Stagnation, Default Or Devaluation

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Last week's Jackson Hole meeting helped to highlight a simple reality: unlike other parts of the world, the eurozone remains mired in a deflationary bust six years after the 2008 financial crisis. The only official solutions to this bust seem to be a) to print more money and b) to expand government debt. Meanwhile, Europe's already high (and rising) government debt levels and large budget deficits raise the question whether we should worry about 'debt thresholds', past which increasing deficits, and hence growing sovereign debt, no longer add to growth? Such a constraint could come from one of at least two sources:

1) Once the debt level gets high enough, debt service costs (even at very low rates of interest) can eat up so much of the budget that it is impossible to spend new money on anything else. Fortunately, most European countries are not at that point. Take France as an example: at roughly €45bn (or 2.1% of GDP), debt servicing costs are not out of line with its recent past (see the chart on page two).

2) Perhaps more insidiously, if the sustainability of the debt becomes dependent on low rates—as increasingly it is in countries like France— then the government has a powerful incentive to do everything it can to keep rates low so it can pursue its existing policies without facing the threat of fast-rising debt service costs. If the price of keeping rates low is low nominal GDP growth, then so be it. This is where Japan has been for some years, and could be where France is now heading. Though, worryingly for France, when it comes to the sustainability of debt accumulation, the similarities with Japan may end there.

When looking at an over-indebted borrower the most important questions should always be 'Who owns the debt?' and 'Will the owner prove patient or fickle?' For example, a family in which a father lends money to his children, will, on a consolidated basis, have no debt. Applying this analogy to Japan, it seems that Japanese savers prefer to buy bonds rather than pay taxes (government debt is nothing but deferred taxes). As a result, 92% of outstanding Japanese Government Bonds are owned by the Japanese themselves. Thus, in a pinch, Japan could choose to convert its repayable debt into perpetual bonds yielding, say, 1%. Even better, it could transform its debt into pieces of paper called banknotes, which are really perpetual debt yielding 0% (perhaps this is what Japan is already doing?). Another option would be for Japan to impose inheritance taxes of 80%, and very quickly the government debt would melt away…

Of course, such solutions are not consequence free. Financing governments through debt rather than a functioning tax system tends to be debilitating for economic growth. Over time it favors the rentier above the entrepreneur (since the only way to find buyers for the new debt is for its yield to be higher than the growth rate of corporate profits). As Knut Wicksell conclusively

Checking The Boxes
Our short take on the latest news

Fact	Consensus belief	GK Research reaction
In Jackson Hole, Yellen's tone unchanged; assessment on labor market fairly balanced	No major departure from the stated Fed strategy; 10y UST yield and USD rose on news	We see sustainable job market recovery; but no bond vigilante to challenge Fed strategy
Canada CPI rose 2.1% Year-over-Year in July, from 2.4% in June**; core CPI rose 1.7%,** from 1.8%	Both are lower than expected 2.2% and 1.9% respectively	Weak inflation data allows the Bank of Canada to keep its neutral tone on policies
European Central Bank's Draghi said inflation expectations have worsened; ready to add fresh stimulus	Unexpectedly called for more fiscal stimulus but still within terms of Fiscal Compact	Favors weaker euro; but quantitative easing & fiscal easing opposed by Berlin; so how long will the wait be?

showed, this pushes the economy into stagnation. Still, Japan has proved that such stagnation is compatible with economic stability. But is the Japanese option open to France?

The other alternative to growing debt levels is the path trodden by Argentina, Russia and Greece in recent decades. What unites these bankrupt issuers is that a majority of their debt was owned by foreign savers. Indeed, when a country accumulates too much debt and begins to find the roll-overs a growing challenge, it really has just two options: the first is a total or partial default; the second is a large currency devaluation. The second choice begs the question 'Who prints the currency in which the debt is labeled?' When a central bank controls and independently prints the currency, then a default is highly unlikely and devaluation a near certainty (which is what is starting to occur in Japan). If the central bank does not control the currency in which the debt is labeled, then the only solution over time is a partial or total default, especially if interest rates are above the nominal growth rate of the economy (debt trap).

