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talkingpoint



Debt dynamics

Eurozone must either move forward to full fiscal union, or pull back by redrawing its boundaries

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Alan Brown

Group Chief
Investment
Officer

The crisis of confidence over government debt, evidenced on one side of the Atlantic by Standard & Poor's downgrade of the US government to AA+, and on the other by the continuing eurozone crisis threatening to engulf Italy and Spain, has taken a long time coming. Yet at the heart of the problem lies a build up in debt levels in Western countries which goes back decades. So why now? It is always impossible to predict which straw will break the camel's back, or which grain of sand will cause the avalanche. Japan (downgraded to AA- in January, 2011) is still able to borrow at close to 1% while carrying a Debt/GDP level well above 200%.

This article attempts to look in general at the question as to why markets have been so spooked by US and European debt levels even though they are very substantially lower than Japan's. Subsequently, I focus on the special issues affecting the eurozone. There are obvious substantial differences between the US, Europe and Japan, but one common factor lies at the heart of today's market turmoil. Investor fears have been expressed in the equity

markets, not in the currency or debt markets. After all, in spite of government debt concerns, at the time of writing 10-year yields in the US, Germany, Japan and the UK are all at, or near, year-to-date lows.

A brief bit of history

In the 1920s and 1930s we had another fixed exchange rate system, the Gold Standard. The mantra of the day was that countries operated broadly balanced budgets, devaluation was not an option and debt problems were dealt with the old fashioned way, through austerity programs. Sound familiar? In this world wealth transfers from debtor to creditor nations.

In the 1950s and 1960s we had all adopted Keynesian style policies. Fiscal demand management was the order of the day, devaluation was possible and the unsurprising end result was inflation. And in a world of inflation wealth transfers from creditor to debtor countries.

Germany is not only the most powerful country in the eurozone, it is also the largest creditor nation and has a well understood historical abhorrence of inflation. No surprise then that Germany today advocates policies which sound remarkably similar to the 1920s and 1930s.



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A country like Greece is therefore faced with three alternatives:

- Get on top of your Debt/GDP problem by growing the denominator. Trouble is that, with Greece struggling to generate any real GDP growth, this could only happen if somehow Greece generates inflation to boost nominal GDP. Of course doing so would further compound its competitiveness problems that are at the heart of the structural imbalances that lie between Northern and Southern Europe.



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- Alternatively, Greece could attack the numerator by putting in place such a fiscal squeeze that it was able to accelerate repayments of debt. To do that would inevitably put Greece back into recession, shrinking the denominator at the same time and driving the country to insolvency.
- Or finally, Greece could buy enough time from its euro partners that it is able to gradually improve its competitiveness through economic reform and wage restraint; a process which would take at least a decade.

An unpalatable choice then between a temporary fix but further loss of competitiveness, savage fiscal cuts leading to insolvency, or the country gets to stand on the naughty step for a decade. The latter being the only option on the table from Greece's partners, and one which tests the political patience of both the debtors and creditors. The creditors are getting restless at being asked to pick up the bill, and the debtors are literally rioting against the austerity measures being implemented.

Why won't the Greeks take their medicine?

What is not clearly understood is the impact of a fixed nominal exchange rate system during a period of fiscal austerity. We live in a world of double-entry bookkeeping. An improvement in public sector finances has to come at the expense of something else. That 'something else' can only be either the private sector or the external account. There is nothing else. If you are able to drop your nominal exchange rate by say, 25%, as happened to many countries in the Asian crisis of the 1990s, the hope is that much of the offset to an improvement in the public sector will come through the external account via an improvement in the current account.

In the absence of a drop in the exchange rate, the current account is only likely to improve in the short-term as a result of a drop in imports as the domestic economy slips back into recession! In that case, every €1 improvement in the public sector comes at the direct expense of say, 80 cents in the private sector. The mechanism is higher taxes, lower benefits and reduced salaries.

Such a direct reduction in living standards is very painful and therefore tests the will of the electorate much more than an indirect drop in living standards as the exchange rate falls and imports become more expensive. Those of us in the UK at the time that we came out of the exchange rate mechanism (ERM) with a 25% drop in the pound overnight in September 1992 remember that it heralded in fifteen years of low inflationary growth. We have quite forgotten that our Greek holidays had got much more expensive.

