



Fiscal crisis

Greek wake-up call for US, UK, Japan

- The Greek crisis highlights the risks when markets doubt fiscal sustainability
- Markets are focused on Europe but the US, UK and Japan need to cut deficits fast too
- Monetary policy will stay loose to offset tighter fiscal policy

This report focuses on the fiscal adjustments required in the US, the UK and Japan and their likely effects on the markets.

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- The developed countries' fiscal crisis is due to profligacy in the good times, deep recession and only moderate growth prospects.
- Countries need a credible medium-term strategy to reduce deficits to zero within a few years and then to bring debt ratios back down again, especially given the looming burden of ageing populations.
- Tight fiscal policy must and will be offset by loose monetary policy. Policy rates will stay relatively low and more quantitative easing may be needed.
- Countries making swift fiscal adjustments will tend to see low official rates, low bond yields, flattening yield curves, weak currencies and strong stock markets.
- Countries moving slowly will have higher real bond yields, steeper yield curves and weaker stock markets. Their currencies may be strong for a while but will be vulnerable to a crisis.
- IMF studies suggest that Japan and the UK need to cut their primary deficits by about 13ppt of GDP, while the US needs to cut by 8ppt.
- The good news is that similar adjustments have been achieved successfully before. At least 12 OECD countries have made an adjustment greater than 8ppt of GDP in the last 30 years.
- Over-rapid tightening could unnecessarily slow the economic recovery, but rising debt brings higher borrowing costs and risks a crisis.
- Estimates suggest that with US net debt set to approach 80% of GDP in 2015, compared with 42% in 2007, bond yields are boosted by 60-190bps. We believe the lower end of this range is most plausible, as long as there is no market crisis.
- If countries move too slowly, there could be a crisis and then a forced and very painful adjustment. With a floating exchange rate the crisis will initially focus on currency and inflation risk rather than restructuring risk.
- Japan's 104%-of-GDP net debt and 8% deficit put it first in line for trouble, especially with domestic financing set to decline in coming years.

Important disclosures can be found in the Disclosures Appendix





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- The outcome in the US is critical for the world economy. Markets will be looking for significant action from 2011 on, but it is unclear whether politicians have grasped the urgency.
- The UK faces one of the largest adjustments of all. Successful fiscal adjustments in the past provide cause for optimism, but the lack of an outright election winner makes the process more difficult.
- The risk that governments will 'inflate out of debt' is real, but not in the short to medium term. It may become an issue in five to 15 years' time if governments make slow progress on cutting deficits.
- Cuts in current spending and transfers are preferable to higher taxes, but in reality, governments will do both.
- The US and Japan are still relatively 'small-government' economies compared with Europe. This could change if deficits are closed via tax increases, opening up a larger gap with many successful emerging economies.
- If the major countries succeed in controlling debt, they will enjoy strong economic growth led by private-sector investment. If they fail, expect weak growth and periodic crises, with the economic centre of gravity shifting even faster towards the emerging world.
- Few major emerging countries have a serious fiscal problem at the moment and even those that do, for example India, are able to manage it with their very strong GDP growth.

Deficits are high and debt ratios are rising rapidly; the required adjustments are huge

Slow growth is a key problem; India can handle a large deficit because it is growing so fast

The scale of the problem

Rising debt and alarming deficits

Prior to the 2008-09 crisis, most OECD countries were running budget deficits of less than 3% of GDP and their debt ratios were declining. A fiscal crisis loomed on the distant horizon due to the combination of unrealistic pension promises and rising health-care costs, but this still seemed far away both for governments and markets. The financial crisis and recession changed all of this for many countries by pushing deficits and debt on to a much higher path for the next several years. The higher levels of debt now projected five and 10 years out will be a much worse starting point for the coming demographic crunch.

While the unexpectedly deep recession was bound to cause a major fiscal deterioration, troubles in the financial and real-estate sectors hit public finances in the US and UK particularly hard. Bailout packages have cost governments money, but the main problem is lower tax receipts from financial companies and employees. Nevertheless, it is also clear that the countries in trouble now are mostly the ones that ran relatively large deficits, even in the boom years of 2005-07. For example, Greece ran a deficit of 4% of GDP in 2007, while the US, the UK, Japan and Portugal all had deficits of about 2.5% of GDP.

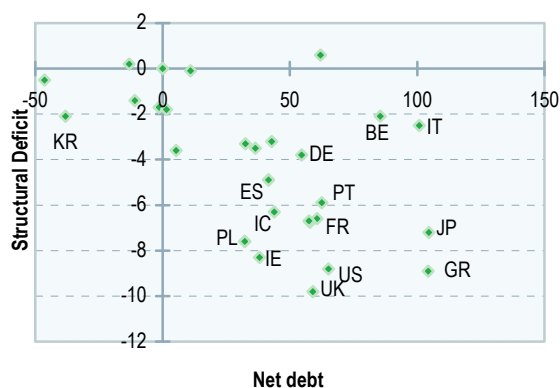
OECD Secretariat projections for deficits and debt are given in Charts 1 and 2, which show the expected levels for OECD countries in 2010. The worst place to be is on the lower right-hand side, with high debts and high deficits. The problem countries can be quickly identified: Belgium, Greece, Italy, Japan, Portugal, Spain, the UK and the US. Strikingly, fiscal problems are primarily a challenge for advanced economies. Among the large emerging countries, only India has a fiscal position of concern, but it is of course enjoying much faster GDP growth.



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Chart 1: Net debt and structural deficits, 2010

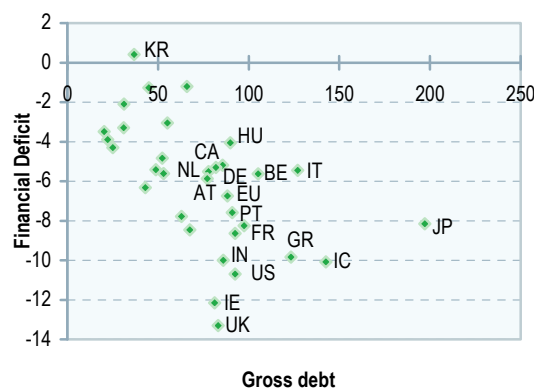
US, Japan and the UK look weak



Sources: OECD, Standard Chartered Research

Chart 2: Gross debt and financial deficits, 2010

Japan and the UK stand out



Sources: OECD, Standard Chartered Research

Debt ratios are projected to rise by 40-50ppt in just a few years

Large deficits mean that net debt will continue to rise in coming years. IMF projections (IMF 2009) suggest that the US, Japan and the UK will all see debt rise by about 40-50ppt of GDP by 2014 compared with pre-crisis levels. For the US and the UK, this means that net debt will move up to around 80% of GDP, while in Japan it could reach 150%. The euro-area countries with high deficits – Greece, Portugal, Ireland and Spain – will also significant increases.

The IMF has estimated the change in the primary balance (i.e., excluding interest payments) required to bring gross debt-to-GDP ratios back down to 60% by 2030 (see Table 1). Four countries require an adjustment of more than 10% of GDP – Japan, the UK, Ireland and Spain. Another four countries need a shift of between 6-10% of GDP – Greece, the US, Portugal and France. Historically, even an adjustment of 5-6% is considered quite large.

