

Return of the Bond Vigilante

Will markets coerce fiscal policy again?

Ramana Ramaswamy



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BOND MARKET VIGILANTES are a vanishing species. The label refers to bond traders who are averse to fiscal profligacy but also captures politicians who are wedded to small government. They wielded significant influence over global fiscal policy for two decades until 2008 but are feared no more. The bond market has been unable to assign risk premiums—higher yields—to countries with unsustainable fiscal policies in recent years. The customary political forces arrayed in support of small government have also fallen silent. The recent reticence of the fiscal hawks in the US Congress, for instance, has perplexed many.

What happened? Has the economic structure in advanced economies changed to accommodate a larger public debt than reckoned previously? Does the Republican support for fiscal expansion in a full-employment economy reflect political exigency, or is it an indicator of deeper changes in the economy? Will bond markets ever pressure governments again? Getting a handle on these questions is critical for both policy and markets.

It is no great revelation that quantitative easing (QE)—large-scale purchases of government bonds by central banks—fundamentally changed the relationship between debt and bond yields. Having a big new buyer of bonds invariably pushes yields down. What is less obvious is that the sensitivity of bond yields to inflation is much higher than their sensitivity to fiscal sustainability. And QE did not drive inflation up as quickly or as much over time as was envisaged initially. This combination of direct bond buying under QE, its failure to rev up inflation given the scale of the bond purchases, and bond yields' strong sensitivity to inflation proved a powerful cocktail in keeping bond yields low for years.

Low bond yields transformed the politics of debt and deficits radically. There is less crowding out of noninterest government spending when yields are low. That decreases pressure on politicians to make hard choices between competing spending objectives. There is simply less of a reason to antagonize anybody with spending curbs when there is more to go around. It gets close to a free lunch; railing against free lunches would be somewhat quixotic. The silence of the political forces favoring small government and balanced budgets reflects mainly this coexistence of high debt and low yields.

The reticence of small-government politicians could, presumably, also reflect a more sophisticated understanding of fiscal policy—that in demand-deficient economies where monetary policy cannot get traction, fiscal expansion is needed to prevent a deep contraction. I doubt, somehow, that this epiphany muffled the fiscal hawks. Persistent low yields are a more credible explanation for a shift in the politics of fiscal policy.

Changing perceptions about sovereign default are also at play. The Japanese and euro area experience with QE fundamentally changed how the market perceives default today. Japan and Italy have deeper challenges with debt sustainability than the United States. There are significant differences between

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Italy and Japan, but essentially their debt is large, their growth is slower, and their populations are aging faster. That is an onerous combination for debt sustainability.

As in the United States, the stated objective of QE in Japan and the euro area is to push inflation higher. But its unintended effect—some might say its “unstated intent,” even though central banks deny it vehemently—has been to remove default premiums from the bond market. When a country with a debt ratio of 240 percent of GDP, as in Japan, manages to lock in 10-year bond yields close to zero, it makes it hard for bond markets to price default probability elsewhere. So, as QE becomes an integral part of the central bank toolkit, it fundamentally alters the market’s perception of default—and its capacity to price it. Fiscal profligacy imposes minimal costs on governments.

It is this factor—the inability of the bond market to price risk premiums—rather than changes in the structure of the economy that allowed higher debt with little collateral impairment. The political process simply gobbled up the free lunch. If anything, the structure of advanced economies may warrant lower debt levels today. Aging populations imply larger future spending on health and pensions, along with a lower capacity to grow.

The layering of QE on the strong disinflationary forces of technology, globalization, and labor’s weakened position neutered the bond vigilantes. While QE is being gradually withdrawn from a stronger US economy, it continues in both Japan and the euro area. With low inflation and the implicit fiscal support it offers, the bar to withdrawing QE in both places is high. A global bond market will therefore continue to feel the effects of QE despite its gradual withdrawal in the United States.

Inflation is key to resurrecting the bond vigilante. We don’t know quite how long the structural disinflation trend of the past two decades will last. It is unlikely to persist if globalization goes into retreat. We may be at one such inflection point as the backlash against free trade and the cross-border movement of labor gains traction. Policy could also force greater so-called onshoring of production

through tax incentives and could make it costly to rely on international supply chains.

If the disinflation trend morphs into inflation, it would force global QE withdrawal. And that would peel away the implicit fiscal support that has been an unstated but nevertheless powerful feature of QE. The entire chain of events that pushed the bond vigilantes close to extinction would reverse. Google searches would start spawning reports about the bond vigilante, and fiscal hawks would emerge from Congress’s woodwork. Governments would then feel the pinch, and it would profoundly transform the politics of fiscal policy. **FD**

RAMANA RAMASWAMY is a distinguished academic visitor at Queens’ College, Cambridge University.

