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Analysing the impact of fiscal policy on
economies and markets

- Major economies will see a noticeable fiscal headwind for several years, but on its own this is unlikely to cause a further recession
- The important risks for investors and governments are the long-term impact of historically high debt levels for advanced economies, including potential funding problems and higher interest rates

Global Perspective

Analysing the impact of fiscal policy on economies and markets

Fiscal pressures are the centre of market attention. While short-term pressures are more manageable than most investors realise, there are significant long-term risks from high levels of public sector debt. In particular, there are potential funding problems, crowding out effects and sovereign debt rating concerns for the decade to come.

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Fiscal policy is centre stage

As the world economy enters the second year of economic growth, some commentators question whether tighter fiscal policy could cause a slide back into recession. In this article we consider key issues raised by high levels of government debt in many of the advanced economies. We argue that the impact of tax increases and spending cuts will be more moderate than bearish commentators are arguing. However, we do warn about the longer-term risks facing governments: unfunded liabilities mean difficult tax and spending decisions. The implications are twofold: firstly financial markets will be volatile as they try and price in different policy responses in different countries. Secondly, the House View strongly advocates the theme of 'interest rates lower for longer' as central banks will need to keep monetary policy very loose to offset the fiscal headwinds.

What is the fiscal situation?

Most advanced economies face a very difficult fiscal position (see table 1). There has been a pronounced deterioration in budget deficits; the advanced economies ran a budget deficit of only 2% of GDP in 2007 but about 10% of GDP in both 2009 and 2010. Hence, the OECD warned that total industrialised country public sector debt will exceed 100% of GDP in 2011, something that has not happened since the early 1950s. In response, governments face considerable political opposition as they begin to implement the largest fiscal consolidation in decades.

The size of the deficits partly relates to the starting positions, e.g. France, the UK and the USA were still running an annual deficit of some 2-3% of GDP even when their economies grew strongly in 2007-08. Other features include counter-cyclical policies, although in few countries the impact did exceed 1% of GDP a year, as well as measures related to bank bailouts. More important, however, are the structural flaws which the recession exposed, for example, the dependence of tax revenues on earnings and taxes related to housing, asset prices and the financial services sector. The permanent loss of output from the recession, impacting on government revenues, has been estimated about 4-6% of GDP in the UK, for example.

Recession fears are overblown

Some commentators suggest fiscal tightening will cause a renewed recession. As political rhetoric is often aimed at altering public perceptions, we need to analyse the precise details. Certainly Greece, Ireland, Portugal and Spain, for example, are taking unpopular decisions; however, these only

produce one fifth of Euro-zone output, while the tightening announced in most of the largest economies is much smaller. Looking at either Europe or the larger OECD economies, then the net fiscal tightening is only equal to some 0.25% of GDP in 2010 and 1.0-1.5% of GDP in 2011. This may appear large, but it should be recalled that a fiscal tightening does not have a 1-1 impact on economic growth. Just as an economic stimulus rarely has as large an effect in the uptrend as politicians hope for, so a fiscal contraction has a more muted impact than many commentators realise.

A number of academic studies have examined this, with mixed results. On balance, most models used by central banks and governments suggest the fiscal multiplier is about 0.3-0.5; in other words that a net fiscal tightening equivalent to 1.0-1.5% of GDP in 2011 may only reduce actual GDP growth by say 0.5-0.75% at most. The research is more helpful in showing how and when fiscal tightening is effective, that is consolidating debt/GDP ratios while limiting the growth impact. Better results are generally seen when the programme is focused on spending cuts rather than tax increases; there is less effect on household incomes and confidence. Structural changes can be important; a fiscal retrenchment via postponing the retirement age has the potential to boost GDP growth while simultaneously raising government revenue and lowering public spending. Whether the economy is open, such as the UK, or more domestically oriented such as Japan, will alter the impact of national tightening. Credibility matters: countries with fiscal rules achieved better results. Lastly, the movement in the various sectoral balances matters: how does the corporate and household sector, often in a sizeable financial surplus, respond to changes in public sector deficits.

We do warn that a major risk is that so many countries are tightening fiscal policy at the same time, hence the multiplier effect could be larger in aggregate. More positively though, we emphasise that the underlying monetary and exchange rate stance is also important when fiscal policy is tightened. In this regard, investors should note the recent depreciation of the euro currency. Standard models suggest that a 10% fall in the effective exchange rate should boost Euro-zone GDP growth by about 0.5-1.0% over the next two years. The benefits are already being seen in the strong export orders reported by countries such as Germany.