Table 1: IMF estimates of the required adjustment in primary balances 2010-20

Advanced economies	Required adjustment % GDP	Advanced economies	Required adjustment % GDP
Japan	13.4	Iceland	4.4
United Kingdom	12.8	Australia	3.7
Ireland	11.8	Netherlands	3.5
Spain	10.7	Germany	3.4
Greece	9.0	Canada	3.1
United States	8.8	Finland	2.8
Portugal	6.5	New Zealand	2.3
France	6.1	Sweden	1.9
Belgium	5.6	Norway	1.3
Austria	5.1	Korea	0.1
Italy	4.8	Denmark	-1.7

Source: IMF November 2009



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The true scale of government liabilities is hard to quantify because so many promises are unfunded

US health care is alarmingly expensive, and the US lags Europe in terms of social security reform

Growth prospects are the biggest source of uncertainty, as potential output may have been depressed by the financial crisis

Unfunded liabilities

The difference between gross debt and net debt is the financial assets of governments and government agencies, and these can be very large in some cases. Japan's gross debt, for example, is around 200% of GDP, but nearly half is held by the public sector. Some of these assets are genuine assets which should legitimately be deducted when considering a country's real debt burden – foreign exchange reserves, for example. However, some government bonds are held by other government agencies against specific future liabilities – for example, the social security fund in the US. So looking at net debt rather than gross debt ignores those liabilities completely.

In fact, many countries also have large unfunded liabilities, and these are not captured by either debt measure. As well as pay-as-you-go government pension schemes for public-sector workers (and in some countries for all workers), there is the implicit promise that governments will provide high-quality health care despite burgeoning costs. If health-care costs continue to rise faster than nominal GDP, governments can only provide the best care by spending a larger and larger share of GDP. Even before the latest health-care reform, the US government was just as affected by this problem as European countries, as it already paid for health care for government employees, the poor and the elderly, with the latter accounting for the bulk of health expenditures.

There is no definite and comprehensive account of the unfunded contingent liabilities governments have accumulated (Cecchetti 2010), but estimates for various countries often range from 100-300% of GDP, usually dwarfing existing debts. It has often been argued that continental Europe and Japan have the biggest problem here because their age-dependency ratios are forecast to be worse than those of the US or UK. But other studies suggest that the US and the UK may in fact be in worse shape (Hagist 2009).

The US government runs a particularly expensive health-care programme, partly because it does provide for the poor and the elderly and partly because there is very little cost control. Also, the US has not reformed its social security system to the extent that many continental European countries have in recent years. The problem in the UK is the size of the budget deficit, which is huge now but was running at high levels even before the crisis.

The trouble is that all such estimates are based on a wide variety of assumptions on factors such as growth rates, interest rates, fertility rates and immigration rates over a long-run period, often out to 2050 and beyond. There is also a general expectation that in practice, governments will scale back their pension and health-care promises over time, though this may make for some ugly politics.

Uncertain projections

Projections for deficits and debt are just that – projections. The outcome for individual countries could be much better than forecast if economic growth rebounds particularly strongly and/or spending and taxes are adjusted rapidly. There is also considerable uncertainty about the potential GDP of some countries following the crisis. In the UK, where the financial sector is a leading part of the economy, the government now assumes that potential GDP is 5% lower than earlier estimated.



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The Institute for Fiscal Studies (IFS) believes that the loss is even greater and uses an assumption of 7.5%. The IFS also believes that the growth rate of potential GDP is slower than assumed before, at 1.75% instead of 2.75%. These changes are based on the view that some of the economic growth (and tax revenues) seen during the boom years has gone away for good. The effect is to radically worsen the fiscal outlook.

In the US, the Congressional Budget Office (CBO) is also pessimistic about the rate of growth in potential output following the latest recession. In part, this reflects the slowdown in US labour-force growth due to the ageing of the population. But the CBO also anticipates a lower rate of private investment in the next few years as investment recovers slowly from the recession. It has also made a small downward adjustment to expectations for productivity growth.

Future growth may also be better than expected, as recessions can spur efficiency

However, economists often underestimate the growth-enhancing role of recessions in weeding out poor investments and marginal activities. Recent US data provides strong support for this view. US labour productivity rose by 7.6% cumulatively in the two years starting in Q4-2007 (the peak of the cycle), or 3.7% annually. This is twice the rate seen during the upswing years of 2004-07. The flipside of this achievement is that US unemployment rose much more than might be expected based on the decline in GDP. In the UK, the opposite is true. Unemployment has risen less than expected, suggesting that the UK is not achieving the same productivity gains. Nevertheless the UK has an open flexible economy with a floating exchange rate and so we suspect that the IFS view of potential growth is too pessimistic. The old (assumed) 2.75% rate was probably always too optimistic but 2-2.5% may still be attainable.

The fiscal outcome could also be worse than projected for a host of reasons: slower-than-expected growth, new fiscal burdens due to further stress in the financial sector, higher interest costs due to market worries about debt, a policy mistake, or political unwillingness to make necessary fiscal adjustments. In our view, a double-dip recession is unlikely, but there is always the risk that an unexpected shock may knock the still-vulnerable recovery off course.

The importance of GDP growth to controlling deficits

The sustainability of a particular country's fiscal position depends critically on its rate of growth. Fast-growing countries will see the denominator of the debt/GDP ratio expand rapidly, so even if debt is growing too, the situation is contained. This is why India, with its large public-sector deficit, is able to retain market confidence. It also explains why China was able to use banks as a conduit for its fiscal expansion after the crisis, safe in the knowledge that if those banks have a bad debt problem down the road, the fiscal burden will be manageable.

In contrast, a key worry with the countries of southern Europe is whether they can achieve even modest economic growth over the next few years. Greece is obviously heading for a severe recession this year, and Portugal and Spain will be weak too – especially if they respond to recent events by accelerating fiscal adjustment, as seems likely. But they cannot cut interest rates and they cannot devalue within the euro area.

Asia's strong growth gives it more protection against fiscal crises



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Moreover, these countries are widely seen as uncompetitive within Europe, making it difficult to achieve strong economic growth. Both Greece and Portugal are running current account deficits of around 10% of GDP, a clear sign of excessively high wages. Meanwhile, measures of unit labour costs suggest that Italy and Spain have seen the largest rises in costs among euro-area members since joining the euro in 1999 – almost 50% in the case of Italy and 28% for Spain (OECD Economic Outlook 2009).

For a decade or more, growth in Spain and Greece (and, to a lesser extent, Portugal) has been fuelled by a construction boom. Those booms have turned into a bust, with huge oversupply of both housing and commercial property. It will be some years before the property cycle turns. Meanwhile, without the advantage of devaluing the currency (as in the British and US cases), it may be hard to generate a strong recovery.

The price of failure

Higher interest rates

A sustained widening of the fiscal deficit by 1% of GDP is estimated to raise bond yields by 10-60bps

Numerous studies suggest that higher deficits and higher government debt add to the cost of borrowing, but estimates vary widely (IMF 2009). A sustained increase in the fiscal deficit of 1% of GDP is calculated to bring a rise in bond yields of between 10-60 basis points (bps). In the US context, if the markets currently believe (as seems reasonable) that the budget deficit will average 5% of GDP over the medium term, whereas it previously averaged 2%, then 10Y Treasury yields will be anywhere from 30-180bps higher than they otherwise would have been.

