

Troubled times for bond markets

by Michael Heise

The private sector debt crisis has in some countries mutated into a government debt crisis. The high risk premiums on securities of peripheral euro nations, for instance, are signaling a substantial risk of sovereign default. Could this be a harbinger of a general shift in sentiment on the bond markets?

In the months gone by, hardly anybody questioned the need for an extremely expansionary fiscal policy at the global level to tackle the worst economic crisis for decades and prevent a repeat of the Great Depression. There was also widespread agreement that governments should start addressing consolidation in 2011.

But not all countries were equipped for such crisis management. Greece had already been on an untenable budgetary path before the financial crisis – and therefore finds itself in even deeper water now. To regain its grip, the government has no choice but to resort to radical consolidation measures despite protests on the street. Greek withdrawal from the euro is not a viable alternative, indeed it would deal a further blow to the country's economy.

In many respects it can be said that Greece is a special case. Nonetheless, the risk of a general shift in sentiment on the market for government bonds is not inconsiderable. Other European countries are also groaning under a hefty debt burden. A loss of confidence in US Treasuries would be particularly disastrous. America's huge budget deficits are obviously a reflection of the private sector's higher propensity to save (drop in demand). However, unlike in Japan, public-sector funding needs still cannot be covered by private domestic savings. Rather, close on half of government debt financed via the bond market is in foreign hands. Moreover, current official budget projections give no indication as to how the debt ratio is to be stabilized in the years ahead. It remains to be seen what recommendations the newly formed bipartisan National Commission on Fiscal Responsibility and Reform comes up with in early December of this year.

The fiscal challenges are thus by no means confined to the southern or far-northern EMU countries, they are an international phenomenon. Fiscal policy cannot eliminate the deficits swiftly. But it can counter the risk of dislocations on the bond markets by providing the markets with a sufficiently clear picture of the longer-term development of public-sector

budgets. This requires the establishment of credible strategies staking out the path to sustainable budgets with clear targets. And existing budgetary rulebooks need to be improved. For instance, the EU Stability Pact needs to be supplemented with rules on spending and stiffer sanctions for miscreants. It is not yet clear how policymakers will proceed in detail.

Nor do the fruits of such a policy ripen overnight. For the time being, therefore, markets are likely to remain jittery about government finances and possible sovereign defaults. In such an environment, rising yields on government bonds are practically inevitable given higher risk premiums for such paper.