

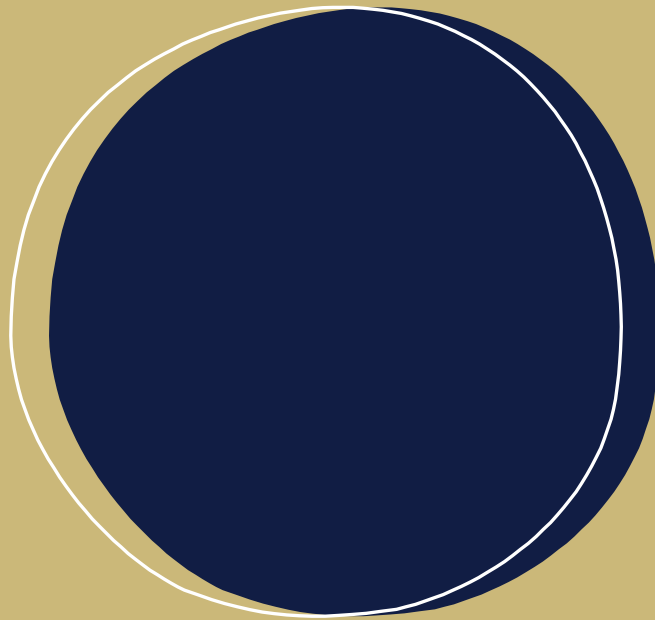
# News from the financial markets

The post-crisis world

Volume 1: Government indebtedness restrains growth

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The post-crisis world

## Volume 1: Government indebtedness restrains growth

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**The current financial and economic crisis is propelling the national debt levels of key industrialized nations to unaccustomed heights. A stabilization of the debt levels is possible – and an erosion of the value of that debt through inflation is not necessary. However, economic growth in the coming years is likely to progress at a slower pace than in the past. Any aggressive austerity program would unnecessarily curb growth even further.**

### **Government indebtedness rising too rapidly**

The rescue packages for beleaguered banks, as well as the numerous economic stimulus plans and additional expenditures to finance unemployment and work-sharing, are all leading to significantly increased public sector spending in many industrialized nations. At the same time, corporate and personal income tax revenues are on the decline as a result of the recession. Consequently, within one year's time, the debt ratio (total national debt expressed as a percentage of GDP) in Great Britain rose from 36% to more than 50% and in the euro zone from 54% to 60%. In the USA, that reading has risen from roughly 50% to almost 65% of GDP. Among the industrialized nations, the leader of the pack in this regard is Japan, where national indebtedness stands at 180% of GDP.

### **Primary surpluses rein-in a potentially vicious cycle**

Annually recurring large budget deficits cause a country's indebtedness to swell relentlessly. That increased debt burden results in larger interest payments, which in turn weigh on the following year's budget.

If the nominal debt interest rate is higher than nominal GDP growth – as is the case today – the debt ratio rises even if the pre-interest national budget is balanced. In such an instance, additional debt has to be incurred in order to cover the ongoing interest payments, which then increases yet again at a faster pace than GDP growth. Thus as a general rule, a country must be able to generate what is known as a primary surplus (i.e. a budget surplus before interest payments) if it wishes to reduce its debt ratio.

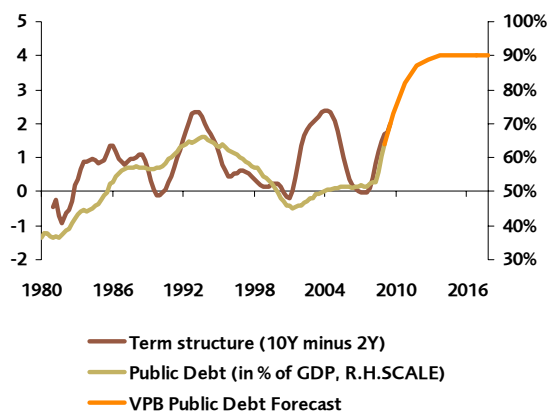
The USA is likely to end the current budget year with a primary deficit of roughly 9% of GDP. Thus it goes without saying that the need for consolidation is great. However, in order not to jeopardize GDP growth, the introduction of an austerity plan already in 2010 would be clearly premature.