The implication is that if the fiscal deficit were to miraculously disappear, perhaps because of an aggressive new approach to public finances, then the 10Y yield of about 3.80% (the level before last week's crisis depressed yields in flight to safety) would give way to a yield somewhere between 2% and 3.5%. It is easier to believe the higher number than the lower, so it seems likely that the effect of the fiscal deficit on US yields, so far at least, is nearer the lower end of this range.

Studies also suggest that a 1ppt increase in the level of debt adds 1.5–5bps to borrowing costs (BIS 2010 and IMF 2009). US net debt is projected to reach 57% by the end of 2010, up from 39% at end-2007. So these estimates suggest that yields today should be in the range of 27-90bps higher than before, all else being equal. Further ahead, Congressional Budget Office projections show that the debt/GDP ratio will rise by another 20ppt over the next five years or so to about 80% of GDP. Compared with debt at 42% in 2007, this should push bond yields 60-190bps higher. Again, it is not easy to reconcile the higher end of this range with bond yields today. Would US 10Y yields really be at 1.9% if government debt was not rising? The lower end of the range would point to yields running at 3.2% without the fiscal problem, which seems more plausible.

A staunch Keynesian might argue that yields would indeed be much lower without the large deficit and rising debt, since the outlook for growth and inflation would be much lower without the stimulus they provide. But unless the bond market is pricing in the view that the stimulus is a waste of time and that the economy will slow sharply again once the stimulus is withdrawn, this is beside the point.



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A high deficit probably raises yields more if debt is already high

Another view is that the effect of higher deficits and debt is non-linear. There may be only a limited effect on yields when debt/GDP ratios are relatively low, say in the 40-80% range, but a much greater impact at higher debt levels. One reason for the non-linearity of yields is that the risk of inflation and default rises with the level of debt in a non-linear way. Relative spreads in Europe in recent weeks – comparing, for example, Greece, with Portugal and France – certainly support this view.

A third answer, with which we have considerable sympathy, is that one result of the financial crisis is much higher demand for government paper now than before, offsetting some of the usual effect on yields. Banks' holdings of government paper are going up, both for market and regulatory reasons. Meanwhile, investors view Treasuries with more respect after the experience of 2008-09, when Treasury bonds were almost the only asset class not plunging in value. The view, widespread before 2008, that certain types of alternative funds could completely replace Treasuries in a portfolio, is now rare.

In practice, looking at bond yields in any country, it is hard to disentangle the effects of deficits and debt from the outlook for growth and inflation. This is particularly true given the wide divergence of views on the outlook going forward, with some in the markets convinced that we are heading for serious inflation and others worried about deflation. Our tentative conclusion is that so far, higher deficits and the prospect of much higher debt are likely only pushing up government yields by modest amounts in the US and UK. Japan is a special story, while Greece and, to a lesser extent, other high-deficit countries in the euro area have already transitioned into a crisis scenario. We look at these cases separately below.

High debt ratios are risky, especially with the looming demographic burden

Fiscal impotence

While the fiscal profiles of the US and UK may have had little impact on the markets so far, governments would be unwise to assume that they can move up to debt levels over 100%, or even over 80%, without trouble. First, pre-crisis market complacency about looming demographic pressure on fiscal positions may well have reflected a view that 2007 debt ratios in the 30-50% range left room to deal with the demographic burden. But if debt ratios are in three figures or approaching these levels even before the demographic burden increases, markets may be unnerved, especially if the ratios are still increasing.

Second, high debt ratios leave little or no room for future fiscal stimulus in the event of a new recession. Italy, for example, with a debt ratio of around 100%, was unable to implement an effective fiscal stimulus in the last couple of years and has suffered a steep recession (GDP down by 6.9%) with a so-far lacklustre recovery. For the US and the UK, while a double-dip recession in 2010-11 is unlikely, there will almost certainly be another recession before 2020. At that time, there will be little scope for fiscal stimulus. Even without stimulus, the deficit will expand again as automatic stabilisers kick in, and this could upset markets and raise borrowing costs if debt ratios are already high.

Third, high debt ratios bring higher debt servicing bills, even without any increase in real interest rates. In the US, interest servicing costs are projected to rise from 9% of federal spending in 2007 to 15% in 2020. In Japan, although interest rates are low, tax revenues are barely rising over time due to deflation and slow growth.



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High government debt can slow growth by discouraging private investment

Crowding out

Finally, high government borrowing might 'crowd out' private-sector borrowing, reducing investment and therefore GDP growth and making the fiscal outlook correspondingly worse. This is not a concern in 2009-10, in our view, because investment was dramatically cut back in the face of the recession, while personal savings rose. A large government deficit has therefore been an entirely appropriate policy to offset the surplus in the private sector. But continuing large deficits in coming years could well lead to reduced private investment and slower growth.

One recent study found that the effect may be non-linear, in that higher debt slows economic growth, but only above a certain point (Reinhart and Rogoff 2010). When debt rises above 90% of GDP, the study found that real GDP growth is slowed by about 1ppt per annum.

How does Japan get away with such high deficits and debt?

The case of Japan

In the US and UK, there is considerable alarm that without urgent fiscal tightening, budget deficits will still be at 4-5% of GDP or more by the second half of this decade, and net debt ratios will have reached close to 80%. As we have argued above, while the immediate outlook may not be dire, this level of debt would begin to create problems. Yet Japan was already there several years ago. Japan's net debt ratio topped 80% in 2004 and continued to rise, while the deficit was running at about 6-7% of GDP. OECD projections suggest that Japan's net liabilities will be 104% by end-2010, rising to 112% by end-2011. But bond yields have remained in the 1-2% range, and inflation is non-existent. So where is the crisis?

High domestic savings and a home bias help, but these factors are dwindling

Special factors

One view is that Japan is a special case. Domestic savings are much higher than in the US and the UK, and most of the government bond market is owned by residents. In 2007, gross national savings amounted to 27% of GDP in Japan, compared with only 14% and 15% in the US and UK, respectively. However, it is no longer Japanese households doing most of the saving – the household savings rate has declined from the 10-14% range seen in the 1990s to only 3-4% in recent years. Corporate savings are now the main component. But given their existing wealth, households do tend to hold low-risk assets. The share of fixed income assets in Japanese households stood at 55% (as of end-FY08), compared with only 16% in the US. Private-sector banks also hold large amounts of government paper, as they are unable to find enough lending opportunities in the private sector. Meanwhile, two major institutions, the Japan Post Bank (privatised in 2007) and the Government Pension Investment Fund, own around 35% of total JGBs.

Overall, 94% of the Japanese government bond market is owned by residents, compared with only 53% in the US. This is usually seen as an advantage because foreign investors are believed to be more fickle and could suddenly demand higher yields or a weaker currency. However, it could also be argued that the opposite is true – perhaps the US has an enormous advantage in that US Treasuries are still the basic no-risk asset for so many non-residents. The truth is probably that the US is a special case given that the dollar is the major reserve currency. It also still enjoys safe-haven status (so far at least), as we saw last week with the fall in bond yields. But if the US fails to control its fiscal situation in the coming years, that status could change, and there could be trouble.



