How The World Works

by Charles Gave

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Today's Challenge

- We seem to be back to the 1960s when the prevalent belief was that if the private sector increases its savings, then the government needs to increase its spending in order to compensate. A main component of this thinking is that an individual's spending is likely to rise only if his income also goes up. This is an enormous fallacy.

- Indeed, growth in any economy is either a function of the increase in the number of people, a smarter utilization of resources (Ricardian growth), or human inventiveness (Schumpeter's 'creative destruction'). Or to put it another way, **growth is the result of either demographic expansion, rising labor productivity or increases in capital productivity**.

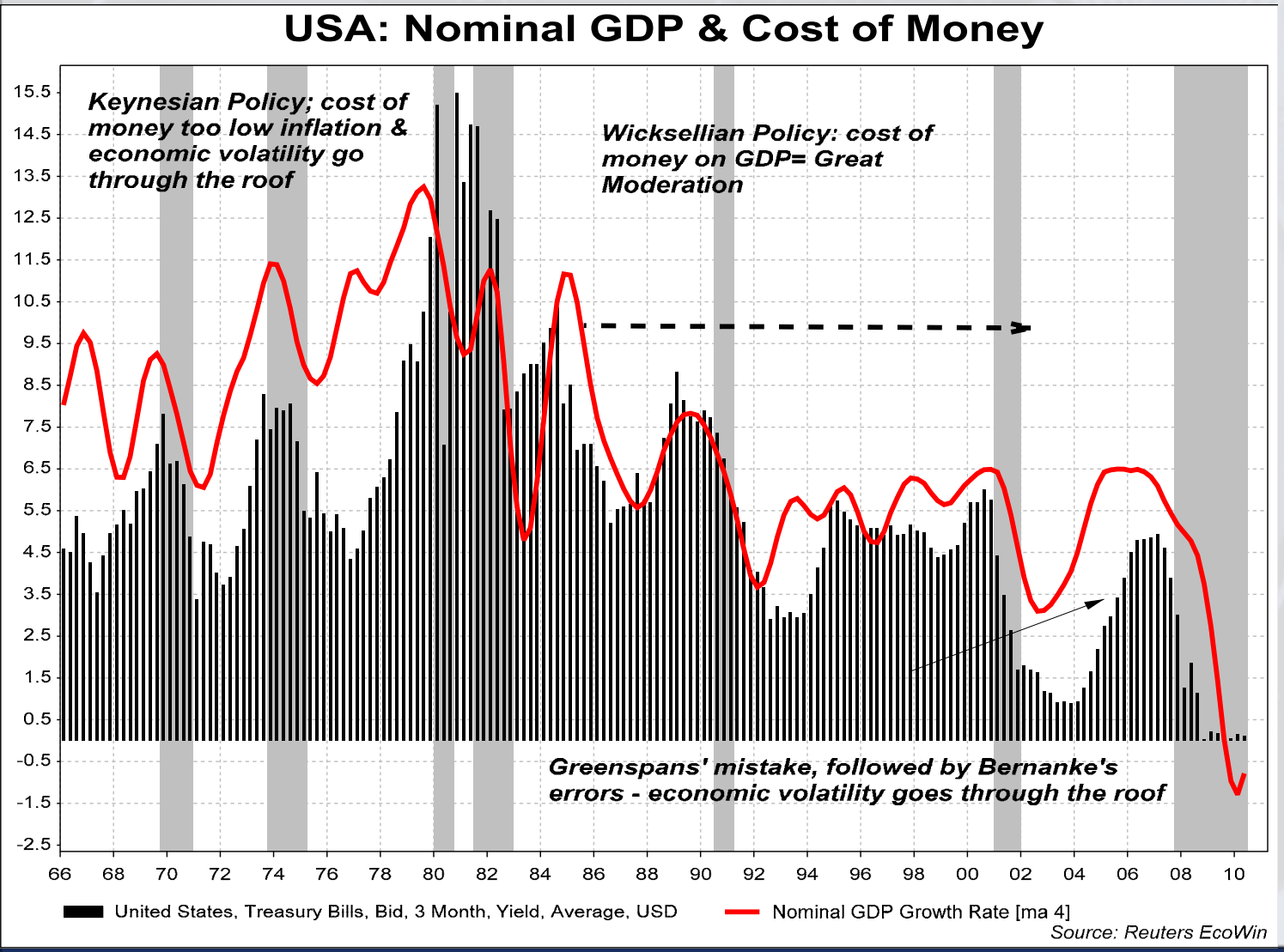
- Now government spending can sometimes boost Ricardian growth – if the spending goes towards productive infrastructure spending (see *The Bullish Growth in China's Road Infrastructure*). But if it goes towards social spending (as has been the case in most OECD countries), there is no creation, no destruction, and hence no growth.

