

## Will budget deficits just push up inflation and bond yields?

### Oliver's insights



#### Key points

- Budget deficits and public debt are on the rise in most countries. Fortunately Australia is in a better position than most countries 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/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 fret 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 hence private sector borrowing rates. Partly, reflecting these concerns, ten year bond yields have risen from their lows early this year – 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, % 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?	NA
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 relation to GDP. However, it should be noted the US budget deficit reached almost 30% of GDP during WW2. The blow-out in public deficits

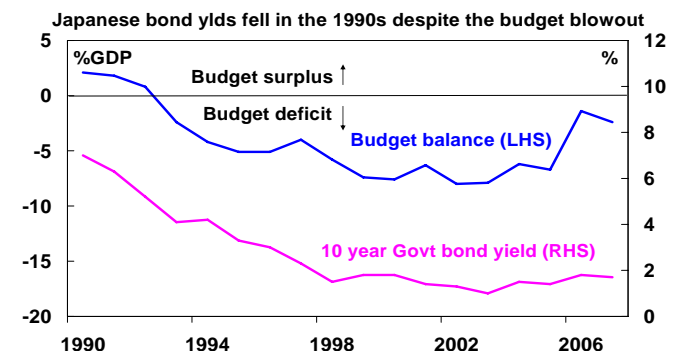
will result in a sharp rise in both gross (and total) public sector debt and net debt (which nets off public holdings of securities such as foreign exchange reserves or holdings of private sector securities). The increase in gross debt will be larger than net debt because some of the public sector borrowing 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 be pushed up 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.

**It's clear that Australia is starting from a reasonably favourable position having 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 in a few years time.

#### Will the deficit financing just push up bond yields?

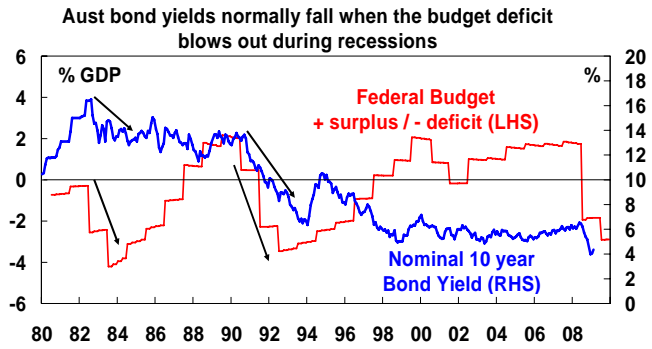
Every time there is a recession and public budgets shift into large deficits there is concern it will boost inflation and the increased supply of bonds will boost bond yields. However, expanding budget deficits don't cause inflation or higher bond yields in economic downturns because they are merely offsetting 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%.



Source: OECD, Bloomberg, AMP Capital Investors

The same is evident in Australia, as indicated in the next chart, which shows that bond yields fell during the early

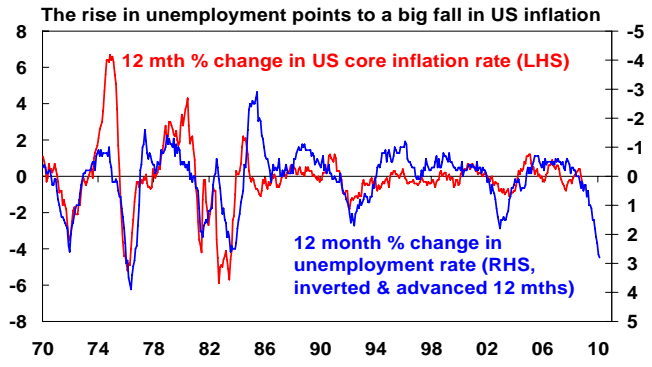
1980s and early 1990s recessions despite a blow-out in the budget deficit at the time.



Source: OCED, Bloomberg, AMP Capital Investors

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

**Firstly, 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 downwards pressure on inflation. For example, the rise in US unemployment is pointing to a very sharp fall in US inflation as indicated in the next chart.



Source: Thomson Financial, AMP Capital Investors

Similarly, if our predictions are correct and the unemployment rate in Australia rises to 7% by year end, then 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.

**Secondly, 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 is likely to rise, possibly by around 5% of GDP, and it's 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 there will be plenty of funds 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<sup>1</sup>) and reduced corporate borrowing as business investment falls. This increase in private sector savings will likely mean that there will be plenty of funding for an increase in public borrowing. In fact we will have the perverse situation over the year ahead that 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 that 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.

So 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 will remain low and may even revisit recent lows (ie 2% or less in the US and sub 4% in Australia) if at any time over the next few months there is renewed doubt regarding the timing of the economic recovery.

**Qualifications**

There are two qualifications to this. Firstly, **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. This, plus the fact that investment grade corporate debt is still trading on a yield spread consistent with a depression, suggests that corporate debt may be a more attractive investment than government debt in this environment in most scenarios (unless of course the economic environment takes a renewed turn for the worst). These considerations will limit the downside in government bond yields.

Secondly, 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 recovers. **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 a challenge 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. Worries about 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. It will be critical though 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.

However, with government bond yields so low at around 4% or less, it's hard to get excited about them as a long term investment.

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

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