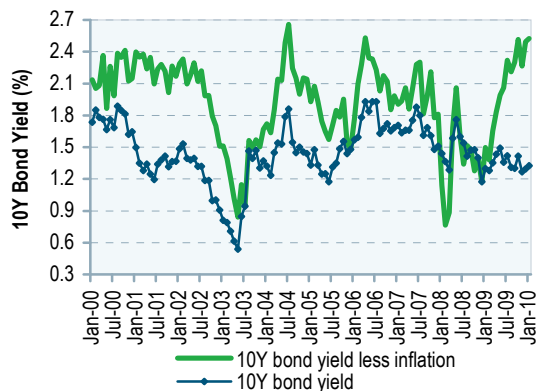
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Tokuoga (2010) provides estimates of the relationship between Japan’s public debt and bond yields after allowing for special factors, and finds that each 1% rise in debt has added about 2bps to borrowing costs. This is near the lower end of the range of estimates for the effects of debt on bond yields described above, supporting the view that some of the predictions of drastically higher bond yields resulting from higher debt are exaggerated.

As the population ages, the household savings rate will fall further

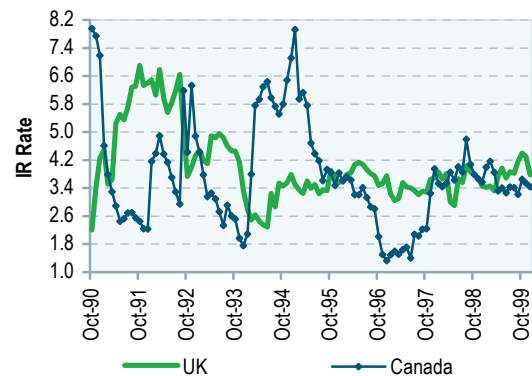
Tokuoga argues that many of the special factors keeping Japanese yields low will dwindle over time. The household savings rate will probably decline further and even turn negative as the population ages. Corporate savings may also decline as the economic recovery takes hold. Finally, financial reforms have given Japan Post Bank and the Government Pension Investment Fund more freedom to diversify. This implies that, over time, Japanese yields will be more closely tied to deficit and debt developments, and therefore may well rise in coming years.

Chart 3: Japanese real bond yield is rising
Near the top of the range



Sources: Bloomberg, Standard Chartered Research

Chart 4: Real interest rates in the 1990s
UK and Canada



Sources: Bloomberg, Standard Chartered Research

Another reason why bond yields remain low could be that Japan appears very unlikely to inflate its way out of the situation. Core consumer prices have been falling since 1999 and the Bank of Japan has been relatively cautious in its purchases of long-term government debt, in contrast to the large-scale quantitative easing programmes in the US and UK. In part this reflects the Japanese experience in the 1930s when over-expansionary policy following the Depression quickly led to inflation.

In fact, although Japanese bond yields remain at very low levels, around 1.3% for the 10Y, real yields are currently near the top of the range. This may simply reflect a temporarily depressed inflation rate or it may be due to expectations of a stronger economy. But there is a chance that it is the beginning of a somewhat higher real rate level for Japanese bonds, as the domestic bias towards JGBs declines and concerns begin to build about the level of debt. Certainly CDS spreads have been on an upward trajectory over the last two years



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The exact deficit and debt levels that cause a crisis vary by country, but Japan is playing a dangerous game

Japan's crisis may lie ahead

The other possibility is that Japan is not a special case, but that fiscal crises in advanced countries borrowing in their own currency do not start until debt ratios are somewhat higher. Greece, with a net debt ratio expected to reach 100% this year, obviously does not borrow in its own currency as a member of the euro area.

Exactly what level of debt is truly dangerous is unknown and may vary by country. This is partly about the arithmetic of debt sustainability, which depends ultimately on the size of the primary deficit (excluding interest payments) and whether nominal GDP growth exceeds the interest rate (Escolano 2010). But it is also about market tolerance of uncertainty. Italy and Belgium both had net debt ratios above 100% of GDP for many years in the 1990s without a crisis. Historically, the US debt burden peaked at 121% in relation to GDP after World War 2, while the UK shouldered a debt burden of 300% for a while.

However, the Greek crisis has focused the markets on fiscal issues and we suspect this focus will continue and spread in coming years. With Japan's ratio set to rise above 110% in 2011 and continue to climb, it may be the first test of bond-market tolerance among the major economies.

Fiscal crises in focus

A crisis threatens higher bond yields and a weak currency

The most common crisis scenario is that increasing concern about the fiscal outlook leads to some combination of rising long-term interest rates and a depreciating currency. If the fears are mostly about inflation, higher rates show up mainly at the long end. If default risks are seen as near-term, this can affect 2Y yields too, as we have seen in the Greek case. Rising rates would make the fiscal outlook even worse, while a depreciating currency would add to inflationary worries. In Japan, a weaker yen might be welcome, given its chronic deflation, but rising yields will raise questions about the arithmetical sustainability of debt, given Japan's ageing population and slow growth.

The best way out of crisis is a programme of fiscal austerity, with spending cuts and/or tax hikes. This needs to be combined with accommodative monetary policy, which usually leads to a continuing weak currency. But even this 'best way' would likely bring a recession or slower growth, which in turn makes the fiscal adjustment that much harder.

The problems become even more difficult when there is a fixed exchange rate or the borrowing is in foreign currency. This is the case now for Greece, and requires a macroeconomic adjustment of such proportions that many investors believe it is not feasible. The adjustment is also harder when political conditions make agreement on cutting the deficit hard. Minority governments, gridlocked party positions, strong public-sector unions and a tendency for violent street demonstrations can all be major obstacles. Again, when any of these conditions are present, market scepticism about the prospects for adjustment, as well as business and consumer caution towards spending, can make the situation worse.



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Greece highlights the risk of a sudden crisis. But fiscal adjustment takes years not months

The final point to make about fiscal crises is that they often spring up unexpectedly. It is not so much that the problem is not visible beforehand (though in the Greek case there was under-reporting of deficits) but that markets tend to suddenly focus on issues. The trigger can be particular news in that country but it can also be contagion from other countries. In short, just because the markets appear relaxed about a country does not mean that the view cannot suddenly change.

This creates an asymmetry because, while market concerns and borrowing costs can escalate suddenly, governments cannot fix the problem on anything like the same time-scale. Legislating and implementing budgets takes time and usually a major fiscal adjustment requires a sustained effort for several years. If borrowing rates remain high for a prolonged period the debt arithmetic is correspondingly worsened.

Inflating out of debt could be attractive to governments but is not as easy as it sounds

Will governments inflate out of fiscal problems?

There is a widely expressed view that once government debt reaches high levels, governments have a huge incentive to allow or encourage higher inflation as a way to reduce the debt burden. If inflation runs higher than government interest costs for a few years, then the debt ratio will come down, assuming the primary balance has a small deficit or is in surplus. However, this is not as easily engineered as sometimes assumed.