- Unfortunately, this simple reality has not prevented an explosion of government debt everywhere. And as investors in most developed nations have to confront monetary and fiscal policies of a kind the world has never seen before (zero interest rates, unprecedented budget deficits…), **the sustainability of the current path is increasingly the single biggest question we have to address when meeting with clients.**

- We thus thought that we would summarize our thinking on what has clearly become the single most important structural issue confronting investors, namely how helpful, and how sustainable are the current trends in government spending?

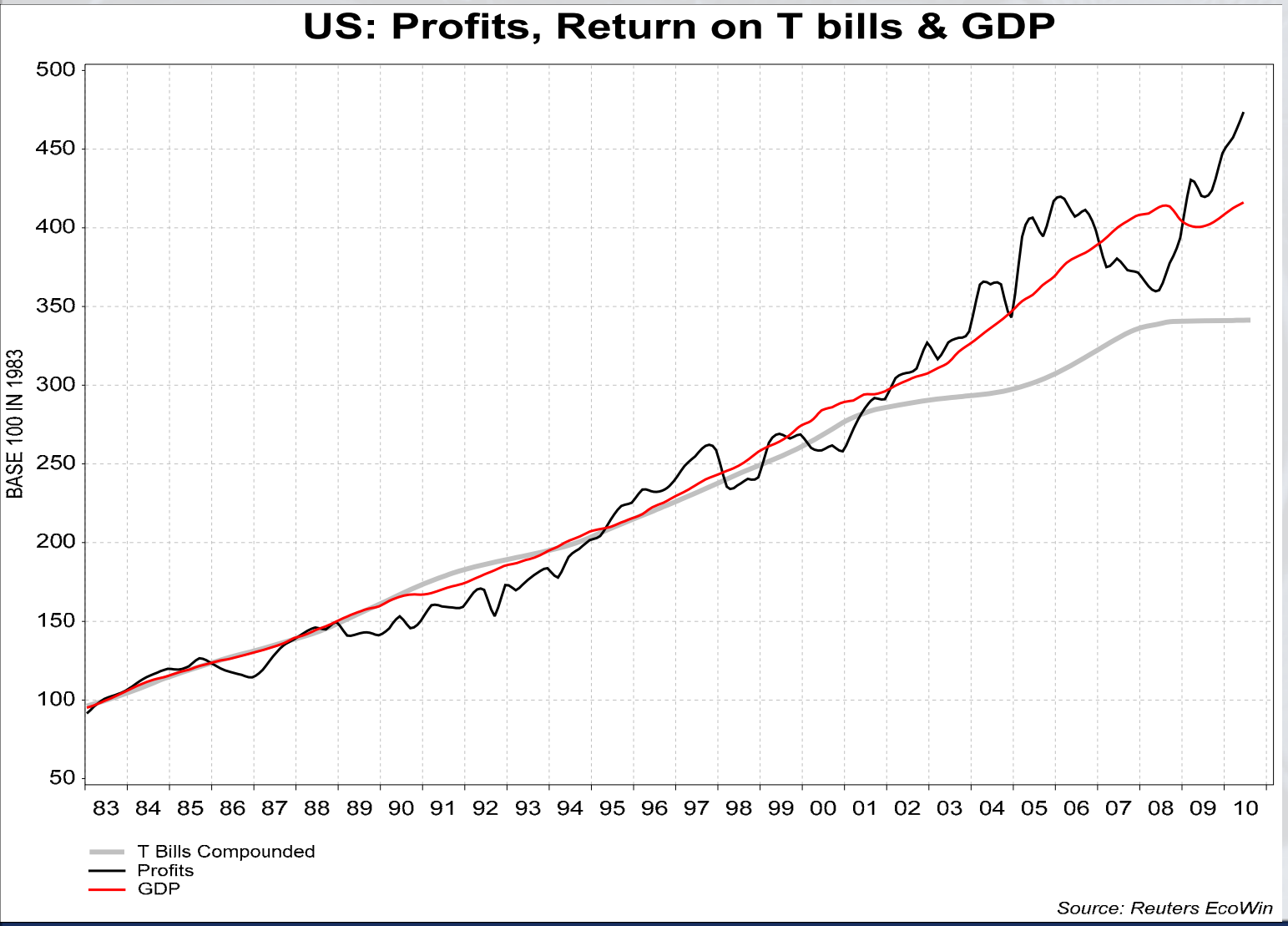
1- Wicksell & Monetary Policy

A Wicksellian View of the World



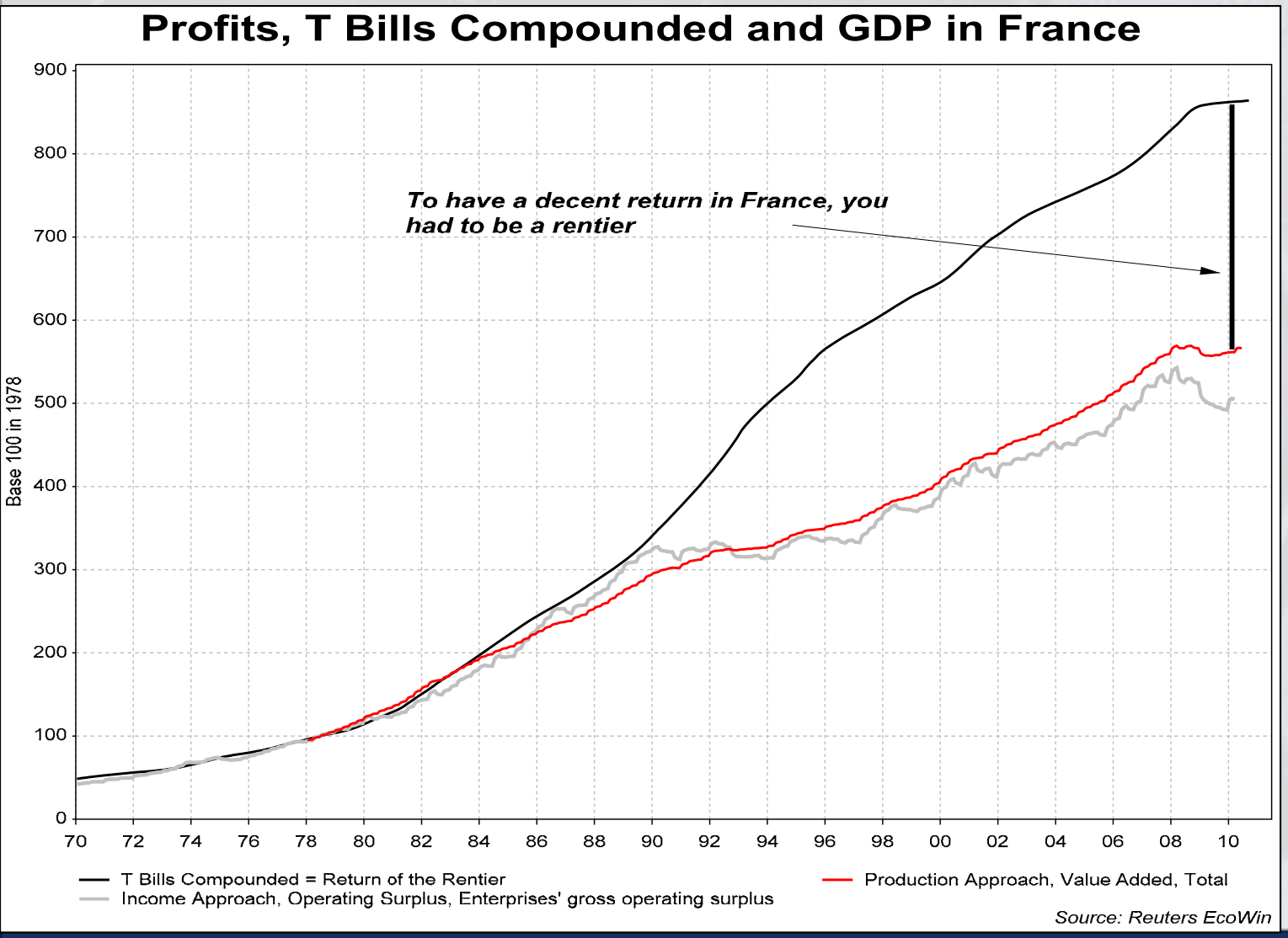
- When properly managed, interest rates should fluctuate around the structural growth rate (demographic growth + productivity gains) of an economy.
- If the difference between the structural growth rate and the interest rates gets too large, we should expect either a boom, or a bust.
- In our career, we have found that the Buba will typically err on the side of having interest rates too high, while the Fed will err on the side of low interest rates.

Favouring the Rentier or the Entrepreneur?



