

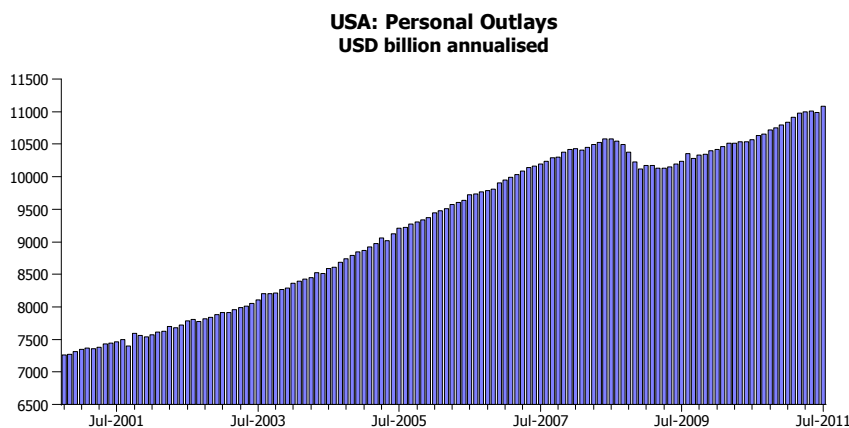
Mission Not Accomplished

On 25 March 2009, in response to the crisis that was at that time engulfing the global economy, the G20 Heads of State met in the rather less-than-inspiring surroundings of the Excel Centre in London's Docklands. Perhaps reflecting the austere times, there was no Louvre Palace or Plaza Hotel as a choice of venue; instead, the politicians were forced to use the London Boat Show's just-vacated venue, but nevertheless the assorted leaders managed to agree a coordinated fiscal stimulus for the global economy that many believed would solve its problems. Indeed, even two years later, the conference host, Gordon Brown, was still claiming to have saved the world to an audience of economists, although it must be said that few in the room agreed with him by then...



It is true that Brown and his counterparts did provide a boost of sorts to the global economy from mid-2009 onwards through their use of huge largely bank-financed fiscal stimuli. When the Global Financial Crisis hit, the household sectors of many Western countries were profoundly cashflow negative (that is, they were dependent on borrowing money simply to cover the gap between their incomes and expenditure levels – a theme that New Zealand's households had taken to an extreme) but when their access to credit was impaired, they were no longer able to spend more than they earned after tax – hence expenditure levels (and profits) dropped sharply. In 2009 and early 2010, though, the expansion of government borrowing that allowed the various public sectors to finance substantial net cash injections to their troubled households did much to bridge the gap between incomes and intended expenditure levels and therefore these policies soon gave rise to a rebound in expenditure, since households were able to top up their income receipts with new inflows from the governments.

Some two years after Brown's original G20 conference, though, many governments, fearing the type of debt crises now facing the periphery of Europe, have begun to take back or at least partially unwind their former expansionary fiscal policies and it has been this shift in fiscal policies, rather than events within the monetary policy environment, that have laid behind much of the recent instability within the global economy. Specifically, while the expansion of government



borrowing in 2009 created at least the appearance of a global economic recovery, the withdrawal of this stimulus in 2010-11 has caused a sharp deceleration and perhaps even reversal in global growth trends.

The importance of changes in fiscal policy has been most apparent in the major developed world economies. For example, over the course of 2007, the US budget deficit (these figures are including asset purchases from the private sector) was running at about USD400b p.a. Over the following 18 months, though, this already significant deficit trebled and in so doing created a USD750b cash flow injection into the troubled private sector, which used at least some of the funds advanced to increase its level of expenditure. The budget deficit then stabilised in late 2009/early 2010, though, an event that seems to have resulted in the economy developing a flat spot/double-dip fear shortly afterwards. Interestingly, the US deficit then surged to a peak of USD1.8tn in the second quarter of 2010 (just before the economy picked up following its 2010H1 stagnation)

but since the northern hemisphere summer of 2010, the fiscal deficit has shrunk back to around USD1.4tn and it is noticeable the economy began to soften almost as soon as this implied USD400b tightening occurred.