Consider a hypothetical example where the debt ratio stands at 100%, the budget deficit is at 5% of GDP (composed entirely of interest costs also at 5% of GDP), and nominal GDP growth is also 5% p.a., with 3% real GDP growth and 2% inflation. This is not an entirely bad place to be, because the debt ratio will stay at 100% if nothing changes. But suppose the authorities engineer a rise in inflation to 4%, resulting in a 7% growth rate for nominal GDP. If interest costs do not change and real GDP continues to grow at 3%, then this scenario will bring the debt ratio down to 75% over 15 years – a better place to be.

But how realistic is this? First, it requires the authorities to push inflation up, but since the experience of the 1970s, there is huge in-built resistance to higher inflation. Central banks now jealously guard their independence and see inflation of 2% or so as sacrosanct. The recent suggestion from the chief economist of the IMF (Blanchard 2010) that countries should perhaps tolerate much higher inflation was greeted with incredulity because it is so alien to the current orthodoxy.

But even if central bankers went along, the markets most certainly would not. Longer-duration yields would quickly rise, even if the central banks held rates down, keeping Treasury bill yields low. Depending on the mix of borrowing, the spread between nominal GDP growth and the effective interest rate would narrow. This might take time as longer maturities needed to be rolled over only gradually, but the markets would likely anticipate coming inflation well before it actually arrived.

Worse, economic growth might slow in this scenario. It is true that low short rates (as the central bank contributes to pushing up inflation) could bring a short-lived boom. But higher bond yields as the yield curve steepened due to fears of higher inflation would push the other way. More importantly, the experience of the 1970s suggests that higher inflation tends to bring weaker profits, weaker investment and a weaker stock market – all of which would depress the trend rate of economic growth.



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A large chunk of government spending is indexed to inflation

The combination of higher interest rates and slower growth could easily overwhelm the apparent gains from inflation. An additional difficulty in many countries is that a significant chunk of government spending is indexed to inflation anyway – particularly pension payments, but also public-sector wages to some extent. Moreover, slower economic growth would mean slower growth in public expenditure, so the political environment would be difficult, and there would be a risk of the budget deficit widening. In many respects this is the same as what happened during the 1970s, except that this time, the bond market is likely to much more vigilant in anticipating higher inflation than it was back then. Overall, then, inflating out of high debt is not so easy.

Nevertheless, many experienced people in the markets are deeply worried about the risks of inflation in the long term. There is a strong suspicion that high debt levels in both the public and private sector, together with fears of another major recession like the one in 2008-09, will result in a bias towards inflation in the coming years; memories of the Depression had the same effect in the 1960s and 1970s. Governments and central banks might not consciously choose the inflation path but could drift on to it gradually over time.

Inflation is still slowing in the US and UK, and Japan is in deflation

Still, inflation is likely to slow in the US and the UK over the next year, and will first have to pick itself up off the bottom. Moreover, in our view, it is too early to conclude that the US and the UK will avoid deflation (or at least very low inflation) in the coming years. US core inflation is currently running at only about 1.1% y/y and will almost certainly fall further in the coming months. While most forecasters expect it to start rising again next year, this is far from certain, given the continuing excess capacity and high unemployment in the economy. It is quite likely that US inflation will be stuck in the 0-1% range in 2011-12, perhaps even lower.

In the UK, core inflation has been running higher, at around 3% y/y in recent months, but this largely reflects the rise in VAT and the substantial devaluation of the British pound (GBP) in 2008-09. If the pound is more stable in the coming years, having reverted to a level at or below long-term equilibrium (as most estimates predict), core inflation will likely slow too. If it goes particularly low, for example to 1% or below, this will certainly bring more quantitative easing, since the Bank of England has an explicitly symmetrical inflation target of 2%.

For the next couple of years, then, inflation is likely to be in the 0-2% range in the US and the UK. The risk for the following few years is that inflation will drift up into the 2-3% range rather than quickly spiralling out of control. The bigger risks are longer-term. If governments fail to deal with the fiscal challenge, inflation could be on a rising trend in the five- to 15-year timeframe. According to the Kondratieff long wave theory, rising prices and/or inflation are indeed predicted for the medium term. The Kondratieff is a 50- to 60-year cycle with 20-30 years of declining prices or deflation and 20-30 years of rising prices or inflation. Given that the last peak in inflation was during the 1970s, the next should come somewhere between 2025-35. Many economists are sceptical of such a long-term cycle. In any case, it says nothing about the level of the next inflation peak – it could be 3%, or it could be 30%.



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Breakeven inflation rates derived from the spread between indexed bonds and conventional bonds have risen from the crisis lows but are still broadly in line with the recent past, suggesting that there is no generalised market fear of inflation so far. Moreover, these breakeven rates likely exaggerate inflation fears because indexed yields are depressed by heavy demand from pension funds desperate to find an exact match for their liabilities. This has long been an issue in the UK but appears to be increasingly true in the US as well. The Michigan survey of inflation expectations five to 10 years ahead shows that US inflation expectations are well anchored near the lows of the last 10 years.

The impact of cutting deficits

Market effects

Tighter fiscal policy must and will be offset by loose monetary policy

Supposing that deficits are successfully cut back in coming years with the help of political action, what then? The Keynesian approach (which was the justification for the fiscal stimulus) says that tighter fiscal policy will slow the economy – hence the emphasis in some quarters on delaying fiscal tightening until the recovery is more entrenched. An alternative is to go ahead with fiscal tightening while keeping monetary policy looser for longer to offset the fiscal tightening. With interest rates already near zero, this could mean holding them there for longer than would be the case without fiscal tightening, or it could mean more quantitative easing.

The markets currently expect the Fed to begin tightening late this year, though we do not expect tightening until 2011. Either way, a much better policy mix would be for most or all of the policy tightening to come from the fiscal side over the next few years, with monetary policy remaining accommodative.

Another view is that a clear fiscal tightening programme will allow long-term interest rates to be lower than they otherwise would be and will also foster confidence in the stock market, which will have the effect of boosting economic growth or at least offsetting the direct effects of a smaller government deficit. It is not necessarily contradictory to hold this view while at the same time believing that governments were right to introduce massive stimulus in 2009. That stimulus was in response to a heart-stopping drop in business and consumer confidence and a corresponding collapse in spending. As private-sector confidence and spending recover, governments should naturally withdraw excess spending.

Nevertheless, the net outcome of tighter fiscal policy is almost certainly going to be looser monetary policy than would otherwise be the case. Central banks will delay tightening or tighten only very slowly if they anticipate strong government action. Such thinking is already clear in Fed Chairman Bernanke's speeches when he emphasises that current buoyant economic growth owes much to inventory normalisation and the fiscal stimulus.

For markets, this combination of tighter fiscal policy and looser monetary policy implies lower bond yields than otherwise, a lower currency and a stronger stock market, although the latter in particular also depends partly on the mix of measures taken to reduce budget deficits. The relative pace of fiscal tightening among the major economies will therefore play a big role in USD-EUR and USD-JPY exchange rates in coming years. But with most emerging countries likely to be focused more on monetary tightening, the majors will be vulnerable to weakness relative to emerging countries, as we have long argued.



