

PIMCO Cyclical Outlook: Deleveraging, Austerity and Europe's Potential Minsky Moment

The year ahead will likely be very challenging for the global economy. Growth faces several hurdles that we believe collectively will impose a sense of greater uncertainty and increased volatility on financial markets. These hurdles include the need for accelerated balance sheet deleveraging, slowly creeping but surely rising risks of financial and economic de-globalization, and the constant drum beat of re-regulation, particularly in developed country banking systems.

Global balance sheet deleveraging will play the dominant role in PIMCO's current cyclical economic outlook. Front and center in this regard is the rapidly progressing sovereign debt crisis in the eurozone, the debt deflationary feedback loop associated with it, and the quality and quantity of policy responses applied to contain it. As goes the eurozone deleveraging, so goes the global economy over the next six to 12 months.

The eurozone is facing an accelerated reversal of imbalances accumulated over several years after the creation of the euro. These imbalances are the product of differing real trends in productivity, labor flexibility, and national savings and investment rates across the member nations of the eurozone. Prior to the implementation of the single European currency, current members had individual currencies and individual control of their respective money supply, making it relatively easy to absorb real economic differences via relative currency value changes and inflation differentials. Today, however, those countries that adopted the euro do not possess the same degree of flexibility needed to smoothly diffuse frictions along these fault-lines. With one common currency and one common central bank, but individual fiscal agents and differentiated trends in economic performance and governance, the full burden of reversing sovereign deficit and debt imbalances falls onto the shoulders of only the fiscal agents. And as we see it, fiscal agents have one option and one option alone: deleverage the government balance sheet by practicing secular austerity.



Saumil H. Parikh, CFA

Managing Director
Portfolio Manager

To judge the impact of eurozone deleveraging on the global economy, we must answer three questions. First, how much austerity will the eurozone impose upon itself to restore the balance between debtors and creditors? Second, will eurozone sovereign haircuts or defaults remain a part of the deleveraging process? And third, what role will the European Central Bank (ECB) play in controlling the depth, breadth and velocity of sovereign debt deleveraging?

Stress Testing the Plan

Eurozone governments are about to legislate a plan of significant fiscal austerity over the coming years. By PIMCO estimates, austerity programs across both healthy and unhealthy balance sheet countries in the eurozone will pose a drag on growth to the tune of 1.5 to 2 percentage points over the next 12 to 24 months. This means that, absent any increase in private or external sources of aggregate demand, the eurozone economy will likely experience a recession in 2012. Indeed, PIMCO expects the eurozone economy to shrink by 1% to 1.5% in 2012.

Eurozone sovereign haircuts and defaults will likely remain a part of the deleveraging outlook. The acceleration of the European Stability Mechanism (ESM) and the introduction of collective action clauses on newly issued sovereign debt under the ESM mean that future haircuts, write-downs and private-sector subordination are still possible -- and probable. This, in turn, means that eurozone banks -- which have been the chief private-sector financiers of eurozone sovereigns -- will need a substantial amount of new capital to maintain their own balance sheets and provide ongoing credit to the real economy for growth. This new capital will be needed primarily to fill the ex ante equity hole generated by now "risky" sovereign credit exposures. It will also be a necessary condition for maintaining an effective monetary policy transmission mechanism to the eurozone real economy. If eurozone banks remain under-capitalized for much longer, their borrowing costs could climb too high for credit growth, and they would be forced to deleverage private credit commitments at a time when eurozone sovereigns are attempting to do the same with fiscal policy.

To be clear: The eurozone economy cannot bear a concomitant deleveraging in sovereign and banking system balance sheets, given an already weak growth outlook.

The ECB, therefore, must play the critical role of deleveraging police in the year ahead. Only the ECB has a balance sheet large enough, credible enough, and flexible enough to prevent the eurozone sovereign and banking system deleveraging from turning into an uncontrolled Minsky Moment (referencing economist Hyman Minsky and referring to the inflection point when investors must sell assets to pay off debts, pushing down asset prices across the board). An acceleration of the debt deflationary feedback loop will be the odds-on outcome if the ECB

continues to play coy with its own balance sheet. The ECB must, at some juncture in the not so distant future, become a lender of last resort to eurozone sovereigns. And, equally important, it must do so with a transparent and credible plan such that private sector demand for eurozone sovereign debt is crowded back in before it is permanently destroyed.