In Germany, meanwhile, the response to the GFC brought a EUR65b easing from the government but crucially there has been a >EUR20b tightening since the middle of 2010. In France, there was a EUR500b easing during the 2009-10 crisis period but we also find that policy “stopped” easing and the deficit declined slightly over the course of late 2010. In Italy, the budget deficit peaked during early 2010 and there has been a EUR30b tightening since then. The UK, meanwhile, saw its deficit peak in June 2010 and there has since been close to a USD100b tightening since then, while even Japan has managed a degree of implied fiscal tightening since the middle of 2010.

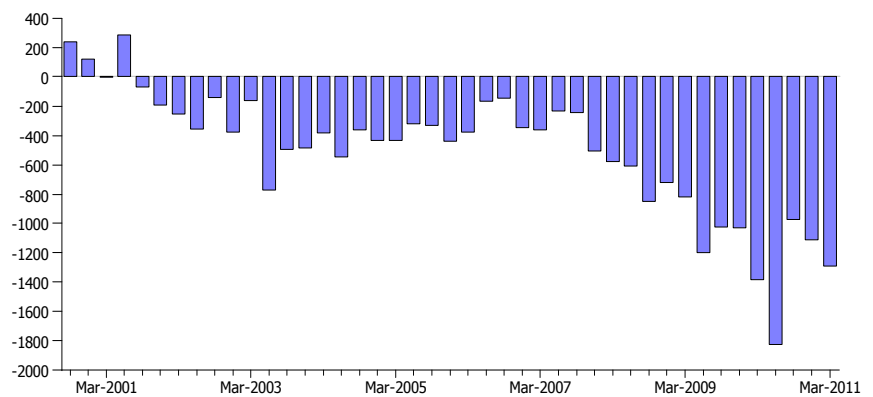
In total, it would appear that since June 2010 there has been an unprecedented and unintentionally coordinated USD600b-plus tightening of fiscal policy in the G7. In practice, this tightening impetus in just the G7, when adjusted for the effects of 2011’s higher rate of inflation (which would have made even an unchanged nominal deficit equate to a tightening in real terms), probably accounted for close to 5-6% of G7 GDP and 2-3 % of global GDP. For those forecasters that were expecting 3% GDP growth in the G7 this year, we would suggest that this is “where it went”. Moreover, it would also seem to explain why western profit rates (at least on a GDP basis) have appeared to fall back again of late – now that consumers can only spend what they earn, corporate revenues have fallen back towards the wage bill and thereby squeezed operating margins.

Although the analysis is less transparent in the emerging markets, it is also apparent that similar forces have been at work here too of late. According to China’s own GDP and investment data, roughly 80% of the economy’s growth since 2007 has resulted from an increase in construction spending by local governments, a situation that both yielded more GDP but also a much higher level of notional public sector debt in the economy. As 2010 drew to a close, though, China’s fiscal expansion

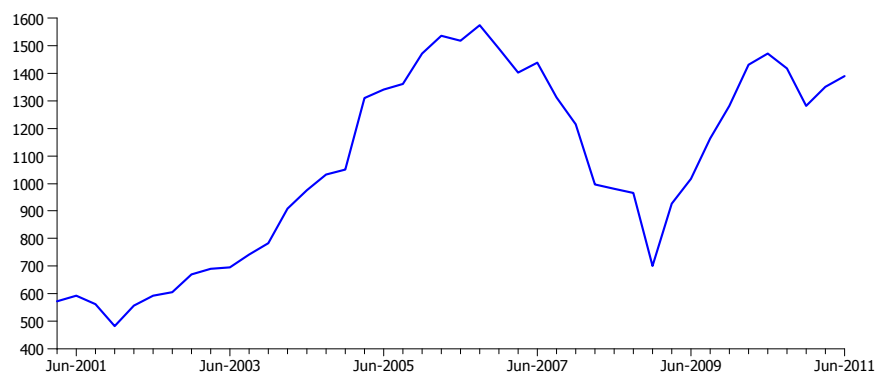
was beginning to cool as well. Meanwhile, Brazil’s recent credit expansion has owed much to the behavior of its publically owned banks and even in India changes within the budget deficit have likely played a significant role in that country’s growth outturn. The impact of capital flows into these economies and the resultant pickup in domestic credit flows have been important, but so too has fiscal policy.