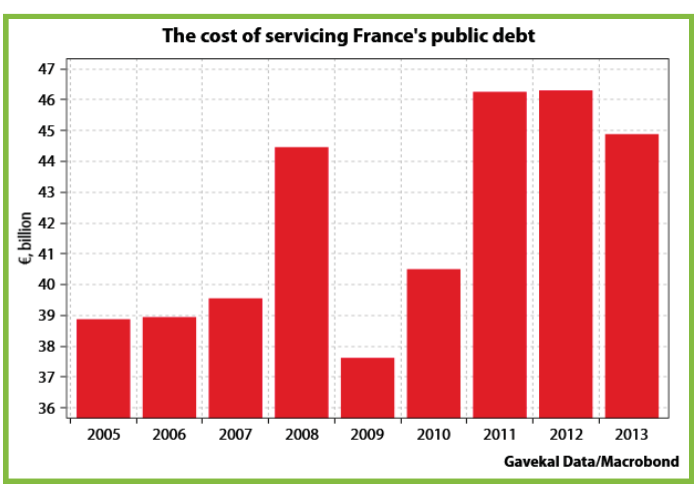
This brings us to Mr. Draghi's speech at Jackson Hole, in which the European Central Bank (ECB) head argued for more fiscal stimulus and more structural reforms before the ECB does more to help out Europe's failing economies. But, at this stage, more fiscal stimulus in countries like France and Italy would likely mean much higher budget deficits and debt levels. Given the roll-over schedule of the next 18 months, those could prove challenging for the bond market to swallow, unless, of course, the ECB is willing to embark on the same kind of exchange program that the BoJ has embraced in the past 18 months, namely trading 0% interest rate bank notes for government bonds. It is a kind of Catch 22: the ECB wants to see more reform before turning on its printing press; however, reforms without growth are particularly tough to deliver. Incidentally, this was the pattern in Japan for 15 years or so: the Ministry of Finance (MoF) pointed the finger at the Bank of Japan (BoJ) for not printing enough, and the BoJ pointed the finger at the MoF for the slow pace of reform in the Japanese economy. Replace MoF with Bercy, and BoJ with ECB and very little has been 'lost in translation'.

But as we know, there are key differences between Japan and France; differences which bring us to the following conclusions:

- Investors who believe that the ECB will always step in to prevent French spreads from blowing out should probably conclude that France is now heading down the Japanese path: that of an underperforming economy whose technocratic elite has a growing embedded interest in keeping interest rates low (and thus nominal growth low), lest a spike in rates trigger a funding crisis.

- Investors who believe that the ECB will not always step in to prevent French spreads from blowing out will have to conclude that a potential debt restructuring lies in France's future. However, this restructuring is unlikely to happen until the ECB decides to let France go. And the ECB won't let France go until conditions in Germany (most likely higher inflation) force the ECB's hand. Hence, this scenario is not a near term concern.

Very clearly, with French Government Bonds (OAT) yields at record lows, and the euro gapping down, the market is acknowledging these conclusions. Nothing Mr Draghi said in his Jackson Hole speech changed this reality. At this stage, the path of least resistance is for the eurozone, and especially France, to continue disappointing economically, for the euro to weaken, and for Europe to remain a source of, rather than a destination for, international capital.



Test Your Knowledge

Which international air route carried the most passengers last year?

a) London-New York
b) Hong Kong-Taipei
c) London-Dublin

Answer: b) Hong Kong-Taipei. Thanks to Beijing's continued restrictions on cross-straits flights between mainland China and Taiwan, Hong Kong-Taipei retained its status as the world's busiest international air route in 2013, carrying almost 4.9mn passengers, ahead of London-Dublin in second place with 3.6mn and Singapore-Jakarta on 3.4mn. The busiest inter-continental route was London-New York, which flew 2.7mn according to aviation trade body International Air Transport Association. Overall, however, the busiest city to city routes are domestic. They include Seoul-Jeju, Tokyo-Sapporo, Rio deJaneiro-Sao Paulo and Beijing-Shanghai. Find more details here.

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