But what will it take for the ECB to make this leap from a bankers' banker to a sovereigns' banker? To begin to answer this question, we have to consider the mandate of the ECB and the "game of chicken" being played between European fiscal agent and the ECB.

The ECB's Evolving Mission

First, the ECB has a clear mandate of maintaining price stability and nothing else. In the best traditions of the German Bundesbank, the ECB maintains fierce independence from fiscal policy and financing sovereign deficits and does not believe it is responsible for shaping cyclical real growth outcomes (unlike the U.S. Federal Reserve). A key question, however, is whether the ECB's mandate is symmetrical around low and stable inflation? Will the ECB act aggressively to combat deflation, as it does to combat above-target inflation when the time comes? And if it will, what tools will it be willing to use, especially if policy rates are already at the zero-bound and the transmission mechanism of policy is broken? At this point, the rate of inflation in the eurozone is too high for the ECB's liking and is thus likely to prevent the ECB from taking any dramatic steps to pre-emptively combat the forward deflation risks arising from a deteriorating economic outlook across the eurozone.

Second, the ECB is engaged in a dangerous but necessary game of chicken with eurozone fiscal agents, which prevents it from becoming a transparent and credible lender of last resort to eurozone sovereigns. On the one hand, with the credit transmission mechanism broken and bank balance sheets stressed, the ECB recognizes that it must prevent sovereign bond prices from falling too far. On the other hand, the ECB remains fearful of introducing secular moral hazard into the process of enhancing fiscal unity and stability across the eurozone by pre-emptively financing fiscal deficits. This game cannot continue for too much longer. If it does, we believe either the deteriorating economic prospects for the eurozone will accelerate the feedback loop to its Minsky Moment, at which point sovereigns and banks will enter a race to try to out-deleverage the other; or the ECB will take pre-emptive action to become a transparent and credible lender of last resort to sovereigns thereby stabilizing the eurozone banking system and the eurozone economy. As things stand today, it is more likely that the ECB will leap to a rescue only when it is too late. As a result, the odds of a European Minsky Moment are uncomfortably high now.

Chinese Growth Levels Off as U.S. Deleveraging Continues

Moving from Europe to Asia, China has joined the U.S., the eurozone, Japan, and the UK in some form of balance sheet deleveraging. However, we expect Chinese deleveraging to be rather benign as long as policymakers use their substantial financial resources to manage the process over time. China for the last two years has engaged in an accelerated program of domestic investment via rapid credit creation in its domestic banking system. This has provided the global economy with a substantial and much-needed boost to aggregate demand at a time when developed economies were all undergoing private sector deleveraging. But this source of global aggregate demand is slowing significantly now.

Due to a combination of issues ranging from excess capacity, rising income inequality and bank capital stresses that will require a slowdown in the rate of credit creation, China is likely to slow future domestic investment in favor of a more balanced and stability focused growth model. China is likely to use its substantial public financial resources to address imbalances between domestic investment and consumption, between capital and labor shares of national income, and to slowly re-capitalize its banking system as non-performing loans crystallize to losses. The major implication for the global economy is that the process of Chinese deleveraging and rebalancing could mean much slower Chinese growth and a smaller impact of Chinese aggregate demand on the global economy. PIMCO expects the Chinese economy to grow by just 7% in 2012, significantly below consensus expectations of 8% to 8.5% real growth.

And what of the States? The U.S. economy continues to make steady progress in private sector deleveraging, but little to no progress when public sector balance sheets are included. U.S. households and banks have generally reduced debt either via defaults or orderly recapitalizations, and many companies have benefitted tremendously from a weaker dollar and strong growth in global trade via the emerging market economies. Despite the progress made to date, the process of U.S. deleveraging is not nearly complete. This is especially the case given that the U.S. government continues to run large structural deficits to support private sector aggregate demand, and that demographically driven unfunded liabilities are starting to crystallize onto public balance sheets at a faster rate.

