TS Lombard

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Economics / Politics / Markets

Daily Note

GLOBAL FRACTURES: KEYNESIAN DEFICITS - A TALE OF 2 ISLES

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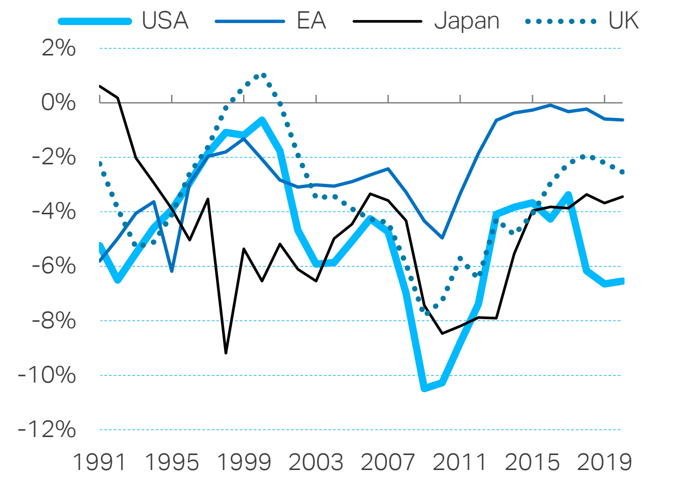
- **Japan and the UK are the two contrasting test cases of fiscal easing**
- **Japan's deficits are forced, and have done little to prevent debt risks**
- **Benefits from Trump's US corporate tax cuts were offset by trade war**
- **UK is swinging sharply towards fiscal stimulus – 1st mover advantage?**

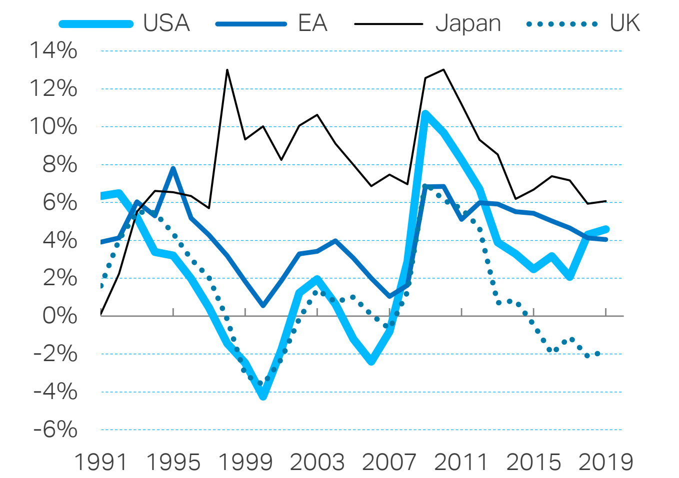
The natural sceptical (or monetarist) response to advocates of Keynesian fiscal easing is: 'Well, it hasn't done Japan much good, has it?!'. This highlights a major point: fiscal deficits arguably can stimulate, but are no substitute for sound structural policies, particularly as regards financial flows and broader economic issues. Japan illustrates the dangers of using fiscal deficits purely as a palliative, and the Trump tax cuts' benefits have been thwarted by trade war. With interest rates still low, the UK should benefit from its lurch into deficits – affecting the intra-EA debate.