To sum up, we expect fiscal policy to act as a noticeable headwind to the major economies, and hence the House View forecasts moderate, no better than trend, GDP growth for several years. Hence, the fiscal position will remain vulnerable to external shocks for some time to come, until deficits are lowered from 8-12% of GDP a year towards say 2-4%.

Table 1
Fiscal position

Economy	2010 fiscal deficit (1)	2015 fiscal deficit	2010 debt/GDP (2)	2015 debt/GDP
G7 economies	-9.5	-5.4	77.1	94.2
Euro area	-6.9	-4.1	59.5	-
USA	-11.0	-6.5	66.2	85.5
UK	-11.4	-4.3	71.6	83.9
Germany	-5.7	-1.7	68.6	74.8
Japan	-9.8	-7.3	121.6	154.7

1 General government primary balance, % GDP

2 General government net debt, % GDP

Source: IMF fiscal monitor, May 2010; OECD Economic Outlook, May 2010

Table 2
Market impact of various debt solutions

Rank likelihood	Policy	Equity impact	Bond impact
1	Cut spending/raise taxes	↓	↑
2	Quantitative easing	↑	↑
3	Grow your way out	↑	↓
4	Restructure/default	↓	↓
5	Sustained inflation	↑	↓

The type of quantitative easing matters, whether it involves central bank purchases of government bonds (more likely in our view) or increasing money supply growth

Source: Standard Life Investments

The long-term fiscal problems

Although the House View argues that fiscal constraint means a period of sub-trend growth, rather than necessarily a renewed slide into recession, we warn of major fiscal dangers ahead. Even in, say, 2015, a number of countries will face worryingly high levels of public sector debt (see table). Governments also need to address the additional problems of unfunded liabilities.

Although OECD governments' plan is to lower their annual fiscal deficits, the actual stock of debt does not stabilise for some years to come. Indeed in many cases, debt rises steadily over the next 4-5 years to 90-100% of GDP. The dangers are several fold; notably the risk of a crowding out effect. Firstly, various studies demonstrate some link between debt levels and government bond yields; the more debt the government has to issue the higher the yield it has to offer. IMF analysis suggests that a 10 percentage point increase in the debt-to-GDP ratio would raise bond yields by about 0.5%. Secondly, various studies, most notably by Reinhart and Rogoff, suggest that where government debt/GDP ratios exceed 90%, then median GDP growth rates typically fall by at least 1% a year, both for advanced and developing economies. This reflects a slowdown in labour productivity growth, mainly due to reduced investment and slower growth of the capital stock. Higher debt levels may also be associated with higher macroeconomic volatility and hence weaker productivity growth. For developing economies, the growth-debt relationship can be even stronger; where external debt reaches 60% of GDP then annual growth rates fall by about 2% a year. The maturity of the debt profile matters considerably, making countries more or less vulnerable.

The second issue concerns the high level of unfunded liabilities in many countries, such as public sector pensions, public-private finance initiatives for infrastructure spending, or the additional health expenditure required as populations age. On some estimates, OECD countries are projected to face increases of 4 to 5 percentage points of GDP in spending for healthcare and pensions over the next two decades, with a potential impact on household savings patterns. To this should be added state and local government debts; for example US states and German Länder are currently running deficits of 1.0-1.5% of GDP. Investors need to examine both central and local government debt dynamics.

Market implications

Debt matters; a higher level of public sector debt usually means a larger share of resources is spent on debt servicing. In effect this is a transfer of wealth from taxpayers (households and corporations), to banks, pension funds, insurance funds and

central banks, as owners of government bonds, whether domestically or overseas. It is estimated that interest payments will rise by about 1% of GDP over the coming five years across the advanced economies. Potentially there is a crowding out effect pushing up interest rates, while limiting the ability of governments to respond to future crises.

This analysis leads us to warn investors to expect sharp market moves, which should benefit the more active fund manager. Different governments will adopt different policies to deal with their fiscal problems; some of the market implications are shown in table 2. Certain European governments may eventually seek a form of debt restructuring. If a fiscal consolidation programme does not work, policy makers could choose enforced savings flows, for example encouraging banks and other financial companies to own more government bonds, as Japan has *de facto* operated. Conversely, if austerity packages become politically unpopular, governments could encourage central banks to initiate a period of higher-than-expected inflation. We warn that investors need to monitor the possibility that central banks implement further rounds of quantitative easing as a 'Plan B'. Secondly, the House View remains strongly focused on 'interest rates lower for longer'. In an environment of fiscal headwinds, relatively weak economic growth, and little core inflation pressure, there will be limited ability for central banks to tighten monetary policy quickly or aggressively. In this respect, the success of fiscal austerity programmes in the US, Japan and Europe will largely depend on the ability of emerging market governments to ensure global economic growth remains sufficiently high over the coming cycle.

