



Bond yields fall into abyss as world turns upside down

The financial world seems upside down. The spectre of inflation haunts countless television and radio debates, gold and other precious metals are the flavour of the moment. And yet, at the same time, yields on the main bond markets seem to be falling into an abyss, as if inflation had been nailed into its coffin for the foreseeable future. Yields on German government bonds have been flirting with all-time lows in early summer, and US long-term interest rates are still hovering at an exceptionally low level.

Bond markets have not only been ignoring all talk about inflation, but they are also absorbing quite a massive increase in the supply of government bonds in recent quarters. The fact that increasing supply is not depressing prices and pushing up interest rates is reminiscent of the Japanese experience, where standard economic theories have not given good guidance for some years. An obvious difference between Japanese government bonds and the US Treasury or German Bund markets is obviously that Japan actually experienced deflation for a number of years, which of course justifies low long-term bond yields.

But the Japanese case also teaches us that, with respect to the interest rate impact, changes

in private savings can compensate for even huge amounts of public borrowing. In fact, we are witnessing a major increase in net private savings almost on a global scale. In the US, the private sector has shifted to a positive financial balance of 6.5 per cent of gross domestic product in 2009, from -2.3 per cent in 2007. Private households are saving more than they are investing, hitting mainly residential construction, and corporations are retaining more profits and higher depreciation allowances than they are spending on investment. In the eurozone, the financial balance of the private sector has increased from 1 per cent in 2007 to 5.4 per cent in 2009. This change in net private savings keeps bond yields low. Besides, there is also a substantial demand for safe assets among global investors

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from Asian emerging markets or commodity producing regions of the world. Treasuries and German Bunds have benefited from the debt crises of peripheral European countries.

Against this backdrop, three questions will determine the future path of bond yields.

The first is will net private savings remain sufficient to absorb the foreseeable debt issuance of governments in industrialised countries? The answer hinges on the future path of economic recovery. Should it continue and possibly even gain momentum, the corporate sector will need more capital for investments and private households for residential investment. Also, the fairly high savings rate of private households in the EU could be reduced somewhat once the labour market stabilises. As a result, demand for government bonds would be lower and interest rates

would increase. Presently an ongoing recovery seems to be the most plausible case. Growth may lose some momentum in the US and in China, but it is likely to stay positive as well as in the EU and many emerging markets.

The second big question concerns inflation. Post-recession experience suggests that inflation remains subdued for quite some time after a downturn of production. This seems to justify mainstream forecasts that inflation will remain low in 2010 and 2011. Inflation should not become a major argument for central bank rate hikes or sharply accelerating inflationary expectations that could push up bond yields. The medium-term path of inflation is less clear, depending primarily on the ability of central banks to rein in abundant liquidity and to step up rates when inflationary expectations do rise.

The third question concerns the prospective end of the debt crisis in the eurozone. Again, the overall global outlook is important. In an expansionary environment, the availability of public funds for highly indebted euro countries should gradually mollify markets and diminish fears of a sovereign default of an advanced western economy. Once some risk appetite returns, benchmark yields in the US or Germany could, according to our econometric estimates, go up by as much as half a percentage point.

All told, benchmark ten-year bond yields may normalise at rates between 3% to 3½ per cent in the eurozone and 3½ to 4 per cent in the US in the course of next year. This is the base case scenario of a continued moderate recovery. A global double-dip would change the situation, as it might increase deflationary pressures. But the arguments for a double-dip are not too convincing. A moderate slowdown of the US economy and a return to high single-digit growth rates in China will not stop the nascent global recovery.

The double-dip recession is in my view no more likely than accelerated growth, which could result from further strong stimulus and global monetary expansion. So odds are that we are not heading for a Japanese scenario.

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