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Secular Outlook Series
Issue 1

Saumil Parikh

How Strategic Deficit Reduction Could Spur Growth

The world's advanced economies seem to be struggling to maintain economic growth, but few politicians appear willing to implement structural reform.

In the first of a series of Q&A articles accompanying the recent release of PIMCO's Secular Outlook, portfolio manager Saumil Parikh discusses public debts, the global economy and what governments could be doing to spur growth over the long haul.

Q. In the developed world, have public debts reached such levels that they are likely to impede economic growth?

Parikh: Part of our New Normal hypothesis for the global economy speaks to the high level of debt across the developed world. Regarding public debt, we focus in particular on the United States, the core and peripheral European countries, the U.K. and Japan. Among these advanced economies, Japan is by far in the greatest danger of being over-indebted at the public level. However, the U.S., parts of Europe, and the U.K. are catching up quickly.

"Most developed world policymakers remain focused on the cyclical, not the secular, outlook."

Our research and that of others, such as Ken Rogoff and Carmen Reinhart, suggests that economic growth will slow amid the public debt levels these nations are reaching. We see this slowdown occurring over a secular period of time – over the next three to five to seven years. Part of this expected slowdown is driven by forecasted debt service costs rising to generationally high levels in real terms. Yet, another part of this slowdown is driven by an expected decline in private "animal spirits" as national savings rise to pay down debts.

For Japan, we have modified our outlook to incorporate economic implications of the devastating tragedies there. Aside from the incredible human and environmental impacts, from a purely economic perspective, Japan has lost a significant amount of productive capacity in 2011. The secular outlook for Japan, as a result, has become even more challenging from a debt and deleveraging viewpoint.

For Europe, the U.S., and the U.K., much of the evolution of our secular economic outlook will depend upon the degree and success of structural policy changes that are undertaken. To date, very few such policies have been implemented. Most developed world policymakers remain focused on the cyclical, not the secular, outlook.

Q. Are advanced economies becoming credit risks?

Parikh: To a degree the answer is yes, but it is important to make a distinction between various types of sovereign credit risk. For countries like the U.S., U.K. and Japan, where public debt is almost exclusively denominated in local currency that central banks can freely print, we feel sovereign credit risk manifests itself in the form of depreciating currency and rising inflation risk. These risks translate into a form of financial repression whereby sovereign bond markets will deliver negative real returns and therefore a decline in the real purchasing power of savings in these countries.

In continental Europe, the situation is slightly different, particularly when it comes to peripheral countries like Greece, Portugal, and Ireland. They also face over-indebtedness and deteriorating competitiveness vs. the rest of the world, but these countries lack independent currencies to depreciate. So sovereign credit risk in these countries is manifesting itself purely as default risk, and the expected real return of sovereign debt in these countries will be reduced, we believe, in future years via restructuring (reduction in principal or in interest) or in some cases through outright default.

Q. What are the economic implications of current fiscal deficit reduction measures in advanced economies and of potentially more substantial measures in the near future?

Parikh: Starting with the eurozone, deficit reduction across the periphery of Europe is being addressed via old-fashioned fiscal austerity. As these countries adopt fiscal austerity, we anticipate economic growth for the next three to five years will come in well below potential, leading to lower profit growth, higher unemployment and a period of adjustment, whereby the political pressures internally will likely be very volatile and unpredictable.

In contrast, the U.K. adopted fiscal austerity in 2010, but did so amid an extremely easy monetary policy regime. Real interest rates in the U.K. are poised to be significantly negative over a secular horizon. Still, at PIMCO, we think the U.K. is implementing what is probably the best combination of fiscal and monetary policies to address deficit reduction, as they have an eye to structural issues.

They are trying to reduce spending and public programs that are focused on current consumption and thus arguably not contributing to future economic growth. Also, they are reducing certain corporate tax rates, increasing incentives for investment, and trying to promote activities that have what we would call high multipliers to economic growth – all so that the future state of the U.K. economy will be, if all goes according to plan, in a much more stable and a much more competitive position.

We think the U.S. could learn from the U.K. in this regard. To achieve meaningful economic growth in the U.S. over a secular horizon, we strongly recommend a combination of revenue-side and expenditure-side changes in policy that are structural in nature. In our view, a growing percentage of U.S. expenditures are income transfers to the household sector that do not address the long-term structural issues of high unemployment and a dearth of job creation.

We see great economic benefit from shifting some of that spending from consumption to investment – for example, to the energy sector, where the U.S. has a large deficit vs. the rest of the world. More spending on research and development of domestic energy sources would not only create jobs today, but would also reduce the U.S. trade deficit in the future. We also advocate more spending on other research and development and on education, because ultimately, if the U.S. continues to fall in education standards and in its share of global patents and global innovation, then this reduces its ability to be a world leader in future economic growth.

Finally, U.S. government revenues as a percentage of GDP are too low, even adjusting for the cyclical position of the U.S. economy, relative to the rest of the world and especially on consumption activities. We believe low tax revenues reflect a tax code that is too complicated with too many loopholes allowing both households and corporations to avoid paying taxes. These loopholes need to be closed.

Q. Regarding fiscal debts and structural issues, what are the implications for investment strategy?

Parikh: Over any secular period, the first thing that we want to focus on is to seek to preserve investors' purchasing power after inflation. And if we are truly in a New Normal, where advanced economies face persistent headwinds to growth, then any developed country that fails to address structural issues is likely to deliver very sub-par real returns to investors as a result of either high inflation or debt restructuring. PIMCO seeks to avoid negative real returns for our investors. The bond market in the U.S., for example, for the last 30 years has returned after-inflation annualized returns of 5.5%, as of year-end 2010. Over a longer historical time frame, a study from 2003 found that since 1900, typically U.S. fixed-income markets have returned 1.9% per year after inflation. If we are right about how developed countries will attempt to reduce their debt overhangs, then delivering 2% real returns per year is going to become incredibly difficult over the next three to five years.

Also, one of the biggest lessons we think that investors learned from the financial crisis is not to place blind faith in the rating agencies and their triple-A ratings. At PIMCO, we are focused on understanding what the future group of true triple-A countries is going to look like, because this will essentially determine where high and positive real returns will come from. These countries may very well be outside today's definition of "developed" world.

Thank you, Saumil.

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Sources: PIMCO; Barclays; The Federal Reserve; *Triumph of the Optimists: 101 Years of Global Investment Returns,* Elroy Dimson, Princeton University Press (2002)

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Newport Beach Headquarters
840 Newport Center Drive
Newport Beach, CA 92660
+1 949.720.6000

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