Fiscal crisis

Cuts in transfer payments and in government spending are best

Taxes versus spending

There are different ways to reduce the fiscal deficit, with differing effects on incentives to work and save and therefore on the pace of economic growth. Generally speaking, cuts in current spending and transfers are likely to be less damaging to long-term growth than tax increases or cuts in investment spending. There is also historical evidence that fiscal adjustments are more likely to be sustained when the deficit is closed via cuts in transfer payments and in compensation of government employees rather than via tax increases (Alesina 1995).

Any increase in taxation can have the effect of discouraging work at the margin by reducing the rewards of earning money. But taxes on spending – such as VAT, sin taxes and petrol taxes – have less effect on reducing the incentive to work than higher income taxes. There is also some evidence that countries which have relied on tax increases to reduce deficits have seen less reduction in interest rates (both policy rates and bond yields) than if they had relied on expenditure cuts. This may be because tax increases often raise costs and prices, thereby showing up in inflation.

High marginal tax rates for high earners

If income tax must be raised, it is far better (from an incentive point of view) to spread the pain over a broad base of people. Raising income taxes only for the highest-paid means high marginal rates. Raising rates at the lower end of the income band obviously hits people earning within that band, but most of the increase in tax revenues actually comes from people in a higher band. Crucially, raising rates in lower bands does not affect higher earners' marginal rate of tax and is therefore not a disincentive to earn more.

Unfortunately the outlook is not good here, certainly for the US and the UK. President Obama has repeatedly said that he will not raise income taxes for people earning under about USD 200,000 a year. (As an aside, one positive sign for controlling the deficit is that Obama used to say that he would not raise *any* taxes for people earning under USD 220,000.) But rates for higher earners in the US are rising, and many people will face a top marginal income tax rate of around 50%, depending on which state they live in. Meanwhile, in the UK, the outgoing Labour government has introduced a new top tax rate of 50% and, through other changes to allowances, has left some people facing a marginal rate of 60%.

Raising taxes on employment, whether via higher social security contributions (as planned by the Labour government in the UK) or by forcing employers to pay higher medical costs (as planned in the US), may not be helpful in creating jobs in the short term, though its long-term effects on economic growth may not so bad. It will tend to lower the exchange rate if those jobs go abroad or lead to stronger investment if businesses compensate with a higher capital/labour ratio, both of which could raise trend economic growth. However, raising taxes on investment returns, whether capital gains or dividends, is unambiguously bad news because it discourages private investment. Another favourite of governments looking for savings is to cut government investment spending, on infrastructure as well as education. This is also bad for growth in the medium and long term.



Fiscal crisis

Unfortunately, political realities mean that governments struggle to make the optimal choices. The fiscal stimulus measures of the last two years did put some emphasis on infrastructure investment, but government investment spending is likely to be cut back drastically in future years. That is always politically easier than raising taxes or cutting spending, which people immediately see. Even in the US, where the stimulus did bring forward a number of new infrastructure projects, cutbacks at the state and local levels mean that net infrastructure investment is likely to be lower in the coming years.

Table 2: Previous experiences with large fiscal adjustments

Country (year-end)	Size of adjustment (% of GDP)	Country (year-end)	Size of adjustment (% of GDP)
Ireland (1989)	20.0	Iceland (2006)	6.3
Sweden (2000)	13.3	Netherlands (2000)	6.3
Finland (2000)	13.3	Denmark (2005)	5.9
Sweden (1987)	12.5	Australia (1988)	5.8
Denmark (1986)	12.3	Hong Kong SAR (2005)	5.8
Greece (1995)	12.1	New Zealand (1995)	5.8
Israel (1983)	11.1	Austria (2001)	5.8
Belgium (1998)	11.1	Iceland (2000)	5.7
Canada (1999)	10.4	United States (2000)	5.7
Cyprus (2007)	8.5	Germany (2000)	5.3
United Kingdom (2000)	8.3	Germany (1989)	5.3
Japan (1990)	8.1	Switzerland (2000)	5.2
Italy (1993)	7.9	Cyprus (1994)	5.2
Portugal (1985)	7.5	Spain (2006)	5.2
Luxembourg (1985)	6.9	Ireland (1989)	20.0
Luxembourg (2001)	6.7	Luxembourg (2001)	6.7
Iceland (2006)	6.3	Luxembourg (2001)	6.7

Note: Cumulative change in cyclically adjusted primary balance; Source: IMF



Fiscal crisis

Encouragingly, large fiscal adjustments have been achieved before

The UK has made large adjustments before, but not this large

Tight fiscal policy was offset by big interest rate cuts

Past examples of fiscal adjustment

The IMF has collated the experiences of countries that have made large fiscal adjustments, and we reproduce the key findings in Table 2 above. The size of the fiscal adjustments required by the US, the UK and Japan, as well as Greece, Portugal and Spain, is of the order of 8-12% of GDP (though the exact amount is highly sensitive to the assumptions on which these numbers are based). It is therefore reassuring that an adjustment of more than 8% has been achieved before – 12 times in fact, including Ireland's spectacular adjustment in the 1980s amounting to 20% of GDP, large adjustments by Scandinavian countries, and Canada's adjustment in the 1990s. The table also reveals that Greece has done it before, while Sweden has done it twice.

The UK adjustment in the 1990s

Today is far from the first time the UK has faced a difficult fiscal adjustment. It did so both in the 1980s and the 1990s. The adjustment in the 1990s was particularly large, though it was 'only' 8.3% of GDP (calculated as the cumulative change in the cyclically adjusted primary balance in relation to GDP), compared with the 12.8% the IMF reckons will be necessary between 2010-20. At the beginning of the 1990s, the UK joined the European Exchange Rate Mechanism (ERM) to try to find an anchor for monetary policy. When the economy went into a major recession amid the collapse of the 1980s housing bubble, efforts to remain in the ERM meant keeping interest rates very high. The government sensibly compensated with an expansionary fiscal policy.

Once the GBP collapsed out of the ERM on 'Black Wednesday' (16 September 1992), the government sensibly reversed the policy mix, opting for easy money and tight fiscal policy. According to OECD data, government spending as a percentage of GDP declined from 45.2% in 1992 to 36.6% in 2000. Most of this decline was due to very tight spending controls over a sustained period – a tight approach which was continued under Chancellor Gordon Brown in his first few years in the job. Taxes were relatively stable as a percentage of GDP through the period, in the range of 37.3% to 40.3% (the latter at the peak of the boom).

Meanwhile, interest rates (then still controlled directly by the government) fell from 10% just before the ERM crisis to 6% almost immediately after and down to 4% in 1994. At the same time, the GBP's real effective exchange rate fell by 15% and remained 10-15% below 1992 levels until 1997. The result of this combination of policies was a robust economic expansion, with GDP growth averaging 3.4% p.a. from Q4-1992 to Q4-1999.

A clear lesson of this approach is that fiscal policy can be tightened even when economic growth is strong, provided it is offset by monetary policy. Indeed, by the latter years of 1990s, monetary policy was no longer so loose, and the exchange rate had moved up again as confidence fully recovered and Britain boomed, along with the US, during the stock-market bubble.