Were it not for the brewing crisis in the eurozone, and the expected slowdown in aggregate demand in China (and other emerging economies), the outlook for the U.S. economy might have been relatively sanguine for the year ahead. In 2011, U.S. GDP grew by a modest but decent 1.5% to 1.75%. But with global headwinds gathering -- and U.S. expansionary fiscal policy becoming much more difficult to maintain -- we think the U.S. economy will only manage 0% to 1% growth in 2012. This is substantially below the industry consensus expectation of 2% to 2.5% growth.

Turning from deleveraging to de-globalization, we believe the most important component of this creeping process is occurring in global finance. Global imbalances between savings and investment have long been sustained via cross-border intermediation across an integrated global banking system. European banks have played the major role in this process, with American and Asian banks being perhaps a degree less important. We have discussed the potential impact of European bank deleveraging on the eurozone economy, but have not spent much time on how they might impact the global economy in a direct way. The eurozone banking system is 2.5 times as large as the U.S. banking system, in part because it plays an important role in intermediating global savings. At \$41 trillion in total balance sheet assets, the impact of a eurozone banking system deleveraging would dwarf the effect of any successful re-leveraging of the U.S. banking system, which is only about \$16 trillion in size. The race to higher capital ratios combined with sovereign stresses means that the global banking system will likely turn inward and the process of cross-border savings intermediation could slow substantially in the year ahead. This is yet another hurdle for global growth.

A second component of de-globalization is the glacial but observable increase in trade skirmishes between the U.S. and China. There have been a series of tit-for-tat tariff increases lately, and the U.S. political machine has begun to increase calls for a more transparent and open Chinese economy only to be summarily rebuffed by Chinese officials. This glacial trend is an important one to watch, as trade between U.S. and China has been a very important source of strength for large portions of the global economy.

Finally, the cyclical outlook would not be complete without a mention of MF Global and the implications thereof on financial re-regulation. We have long suggested that the developed world financial system has begun a gradual

process of returning to "utility banking," a boring destination where the financial system largely separates deposit taking and loan making from the riskier endeavors of leveraged finance and asset price speculation. MF Global is likely to spark an acceleration in this process, only because it has shown that the regulatory changes planned (and yet to be fully implemented) after the collapse of Lehman Brothers in 2008 have done little to protect investors from concentrated financial system risks. We expect to see changes in the regulatory architecture of capital markets that may reduce system-wide liquidity,

increase financial transaction costs and de-risk balance sheets even further. Think of this as an incremental source of friction to global growth in the year ahead.

In sum, we expect the global economy to grow by 1% to 1.5% in 2012. This is significantly slower than the 2.5% growth rate achieved in 2011 and the 4.1% rate achieved in 2010. The risks to this forecast lay to the downside, which speaks to the question of inflation expectations. We expect global inflation to slow to 2% in 2012 from 3.1% in 2011.

Table 1: PIMCO Cyclical Outlook

Forecast	Real GDP		Headline Inflation	
	Current*	Q4 '11 - Q4 '12	Current*	Q4 '11 - Q4 '12
United States	1.5%	0.0% to 1.0%	3.4%	1.5% to 2.0%
Europe	1.4%	-1.5% to -1.0%	2.5%	1.0% to 1.5%
United Kingdom	0.5%	-0.5% to 0.0%	4.5%	2.0% to 2.5%
Japan	-0.2%	0.5% to 1.0%	0.1%	-1.0% to -0.5%
China	9.0%	6.75% to 7.25%	6.2%	4.0% to 5.0%
BRIM**	4.0%	3.0% to 4.0%	6.2%	5.0% to 5.5%
World	2.5%	1.0% to 1.5%	3.1%	1.75% to 2.25%

*Current data for real GDP growth and inflation represent 12-month actual figures from Q3 2010 to Q3 2011.

** Brazil/Russia/India/Mexico

Source: Bloomberg, PIMCO

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

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