Cyclically adjusted budget balances, % of GDP



Source: OECD, TS Lombard

Private-sector financial balance, % of GDP

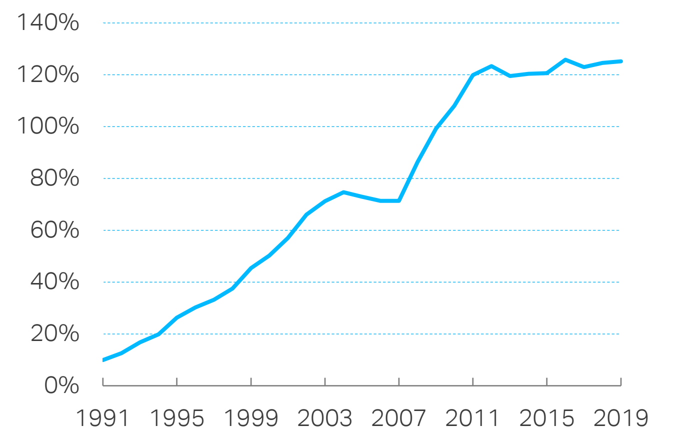


Source: OECD, TS Lombard

We have many times explained how Japan's budget deficits (and government debt build-up) are driven by the private sector's savings glut – particularly the business savings at 25-30% of GDP for most of the past 20 years. Even allowing for high capex (and consequently low returns) the private sector's savings have on average surpassed capex by 9% of GDP since 1998 (r.h. chart above). As financial flows in an economy add up to nil, this huge, structural private surplus will always be offset by a mix of budget deficits and overseas (current-account) surpluses (which count as 'foreigners' deficits'). Vague efforts to curb the budget deficit in 2013-14 (and 2003-07 before that) gave way to the reality that the rest of the world would not or could not absorb Japanese surpluses on the desired scale, so growth suffered and fiscal ease was forced.

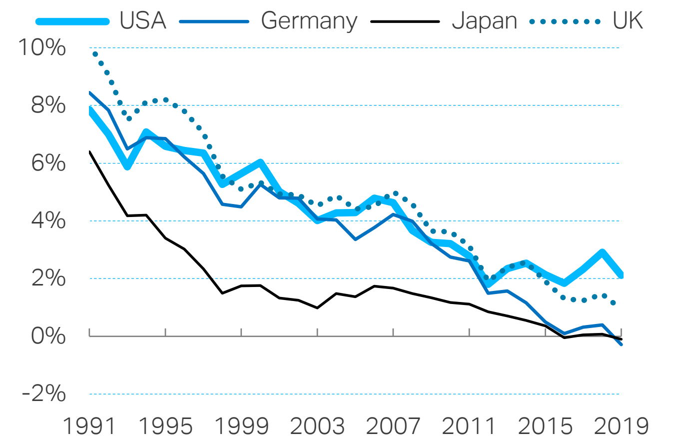
In recent years, Japan's budget deficit has been less than the 20-year average of 6% of GDP, reflecting a lower private financial surplus. But that simply reflects even poorer returns on capital than before, a natural result of perma-low interest rates. Thus in the seven 'Abenomic' years to 2019 Q3, average real GDP growth of 0.7% (weak for recovery years) has seen the contribution of private capex (including inventories) account for 80% of the incremental GDP, and public spending more than 50%. These contributions add up to more than 100%: unsurprisingly, the real consumer spending contribution is negative, and net exports strongly negative (partly because capex is import-intensive, partly because of Japan's uncompetitive export mix). And this was just before a consumption tax hike that will hurt consumers some more. Recent high capex accounts for the lower private surplus, which could be boosted when capex fades.

Japan: net gov't. debt, % of GDP



Source: OECD, TS Lombard

Long-term gov't. bond yields, %



Source: OECD, TS Lombard

We show Japan's government debt net as the government has financial assets worth some 100% of GDP, so conventional debt ratios exaggerate Japan's problems. But simple (or in fact quite complex) arithmetic shows that with budget deficits likely to return to 6% of GDP, real growth less than 1%, and inflation in the 0-2% range, the net debt ratio has to rise towards 200% at least, from the current 125%. A world gasping for 'safe' assets has helped Japan get away with such debts for longer than many expected. But in a global downturn the ratio will rise further. With the long bull market in bonds now gradually likely to reverse, higher yields could hurt badly.

One reason for our expectation of higher bond yields in the 2020s is the well justified shift in sentiment in favour of budget deficits. The damage being done by negative real bond yields is just one argument against the post-2011, tight-fiscal/loose-money policy mix. The lead may lie with the US, but trade war prevented the tax cut in late 2017 was from causing a capex boom.

Britain is about to embark on a major shift into fiscal stimulus. Electoral revulsion against budget austerity is powerful, and with nominal bond yields below inflation – so real yields are negative – the argument for balanced budgets is unpersuasive: Germany's pride in its recent flow of debt repayment is self-destructive – in effect it is investing at a real yield of minus 1½-2%. Britain's nominal yields of 1% (with inflation now down to 1½%) may find a ready market on the continent (and in Japan) even if the budget deficit is clearly mounting – provided the money is seen to be well spent and the economy duly responds with recovery and growth. If this form of first-mover advantage shifts the EU/EA argument towards a less unbalanced demand management mix, so much the better for everyone, though such a 'paradigm shift' could ensure rising yields.