recent lows some time over the next few months (i.e. 2% or less in the US and 4% or less in Australia) if there is renewed doubt about the timing of economic recovery.

Qualifications

There are two qualifications to this. First, **the provision of government guarantees over banks is blurring the distinction between public and private debt**. Given the higher yields, government guaranteed bank debt may be more attractive than public debt. Furthermore, investment grade corporate debt is still trading on a yield spread consistent with a depression. This suggests that in this environment, corporate debt may be a more attractive investment than government debt (in most scenarios), unless of course the economic environment takes a renewed turn for the worse. These considerations will limit the downside in government bond yields.

Second, while there is no reason to be concerned about higher bond yields and inflation flowing from increased budget deficits in the short term, the situation could change quickly once economic growth and private sector borrowing recover. **In a few years' time, it will be critical for governments to wind back their borrowing**. If the history of trying to reduce public sector borrowing in the past is any guide, this could prove to be challenging as economic uncertainty will linger and government spending becomes sticky.

Concluding comments

The recent sell-off in bonds on the back of supply worries is likely to prove temporary. Bond yields are likely to fall back over the next six months. Expanding budget deficits will be more than offset by the impact of continuing low short-term interest rates in the face of falling inflation and increased private sector savings, which will create a natural demand for bonds. However, it will be critical to wind back the blow-out in public borrowing when recovery arrives and private sector borrowing picks up again, otherwise much higher bond yields will result.

Nonetheless, with government bond yields low at around 4% or less, it is hard to get excited about them as a long-term investment.

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1 See "Falling debt and rising savings – how big a problem?", **Oliver's Insights**. February 2009

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