

## **WALKING A DEBT-ROPE**

**October, 2011**

### **A bridge too long**

Well, so much for the third year of a presidential election cycle bringing with it a market rally, as it typically has. If anything, political posturing ahead of the 2012 elections has only aggravated the fragile investor psyche. Meanwhile, stocks remain hamstrung by the festering debt crisis in Europe. Until the Continent's policymakers act aggressively, risk assets such as stocks will continue to gyrate.

At its core, the events in Europe mark the latest chapter of a *Great Unwinding*, the struggle in developed nations to reverse a decades-long debt buildup. We in the industrialized world, as individuals and societies, have chosen to consume more than we have been able to produce. The math can work only by using debt to bridge that gap. And the situation will persist for only as long as lenders are willing and, after a point, complacent.

### **Households start to save**

Since the 2008-09 economic contraction, U.S. households as a group have pared down debt levels and increased their savings rates. Indeed, debt-service ratios (principal and interest payments as a share of income) have dropped below their 30-year average. These adjustments are obviously healthy, although in the near term will continue to retard growth.

In contrast, the U.S. public-sector debt continues to balloon, but much of that stems from deficits aggravated by the deep recession and policy measures to combat it. The U.S. does face a significant longer-term challenge to reduce the size of projected deficits. And the fractious political dialogue has not been particularly helpful toward that end. Perhaps, as a nation, we need to press the reset button and elect a new group of politicians. In any event, the U.S. Treasury may still borrow at extremely low rates, so the government is not facing an imminent credit crunch.

### **Tangled Grecian formula**

Alas, the same cannot be said of Greece, which brings us back to what's ailing stock markets. The Greek government desperately needs capital to fund their budget deficit and roll over maturing debt. In mid-September, Greek two-year government bond yields hit 75%.

That's a problem if you work in the Ministry of Finance. Beyond this short-term funding crisis lies a bigger challenge: Greece is essentially insolvent; that is, it is doubtful that they will have the capacity to meet their future liabilities.

But why is a country with an economy the size of Boston's causing such a global stir? After all, over the past two hundred years, Greek governments have spent half the time in default. The answer lies in the interconnection of global financial systems and the resulting risk of contagion. Greece's challenges have raised doubts about the solvency of other, much larger players — most notably Italy and Spain. A default by either would have severe repercussions for the European banking system, where most of their outstanding debt is held.

### **Breathing room**

You wouldn't detect it from watching stock and bond markets, but Italy and Spain are not insolvent. Fundamentally, they should be able to service their debt; they merely need some breathing room. Like the United States, those governments can meet their obligations — assuming markets lend to them at a fair rate of interest. By fair, we mean a rate that reflects their true underlying public finances. Both nations have seen their bond yields spike as bond vigilantes presume they are *going Greek*. This simple fear of insolvency could become self-fulfilling, as prohibitive borrowing rates crush a government's finances.

The Italian government does have a sizable amount of debt outstanding, roughly €1.9 trillion (\$2.5 trillion) or 120% of GDP. But unlike many of its counterparts, Italy's annual deficits are small. In fact, before interest payments, Italy is actually running a budget surplus. The nation's banks are in reasonably good shape, with low exposure to the PIGs (Portugal, Ireland, Greece) and no housing bubble to weather. However, about one-quarter of Italy's debt matures and must be refinanced over the next eighteen months. It is absolutely critical that the Italians be able to access sufficient capital to do so.

Spain's level of public debt is actually below that of Germany and France, adjusted for the size of its economy. And at approximately 68% of GDP, it is not all that far above the EU's statutory "limit." Furthermore, the average maturity on that debt is around 6.5 years. But unlike Italy, Spain has been running sizable annual budget deficits, so the debt level has been growing. Spain must also deal with the after-effects of a housing bubble that has weakened its banks and contributed to high unemployment.

### **Extend and pretend**

But again, we are just talking about the need for some breathing room. After much dithering, the European Central Bank (ECB) did announce in early August that it would buy Italian and Spanish bonds to drive down the yields. Their rates dropped at first but remain onerously high. This episode is endemic of European policymakers' piecemeal and wholly inadequate response to their debt crisis; indeed, their actions

— or rather, inaction — suggest that there is no crisis. The authorities’ policy of “extend and pretend” since all this began in early 2010 has dramatically raised the stakes.