Despite the country's large deficit, we consider the recently introduced economic stimulus programs – even in their magnitude – to be appropriate, inasmuch as they fill the vacuum caused by a lack of private demand. In other words, debt is in the process of being shifted from the private sector to the public sector, which should ultimately buoy consumer confidence and reduce mortgage interest costs.

### **High debt levels hinder growth**

Equally spoken, an increasing debt ratio normally results in rising interest rates and greater country-specific risk. And that higher cost of money represents a growth restraint in the following years.

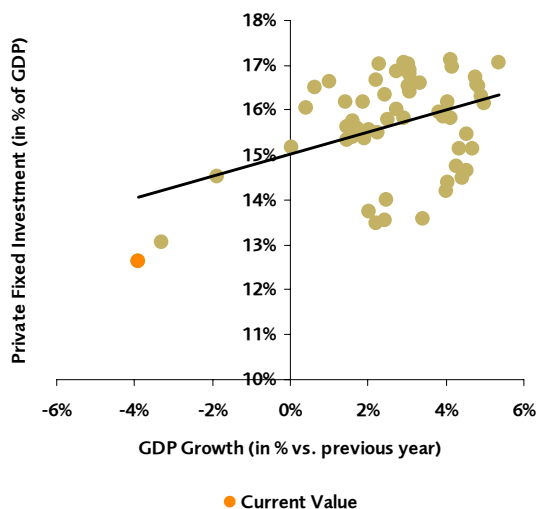
USA: Indebtedness heightens long-term interest rates



Sources: VP Bank, Datastream

"Crowding out" is another impediment to economic growth. The greater borrowing needs of the government absorb a larger portion of private-sector (household and corporate) savings; hence that money is no longer available for capital creation. The result: a declining private-sector investment rate, a drop in productivity growth, and the corresponding negative effects on GDP growth.

USA: Reduced investment hinders growth



Sources: VP Bank, Datastream

A government can counteract this syndrome by obtaining capital abroad, provided it can find a sufficient number of willing lenders. But such a move places an increasing burden on the country's currency because of the undue rise in consumption and the current account deficit.

### Debt reduction is unrealistic

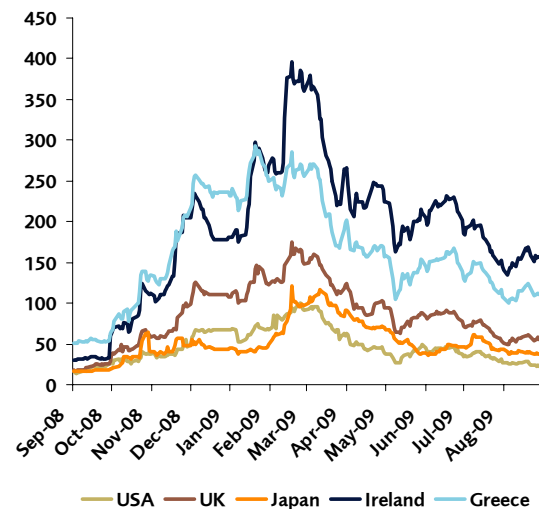
Because of its potentially negative impact on growth, a debt-reduction move on the part of the US is unrealistic over the next ten years. If one assumes that America's budget deficit will decrease only negligibly next year, an annual

primary surplus of about 4% of GDP would have to be generated in the following years in order to bring the debt ratio back below the 60% level. That calls for cost cuts, which for all intents and purposes would appear unrealistic in today's difficult economic and social environment. For that reason, debt cycles tend to last several years longer than economic cycles.

### Fears of national bankruptcy nevertheless unjustified

However, the threat of a national bankruptcy is a very distant prospect. Although certain market participants do not entirely rule out the possibility of a G7 state going belly-up, the spread on CDSs (credit default swaps) – i.e. the premium demanded for "insurance" against the risk of non-payment) – has narrowed again significantly even for Great Britain, despite the fact that it was downgraded by S&P in May. Premiums for the G7 states are anyway at the lower end of the spectrum. On the other hand, CDS spreads for countries such as Ireland and Greece have yet to return to the level they were at prior to the Lehman Brothers collapse.