Recently we met with an economist at the RBNZ who, in a previous role at the IMF, had studied fiscal consolidations in the 1980s and 1990s in Scandinavia, North America and elsewhere. During our conversation, our contact noted that when he thought back over his papers, what distinguished the “successes” within the list of fiscal consolidations was that they generally occurred in unique independent years – quite simply, there never has been an attempt at international fiscal austerity before in which virtually every country has implicitly “taken money out of the system” simultaneously. Hence, we should not be surprised that the fiscal consolidations of 2011 are proving both difficult to achieve and expensive in terms of the “growth sacrifices” that they have involved.

USA: Budget Balance (inc asset purchases)
USD billion annual rate



USA: Domestic Profits
USD billion



In practice, the various growth spurts that we have seen since 2008 and the occasional slumps, of which the current one seems the most significant, can be traced to the changes in budget deficits in the major countries and this conclusion only goes to reinforce that the 2009 G20 London Meeting “success” did not solve the world’s problems – it merely provided a public-debt-expensive “Band Aid” that covered over the underlying problems in the global economy, problems that the authorities should then have moved to solve in the time that they had bought themselves with the G20 fiscal initiative.

Rather than attending more conferences and delivering self-congratulatory speeches, the G20 should have been creating long-term supply-side reforms and encouraging the types of innovation-led growth that would have allowed the private sectors the opportunity to grow out from their debt burdens but by-and-large this has not happened and instead the hugely expensive G20 process merely added more debt to the global economy in return for a few quarters of unsustainable growth. Hence, as the fiscal stimuli are removed, the global crisis is returning and this time the public sector coffers are empty – quite simply, we cannot even afford the dowdy Excel Centre again!

In the near term, central bankers (particularly those outside Japan) will not want to be – and perhaps cannot afford to be seen to be – so fatalistic about these outcomes and their probable impotence in the current environment. Their political masters and the markets are clearly demanding action and we suspect that the central bankers are only too aware that to be seen to fail to do anything would likely bring a number of the current problems stalking the markets to a head, particularly in Europe.

Therefore, we expect the US Federal Reserve to continue talking bond yields down with promises of low interest rates ad infinitum, while in Europe, the ECB will presumably be dragged further along the route towards the increased monetisation of peripheral budget deficits and in the UK, the momentum behind the fiscal tightening may slacken and the BoE may offer further encouragement to the UK banks to continue funding the existing budget deficit. In the Southern Hemisphere, talk of rate hikes will doubtless be replaced with talk of rate cuts, particularly in Australia (if not in New Zealand).

In the longer term, though, these policies, which will not address the underlying problems of excessive indebtedness and a lack of innovation in the real economies, seem likely merely to yield longer-term economic stagnation and implicit financial repression (Japan style) but we doubt that the authorities will have anything else to offer except these temporary “quick fixes”. As to whether markets will welcome them in the short term, we remain unconvinced but hopeful...

Andrew Hunt

**International Economist
London**

JP Morgan Alternative Asset Management 2011 New Zealand visit

Tyndall has presentations organised for the upcoming visit of Paul Zummo, Managing Director and Chief Investment Officer from JPMAAM. Paul is based in New York and is visiting New Zealand for the first time. We are honoured to have him make the time to visit us here while on a research trip to Asia. He was one of the founders of JPMAAM back in 1994 and has seen some interesting times in his tenure.

Tyndall has employed JPMAAM since 2001 and the JP Morgan Multi-Strategy Fund II Ltd has been an allocation in our Balanced Fund since 2002.

Cities:	Auckland	Monday, 10th October	10am & 12pm	Tyndall Offices
	Wellington	Tuesday, 11th October	12pm	Wellington Club
	Christchurch	Wednesday, 12th October	10am	The George Hotel

For further details please contact helen.mckenzie@tyndall.co.nz

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Helen McKenzie at helen.mckenzie@tyndall.co.nz or visit us at www.tyndall.co.nz

Phone: 09 307 6366 / 021 608 849

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