The fact is, the European banking system is creeping toward insolvency. But this is just a symptom of the stress in the sovereign debt markets. Angela Merkel and Nicolas Sarkozy keep pledging their support for the banks, but they also need to treat the disease. To save the banks, one must stop Greece from becoming the domino that topples Italy, Spain, Portugal and Ireland. However, the European Union lacks a mechanism to prevent liquidity crises in sovereign debt markets. In other words, there is no official *lender of last resort* if there is a run on a member nation’s bonds.

The ECB has been extremely reluctant to take on this role. Its sole official mandate is “price stability.” It wasn’t that long ago that the bank was still raising policy rates to ward off inflation. Well, what do they think will happen if Italy defaults? Severe Euroland recession and collapsing prices. So much for price stability.

### **Build a firewall**

The financial stress could be largely relieved if the European authorities would act definitively and aggressively. Jean-Claude Trichet, the ECB president, needs to stand up and pledge unlimited and unequivocal support for the still-solvent sovereigns. The key term here is *unlimited*. The central bank must convince the markets that it will extend as much credit and at a reasonable rate as a given member requires. Then, to be credible, the ECB must go out into the secondary market for the bonds and buy assertively. Such moves would effectively fence off Greece’s insolvency, protecting the rest of Europe and its banks from contagion. On its own, Greece is small enough to deal with.

It’s not clear when the Europeans will have such an epiphany, but we’re confident that they will eventually. With even the German and French economies showing signs of sputtering, political pressure will intensify for a true solution to the debt crisis. But the current environment underlines the fact that one of the biggest risks to the global economy (and thus to stock and bond markets) is a policy error.

### **Dysfunction junction**

Speaking of potential policy errors, let’s come back across the pond to the United States. It would be an understatement to label the current political dynamic here as dysfunctional. In fact, by comparison, our politicians make their European counterparts look positively sober and pragmatic. The divisiveness of American politics seemed to reach a crescendo with the absurd debate on the debt ceiling. That episode was not an abstract or academic exercise. It coincided with a plunge in business and consumer confidence.

Our central bank has been aggressive and creative in responding to the 2008-09 financial crisis and the grudging recovery that has followed. The banking system has been shored up and is in a much more solid position. Interest rates are low, the money supply has increased, and financial institutions have capital to lend. However, ultra-expansionist monetary policy has failed to unleash a self-reinforcing recovery. It has also had some serious side effects, penalizing savers among others. Now the Federal Reserve is embarking on what the talking heads have dubbed *Operation Twist*, an attempt to bring down long-term interest rates further.

### **Austerity won't break the trap**

Well, long-term rates are already low and yet few are dancing. The Fed seems to be pushing on a string. Monetary policy has likely run its course. It appears that the economy is caught in a *liquidity trap*, an environment where the private sector is de-leveraging and de-risking after a bubble, there are few animal spirits, and low interest rates will not propel activity. The classic prescription would be for the public sector to step in to help fill the void.

That is a controversial view these days, particularly with already-wide budget deficits. Moreover, the prevailing notion is that the “government” is the problem and if we can simply reduce its size, our economic problems will go away. If only things were that simple. With the economy in a liquidity trap, fiscal austerity will only exacerbate the situation. Politicians risk repeating the mistakes of 1937, when premature fiscal tightening choked the recovery and plunged the economy back into recession. It took the activity associated with World War II — the ultimate expansion of fiscal and monetary policies — to get the country out of the hole. We certainly don't want to have to rely on a reprise.

### **Tread carefully**

So our elected officials need to tread carefully these days. If the country's long-term debt picture is not addressed with a realistic, sustainable and comprehensive plan, the bond market will eventually revolt. Treasury yields will rise sharply and net interest will be debilitating. On the other hand, if Congress front-loads too much austerity, the economy will suffer. Much of Europe is in the same predicament. The bottom line is that, for the foreseeable future, the markets will continue to be driven by the actions of politicians and central bankers. As such, they will be very unpredictable.

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