CDS spreads for selected countries



Sources: VP Bank, Datastream

The example of Japan illustrates how trust in a country's creditworthiness can also allow for high debt ratios. Although Japan's national indebtedness has swelled in the past ten years from 100% to 180% of GDP, the yields on 10-year sovereign debt still lie below 2%. That enables even the enormous indebtedness of Japan to be financed with relative ease. Apart from the trust in creditworthiness, those low yields are also attributable to the long-standing phase of deflation in Japan. America (unfortunately) does not enjoy that confidence at present. Moreover, possible concerns about high future rates of

inflation could lead to increasing yields at the long end of the term structure.

### "Inflating-away" the debt is out of the question

Inflation reduces the "real" (i.e. inflation-adjusted) value of a debt and therefore benefits the borrower. However, a modern-day nation can have only limited interest in bringing about high inflation rates or even hyperinflation. Firstly, politicians have to win their elections. And secondly, government bonds are refinanced in the capital market on almost a weekly basis. Thus the country is immediately punished (via higher interest costs) if inflation accelerates. Given the wealth of information available today, it is hardly possible any more for rising prices to "surprise" market participants.

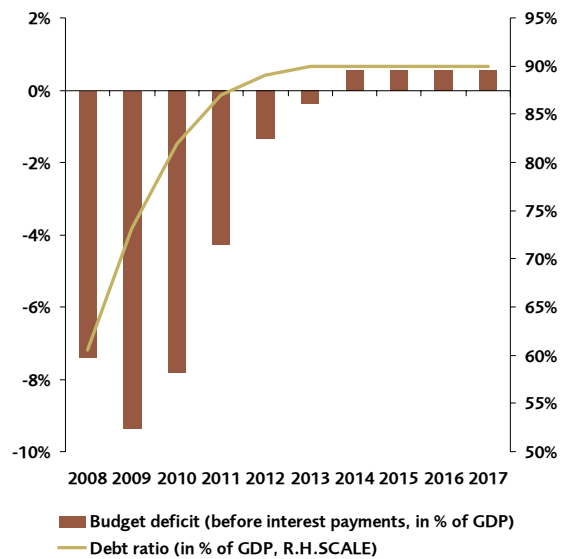
Besides, there are no signs at present that the central banks will lose their independence and end up systematically financing their country's budget. Public deficits only have an inflationary effect if they are financed by means of the printing press. In every other case, it would come to a shift of purchasing power into the hands of the state, whereas no additional purchasing power would be "created".

Thus the independence of central banks is proving its worth yet again, and that factor can be expected to contribute greatly to a stabilization of national indebtedness.

### Debt stabilization is indeed possible

It would therefore appear that high debt ratios are unavoidable under the current circumstances. Given a moderate 1% annualized GDP growth rate next year and a pace of up to 2.5% in the following years, and assuming an inflation rate of 2.5% at the most, it appears realistic that America's debt ratio will stabilize at around 90% of GDP as of something like 2013. Annual cost cuts of roughly 2% of GDP and interest rates of a maximum of 5% over a three-year period are sufficient to achieve that goal. Under this scenario, a modest rise in tax revenues would reduce even further the necessary spending cuts. However, this scenario does not allow for the possibility to "grow out of debt".

Forecast: US budget balance and debt ratio



Sources: VP Bank, Datastream

### The bottom line:

Despite a further increase in national indebtedness, no G7 member state is likely to go bankrupt. Via cost cuts of a reasonable magnitude, the governments can stabilize their indebtedness at a high level over the coming three years. Debt-reduction measures would require much greater efforts, which strike us as being unrealistic right now. Consequently, the high levels of national debt will act as a hindrance to growth because they drive interest rates upward. Thanks to the independence of the central banks, the governments are not in a position to pick the pockets of their creditors by means of inflation.

How does the post-crisis world size up? Your Economics and Investment team will attempt in the coming weeks and months to formulate initial responses to that question. We would be pleased to take your desired topics into account in our analysis and look forward to receiving your suggestions either directly at [investment@vpbank.com](mailto:investment@vpbank.com) or via your personal Client Advisor.

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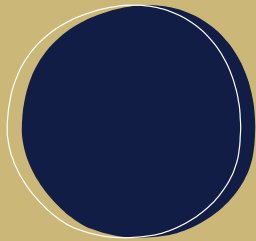
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