Debt arithmetic

Of course it is not just Greece that is of concern; markets have recently turned their attention to Spain and Italy. At first sight, a focus on Italy seems somewhat 'unfair'. After all Italy's primary budget is in surplus. Their deficit arises mainly from debt service costs. Even then the aggregate deficit is materially less than in the UK. Granted the stock of debt is high at around 120% of GDP, but the maturity profile is long and much of the debt is held domestically. So what's the fuss about? Italy's nominal GDP growth rate has been and is expected to be relatively low at say 3-3.5% p.a. Italy too has lost a lot of competitiveness; over 30% against Germany since 2000. With low nominal GDP growth, Italy is quite sensitive to the rate that it pays on its debt. If Debt/GDP is to be stable or better still, declining, Italy needs to ensure that the growth rate of its debt is less than or equal to growth in nominal GDP.

Growth in nominal GDP, $G_n = (1 + Gr) \times (1 + i)$
Or $\sim Gr + i$ where Gr = Real GDP growth and i = inflation

Growth in Debt, $G_d = Pb + Debt/GDP \times Fr$
Where Pb = primary balance as % of GDP and $Debt/GDP \times Fr$ = Debt service cost and Fr = Funding rate

And so for stable/declining Debt/GDP

$Pb + Debt/GDP \times Fr \leq Gr + i$
If $Pb = 1.9\%$, $G_n = 3.1\%$, $Debt/GDP = 120\%$, then
 $Fr \leq 4.2\%$ (as opposed to 5.7% for Germany and -0.2% for Greece)!

Hence market concerns that if Italian bond yields stayed in the 6-7% territory for a long period of time, Italy's Debt /GDP could start to climb further and, in the limit, could drive the country to insolvency.

Italy has announced that they will bring forward measures to reduce their budget deficit more quickly which will involve generating a larger primary budget surplus. The country should also bring forward structural reform to help increase competitiveness and boost nominal GDP growth. With assistance from the European Central Bank (ECB) to keep a lid

on Italian bond yields, there is then no reason why Italy's debt problems should not be manageable. However, the ECB's role (or European Financial Stability Facility (EFSF)) is critical here as Italy needs time to balance its budget and introduce supply-side structural reforms.

The table below provides the data for a sample of countries drawn from European Commission forecasts for 2012 (except where stated). No doubt these forecasts would be revised down if they were updated today. Note that for funding rates I have used current 10-year government bond yields. Government bond yields are not indicative of current aggregate funding costs, but they do indicate the direction of where funding costs might go if yields remained at current levels for an extended period of time. The reader is invited to play with the data as they see fit.

It should be immediately obvious that Greece's position would be completely unsustainable if Greece had to rely on public market access for funding for any length of time.

Although this model is insightful, I don't pretend that it tells the whole story. For example, arguably the reason why Japan continues to borrow at such low rates while carrying such high debts is because first, the country has a structural current account surplus so that it acquires offsetting assets at the same time as it issues debt. In other words, we need to see the whole balance sheet. Second, Japan has historically had a high domestic savings rate so that it ended up selling most of its debt to its own citizens. Note that neither the US nor the UK have current account surpluses or high savings rates!

2012 Forecast %	GDP Deflator	GDP Growth	Primary Balance	Debt/GDP	10 Year Bond Yield*
United States	1.5	2.7	-5.7	107.0 ⁺	2.20
Japan	0.2	1.6	-7.1	218.7 ⁺	1.05
UK	2.1	2.1	-3.6	87.9	2.50
Germany	1.5	1.9	+1.2	81.1	2.25
France	1.8	2.0	-2.4	86.8	3.05
Italy	1.8	1.3	+1.9	119.8	5.10
Spain	1.1	1.5	-2.9	71.0	5.00
Portugal	1.2	-1.8	+0.3	107.4	10.10
Ireland	0.9	1.9	-4.2	117.9	9.45
Greece	0.4	1.1	-1.8	166.1	15.00

* Source: Factset, Bloomberg 11th August, 2011

+ Source: OECD

Debt/GDP = General government gross debt, % of GDP

Primary balance = General government, % of GDP

The opinions stated include some forecasted views. We believe that we are basing our expectations and beliefs on reasonable assumptions within the bounds of what we currently know. However, there is no guarantee that any forecasts or opinions will be realized.