In recent months, financial markets have focused on the debt problems facing a few European countries. In practice, these look to be manageable in the near term, reflecting a mixture of fiscal consolidation and external support. We warn that more important risks lie ahead. It will take a decade or more to bring public debt levels down to comfortable levels. Reform fatigue could kick in; government bond and CDS markets will sell off as and when credit rating agencies consider downgrading sovereign debt ratings. While governments have financed their deficits relatively easily so far, this is not a surprise when investors are looking for safe havens. Lastly, persistently high levels of debt carry a risk of driving down capital accumulation, long-term potential growth, and thus corporate sector profitability.

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House View

SLI recommended asset allocation for Canadian balanced mandates.

	Positive	Negative	Our View
Canadian Equities	<ul style="list-style-type: none"> Earnings will respond to lower loan losses and generally high commodity prices as the economy expands. Canada remains a geared play on global growth. 	<ul style="list-style-type: none"> The market rallied hard in 2009 on the bottoming in the global economy. Key issue is whether commodity prices will be maintained or continue to rise, thus supporting the level of earnings now being discounted in the market. 	<p>The portfolio continues to feature high-quality companies. We increased our focus on higher conviction buys and trimmed lower conviction views. We are positive on banks, oils and select commodity producers.</p> <p>OVERWEIGHT.</p>
US Equities	<ul style="list-style-type: none"> The US market will benefit from a global improvement in earnings and good operating leverage. We also like the more diversified sector allocation, with better exposure to areas such as health care and technology for Canadian investors. 	<ul style="list-style-type: none"> The market is pricing in strong earnings growth in 2010. Lower financial loan loss provisions and positive operating leverage offers the prospect of better earnings in an otherwise muted economic environment. 	<p>We have increased our OVERWEIGHT position in US equities reflecting valuations, the appeal of the dollar vs. the loonie and the relatively steady growth nature of the market. With firmer growth prospects in the US than in Europe and Japan, we think the US dollar can be in a longer-term rising phase.</p>
EAFE Equities	<ul style="list-style-type: none"> EAFE tends to outperform in cyclical rallies, as earnings are more geared to the cycle and valuation tends to improve as well. Valuation in the UK and Europe remains at a discount to other global markets, especially compared to Emerging Markets and the Pacific region. 	<ul style="list-style-type: none"> Challenges remain. The Japanese recovery remains fragile and dependent on exports. Europe is also highly dependent on trade to stimulate growth and faces tighter fiscal policy due to huge budget deficits; European banks have been slower to recognize losses and have higher government involvement. EAFE recovery requires the Euro and Yen to weaken further. 	<p>With a still strong rebound in global activity, we lifted our position in funds in the autumn but remain UNDERWEIGHT. The fiscal situation in Europe, especially Portugal, Italy, Greece and Spain will be a drag on growth even assuming a bail out is organized for Greece.</p>
Real Estate	<ul style="list-style-type: none"> Capitalization rates have risen. Real estate typically produces positive returns even in a difficult period. Vacancy rates are low in Canada. 	<ul style="list-style-type: none"> Market turnover remains very low, and it requires perseverance to find opportunities at attractive valuations. 	<p>This asset class benefits from cash flow and stability over the cycle.</p> <p>NEUTRAL</p>
Canadian Bonds	<ul style="list-style-type: none"> Inflation is low in Canada and the economy is recovering more slowly than the US due to the high loonie. Long-dated corporate and provincial bonds remain attractive. Rates will have to stay low in Canada just to lean against the currency. 	<ul style="list-style-type: none"> Long-term yields at 3.5% are not attractive on a multi-year view, especially compared to equities. Corporate spreads in the short- and mid-term parts of the market are back to their long-term lows, and offer less-compelling value. 	<p>As equity markets fell and bonds rallied, we have cut our position to NEUTRAL in favour of US equities. Within the portfolio, we hold longer-dated corporate and provincial bonds, and benefit from still very wide spreads. With economic momentum likely to peak by mid-2010, long-term credit has solid risk-adjusted return potential.</p>
Cash	<ul style="list-style-type: none"> We can use cash if conditions warrant for acquisitions or short-term defensive reasons. 	<ul style="list-style-type: none"> Not attractive as a long-term asset given the low yields. 	<p>We hold minimal cash levels, given their low yields and favourable outlook in bonds.</p> <p>UNDERWEIGHT</p>

The terms Overweight, Neutral and Underweight express Standard Life Investments' view of a balanced portfolio against a given benchmark.