However, many people take the view that spending was tightened too much during this period, with inadequate resources provided to health, education and infrastructure, while public-sector wages lost ground in relation to the private sector. In the last decade, the Labour government moved away from such tight policy and government spending expanded again, rising back to 44% of GDP by 2007. This was largely unfunded, taking the budget from a balanced position in 2000 to a deficit of 2.7% of GDP in 2007, despite a new boom being in progress. Since 2007, spending has surged to an astonishing 53% of GDP and the budget deficit to about 13% of GDP.



Fiscal crisis

When 364 economists got it so wrong

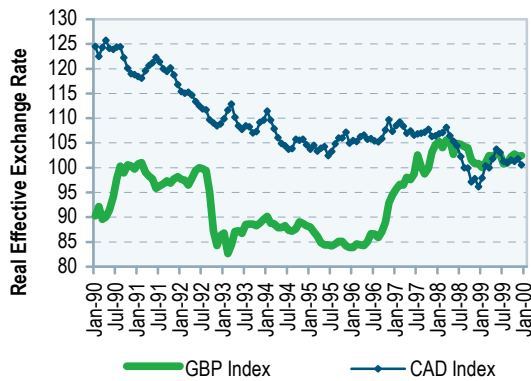
British economists and their letter-writing

The timing and nature of fiscal adjustment has long been a highly controversial issue in Britain. This debate goes back to the 1930s, but it periodically brings about a spate of letter-writing by groups of economists seeking to influence policy. The most famous example was a letter to *The Times* in 1981, signed by 364 prominent economists who claimed there was “no basis in economic theory or supporting evidence” for the tight fiscal policy then being introduced by Margaret Thatcher’s new government in the face of a severe economic recession.

In the event, despite this fiscal tightening, Britain’s recovery from that recession began very shortly afterwards, and in retrospect, the reason is very clear. As was the case a decade later, monetary policy was simultaneously loosened. By 1983, interest rates had come down from the 12-14% range to 9%. Meanwhile, in 1983-84, the GBP averaged about 20% less in trade-weighted terms than its peak in early 1981 (which was influenced by the discovery of North Sea oil). Therefore, the UK has combined tight fiscal policy with easy monetary policy on two occasions – in the early 1980s and the early 1990s.

Chart 5: Weak currencies during fiscal adjustment

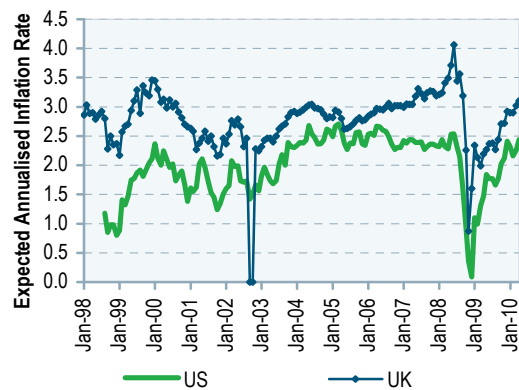
JP Morgan real effective exchange rates



Sources: Bloomberg, Standard Chartered Research

Chart 6: Inflation expectations are still contained

Breakeven derived from indexed vs. conventional bonds



Sources: Bloomberg, Standard Chartered Research

In 2010 group letter-writing has resumed, though this time it is not so one-sided, with economists doing what they do best, disagreeing. Some argue that proposals to cut the deficit hard now are vital for long-term fiscal stability while others claim it would be a mistake to do too much before the recovery is well established. But the letter writers are still not focusing on the key issue, which is the mix of monetary and fiscal policy. There is room for cutting the fiscal deficit provided it is offset adequately by monetary policy. Admittedly, there are questions about this, with interest rates already near zero. But the Bank of England has made it clear that it does not rule out more quantitative easing if necessary.



Fiscal crisis

Canada fixed its fiscal crisis in the 1990s, but it was a tough time

Key policies were a hard budget constraint and targeted spending cuts

Canada achieved fiscal stability despite lacklustre economic growth

The Canadian case 1993-2000

Canada's case is interesting because of the similarity of its economy to the UK and US economies. In 1992, Canada was collecting 44.2% of GDP in total tax revenues and spending 53.3%, and was just emerging from its worst recession since the 1930s (much worse for Canada than the 2008-09 recession), with unemployment over 11%. These figures are comparable with the UK now, with total UK spending projected at 53% of GDP this year, alongside total revenues of 40%.

The US still has a significantly smaller government, with total outlays forecast at 41.5% of GDP in 2010 against revenues of 31%. But health care accounts for a significant chunk of the difference between the US and the other two nations, with about half of US health-care spending bypassing the government and instead relying on private insurance.

Canada cut spending rapidly during 1993-97, to 44.3% from 53.3% of GDP. The tax take was roughly unchanged. A new government elected in October 1993 (under Liberal Prime Minister Jean Chrétien) took a very tough line on spending, helped by a change in public mood. It committed to cutting the budget deficit to 3% of GDP in FY07 (from 7.5%) – an ambitious target which became even more ambitious when the Mexico crisis of 2004 led to a fall in the Canadian dollar (CAD) and a rise in Canadian interest rates. The sovereign rating was also downgraded; Moody's, for example, downgraded it to Aa1 in 1994 and to Aa2 in 1995.

The key reforms were (1) to establish and maintain a hard budget constraint and (2) to institute a 'Programme Review' approach to public spending, in place of the previous approach of reducing spending through simple 'across-the-board' cuts. Each department and agency was given a target for expenditure reductions ranging from 5-60% to be implemented over the next three years. The size of the cuts for each department was chosen by a small group of ministers, but the prioritisation and implementation was then up to the individual departments.

During this fiscal consolidation monetary policy was loosened, though interest rates rose for a time in 1994-95, linked to the Mexican crisis. The Bank of Canada had just introduced an inflation target (1991) and was determined to meet it; as a result, monetary policy was arguably too tight at times during the decade. The real effective exchange rate was devalued heavily in the early stages of fiscal consolidation, declining by over 30% from 1989 to 1995, with about half of that occurring during 1992-95.

Canada's economic growth was only moderate during this period considering the depth of the prior recession, averaging 3.4% from 1993-98. Unemployment trended down only slowly and was interrupted by a rise in 1996 before monetary policy was loosened sharply again. Unemployment was still around 8% as late as 1999 (the same as today's level). Overall, Canada's economy in the 1990s felt less buoyant than that of the US or UK, perhaps because of overly tight monetary policy. In addition, the 1990s was not a good time for commodities, a key part of Canada's economy, and the housing price cycle was also unfavourable. Canadian house prices collapsed in the early 1990s after bubbling in the 1980s (particularly in Toronto) and recovered only very slowly, depressing consumer sentiment.



Fiscal crisis

Can President Obama follow in the footsteps of President Clinton?

Despite only modest economic growth, the fiscal accounts were transformed, with the budget in balance or in surplus from 1997 to 2008 and net government liabilities (including those of the provinces) falling from a peak 70% of GDP in 1995 to 46% in 2000 and 22% in 2008. Canada regained an Aa1 rating in 2000 and Aaa status in 2002. Canada's experience supports the view that it is vital for monetary policy to offset fiscal tightening. It also underlines the need for a determined government backed by a supportive electorate.