The ECB and the EFSF

Given the importance of the ECB and the EFSF in ensuring that markets don't create their own reality, it is important to understand their institutional limits. The EFSF is not a central bank and so cannot create money it does not have. The big question mark therefore is whether it has sufficient resources. Most commentators, and we agree, argue that if the EFSF is to provide an adequate firewall to protect Italy and Spain, it will need much more than the €440 billion it has at its disposal today. Estimates range from €1 trillion to as high as €3 trillion. And before the EFSF can get started with direct interventions in the bond markets, it needs to receive ratification from all 17 eurozone member countries.

Now a central bank can, in theory, create money without limit. However, unless intervention is sterilized, printing money ultimately has serious adverse consequences for inflation, an anathema to the ECB and, of course, to the Bundesbank. In the case of the ECB, there are further political constraints. While the ECB can create money, it can not create capital. The ECB gets its capital from the central banks of the entire EU. However, the 10 non-euro area central banks have only paid up a nominal amount. The 17 eurozone member countries account for about 98% of paid up capital. Germany and France account for about 46% between the two of them.

The ECB then needs the support of its member central banks in order to operate. The ECB has in one sense more independence than any other central bank on the planet in that no country has sovereignty over it, but it still cannot operate without constraints. Not that the ECB shows any signs of running amuck. Indeed it is fair to say that the ECB does a passing impression of a reluctant bride, resisting until the very last minute. Yet resistance is also growing amongst the creditor countries. In the elections in April the True Finns party garnered 19% of the vote just behind the conservative NCP and the Social Democrats. The German Constitutional Court is currently hearing a case challenging the legality of the first Greek bailout in 2010. While no-one expects that it will succeed, Angela Merkel's room for maneuver is wafer thin if she is to hold her coalition together.

Forwards or backwards, that is the question?

We have always said that monetary union without fiscal union leaves the eurozone vulnerable to exogenous shocks. It is interesting to see what hoops the politicians have had to jump through to provide support for peripheral countries. The German constitutional case may have little chance of succeeding, but it alleges that the first bailout of Greece was in breach of the no bailout clause in the Lisbon Treaty (Article 25), was contrary to the German constitution's protection of property (Article 14) and breached the right of democratic representation embodied in Articles 20 and 28 of the German Constitution. Commenting on the first Greek bailout, Christine Lagarde, then France's finance minister, said 'we have violated all rules of law because we agreed that we really wanted to save the eurozone'.

It increasingly appears that the eurozone must either move forward to something approaching full fiscal union, or pull back by redrawing the boundaries of the eurozone to encompass only a hardcore of countries close (in every sense of the word) to Germany. Remember Sherlock Holmes, 'When you have eliminated the impossible, whatever remains, however improbable, must be the truth'. I will leave the reader to make up their own mind as to which is the 'truth'. However, staying where we are today really does seem to be an outcome we should eliminate.

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Politicians protest that it is unthinkable to consider a change to the euro, but then they would wouldn't they. Imagine if they didn't say that! It will be known to many that I regard a move to political union as far less likely than a change in the make up of the euro, a topic I have written on before.

Conclusion

Equity markets have recently been in a tailspin while 10-year US bond yields have sunk to just 2.2% in the same week as the US was downgraded. Meanwhile, the ECB has had to do what was once unthinkable, intervene directly to buy Italian and Spanish bonds. I cannot think of another occasion when a central bank has tried to control both ends of the yield curve! These are truly extraordinary times. Underlying these market moves has been a raft of poor economic news. While we still believe double-dip can be avoided, concerns are clearly rising. Why else would the Fed limit their own room for maneuver, committing themselves to keeping interest rates low until the middle of 2013? Even if we are right and we avoid double-dip, growth will at best be anemic in the West, quite likely for a number of years. This makes adjustment through prolonged austerity programs a lot harder. There is every likelihood that the eurozone will repeatedly be back on the front pages until we ultimately find out whether it is going to move forward or backwards. To hang together, the euro needs two necessary conditions to be met: First, the political will of both debtor and creditor nations needs to stay firm (watch out around election times). Second, markets must not end up creating their own reality, something they have got perilously close to already. As I have said before, this tragedy (or pantomime) has many more acts to go. Stay tuned.

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875 Third Ave – 22nd Floor, New York, NY 10022
(212) 641-3800