The US adjustment under President Clinton

The US achieved a significant fiscal adjustment in the 1990s, though its size was only just over half what is believed to be necessary over the next 10 years. The IMF calculates the adjustment achieved in the seven years to 2000 at 5.7% of GDP, compared with 8.8% required over the next 10 years.

As in other cases, the adjustment was mostly to spending, which was reduced from 38.6% of GDP in 1992 to 33.9% in 2000. But tax revenue as a share of GDP did rise a little, from 32.8% to 35.4%, helped in part by the strength of the economy. Tax increases were put in place in 1992 by President Bush (senior), while the Clinton administration maintained tight spending controls and – at the initiative of the Republicans, who won control of Congress in 1994 – reduced welfare spending as part of a substantial reform.

Monetary policy was accommodative at the beginning of the decade, and was then tightened sharply in 1994-95. This prompted an economic slowdown and policy was loosened again, remaining accommodative for the rest of the decade. The Fed's over-tightening in 1994 was the main reason why Chairman Greenspan tightened so slowly a decade later. Unfortunately, that 'measured pace' is now widely believed to have been a factor in encouraging the housing bubble which ended so badly. Economic growth was choppy in 1992-95, partly because of the sharp tightening in 1994, but the period was one of strong growth overall. The budget moved into surplus in 1998, though this was arguably helped by an overheating economy amid the stock market bubble. The net debt ratio was cut from 54.8% in 1993 to 35.5% in 2000, a reduction of nearly 20ppt.

One lesson of the US experience, which has also been borne out in other countries, is that legislation is likely to further the process more effectively if it focuses on spending controls rather than merely specifying deficit cuts. Thus, the Gramm-Rudman-Hollings (GRH) Act of 1985 (modified in 1987), which was a balanced-budget rule, did not significantly reduce the deficit and was abandoned in 1990. But the Budget Enforcement Act (1990-2002), which consisted of caps on discretionary spending in nominal terms, combined with pay-as-you-go rules for any new spending initiatives or tax cuts, worked well in disciplining Congress.



Fiscal crisis

A successful adjustment means lower official rates, lower bond yields and a weaker currency

Failure to adjust means a steep yield curve, slower growth and eventually a crisis

The 'muddling along' path is risky, and markets may not tolerate it for long

Conclusion: Two scenarios for the West's fiscal crisis

1. Countries achieve a successful fiscal consolidation

Full success means bringing the budget into balance (or a very small deficit) over the next five to 10 years and keeping it there long enough to bring the debt ratio back below 50% on a 10- to 15-year horizon. If a country is on track for this scenario, we can expect to see:

- 1) Low official rates as loose monetary policy offsets tightening fiscal policy.
- 2) Moderate real bond yields and a flattening yield curve as default and inflation risks fall.
- 3) A low currency, at least initially, caused by the policy mix of loose monetary policy and tight fiscal policy.
- 4) A prolonged period of economic growth, backing a rising stock market, as private investment picks up in response to the favourable outlook

2. Countries fail to make progress

If there is very slow progress in reducing budget deficits over the next several years (e.g., still above 5% of GDP in five years' time) amid a difficult political environment, debt ratios will surge with little hope of decelerating. In this scenario, we can expect to see the following:

- 1) Official policy rates may initially move up farther and faster than in the first scenario as economic growth picks up. But growth will be weaker in the longer term than in the first scenario.
- 2) Yield curves may steepen as fears of either default or inflation creep higher.
- 3) The private sector is 'crowded out', with investment weak and a lacklustre stock market.
- 4) Money flows out of the country looking for better opportunities elsewhere.
- 5) The currency may be strong at first, but will be vulnerable to lurching downwards if markets fear the situation is unsustainable.
- 6) The perception increases that the country has lost its way.
- 7) An eventual crisis, perhaps triggered by a new recession which threatens a fiscal disaster or by contagion from another country.
- 8) A sharp and painful adjustment involving a major new recession.
- 9) The risk of political instability.

The reality may be in between

These two scenarios spell out the polar extremes for debt-laden economies. In practice, countries may muddle along somewhere in between. They may also lurch from one path to the other, or the markets may perceive that they are, leading to considerable instability. But as long as countries fail to cut their deficits sufficiently, their debt burdens will continue to rise. Given the demographic crisis looming in the coming decades, this will raise the risk of a crisis at some point. While it may be politically easier to achieve the adjustment during a crisis, the pain will certainly be greater.



Fiscal crisis

In the US and the UK there is a recognition of the problem, but adjustment is politically unpalatable

In both the US and the UK, we are optimistic that there is strong determination in official circles to deal with the problem, and that there is also strong backing from the electorate in general. We also view the problem as technically manageable over time, despite the huge size of the deficits. But particular spending cuts and particular tax increases will always have opponents, and governments therefore need to be in a relatively strong position in order to face them down. This is why markets are nervous about UK prospects following the inconclusive election result.

In the US, the country that matters most for the rest of the world, the key timeframe for dealing with the problem will be 2012-18. If it is not dealt with during that period, the US will risk being in scenario 2 above. Thus far, President Obama and Congress have not formulated an adequate plan to deal with the deficit. The problem is essentially being put off until next year. The president has appointed an 18-member debt commission, including members from both parties and both the Senate and the House of Representatives, which is due to report back on 1 December (just after the mid-term elections).

If Obama is to be a successful two-term president he will need to grapple with the problem

One view is that President Obama, if he is to be a successful two-term president, will need to spend much of the rest of his presidency dealing with this problem. Some believe that big Republican gains in the 2010 mid-term elections could make the job easier for Obama, as they did for Clinton. Others question whether President Obama is willing to make major spending cuts, given his record both as a liberal senator and the big spending seen so far in his presidency with the fiscal stimulus and the health-care act. Some believe that he will seek to balance the budget, but primarily through higher taxes – perhaps including a new value added tax, which is increasingly being discussed in Washington. The markets will be looking for action after the mid-term elections, but there is also a fear that the president will delay serious action until after the 2014 presidential election. The markets may not give him as long as he wants, as European countries have discovered at a high cost.

Emerging countries better placed

In this crisis most emerging countries outside Europe are well-placed, although Pakistan, Sri Lanka and Vietnam warrant attention (see **Special Report – Greece's impact on Asia and the Middle East, 10 May 2010**). Some countries have relatively large deficits – for example Vietnam, India and Sri Lanka have deficits of 9-12% of GDP while Thailand, Malaysia and South Africa are running deficits which are greater than 6-9% of GDP – but strong economic growth helps keep their debt ratios sustainable. Those with high debt, including India, Sri Lanka, Pakistan and Brazil are vulnerable if their economies do poorly, but India and Brazil, in particular, are set on strong tracks at present.

Overall, our view is that contagion from Europe's current crisis should be limited. However, a crisis in Japan and especially the US, bringing a major new US or global recession would inevitably hit Asia hard, as in 2009. Fortunately, it is not imminent, but while it was the failure of US mortgage debt that brought the last global recession, it could be a crisis over government debt that brings the next.



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