- To some extent, the Fed bias towards lower interest rates protects the entrepreneurs and penalizes the rentier.
- In the US, over the very long-term, entrepreneurs (profits) tend to make slightly more than employees (GDP) which make more money than the rentiers (T-bills compounded).

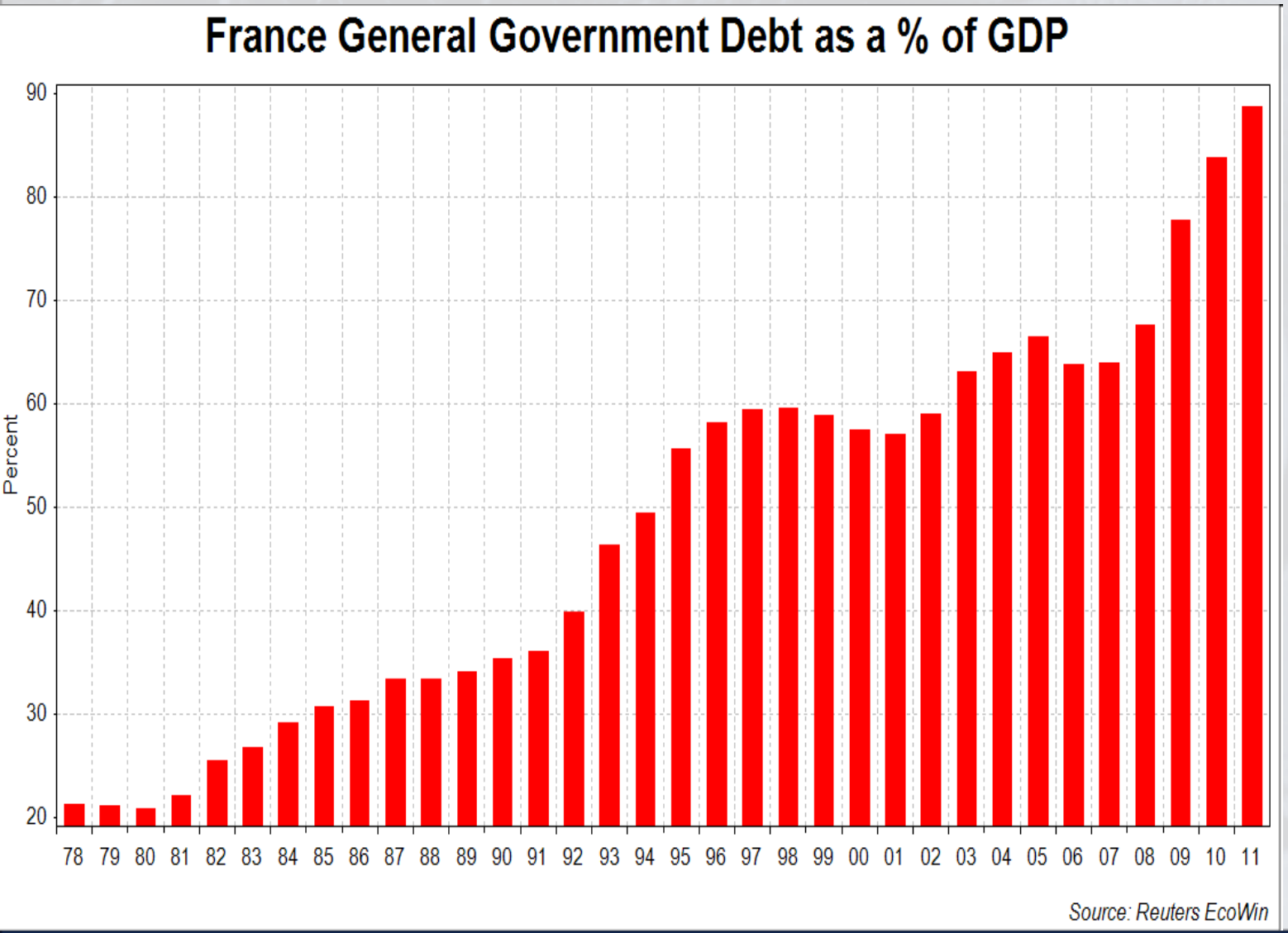
A Very Different Situation in Europe



- In a country like France, the situation has been completely different. To accumulate wealth, being a rentier was better than being an employee or an entrepreneur.
- Needless to say, one of the easiest ways of becoming a rentier has been to join the civil service.
- The problem with constantly favoring the rentier is that it kills growth, and can thus lead to an explosion in government debt.

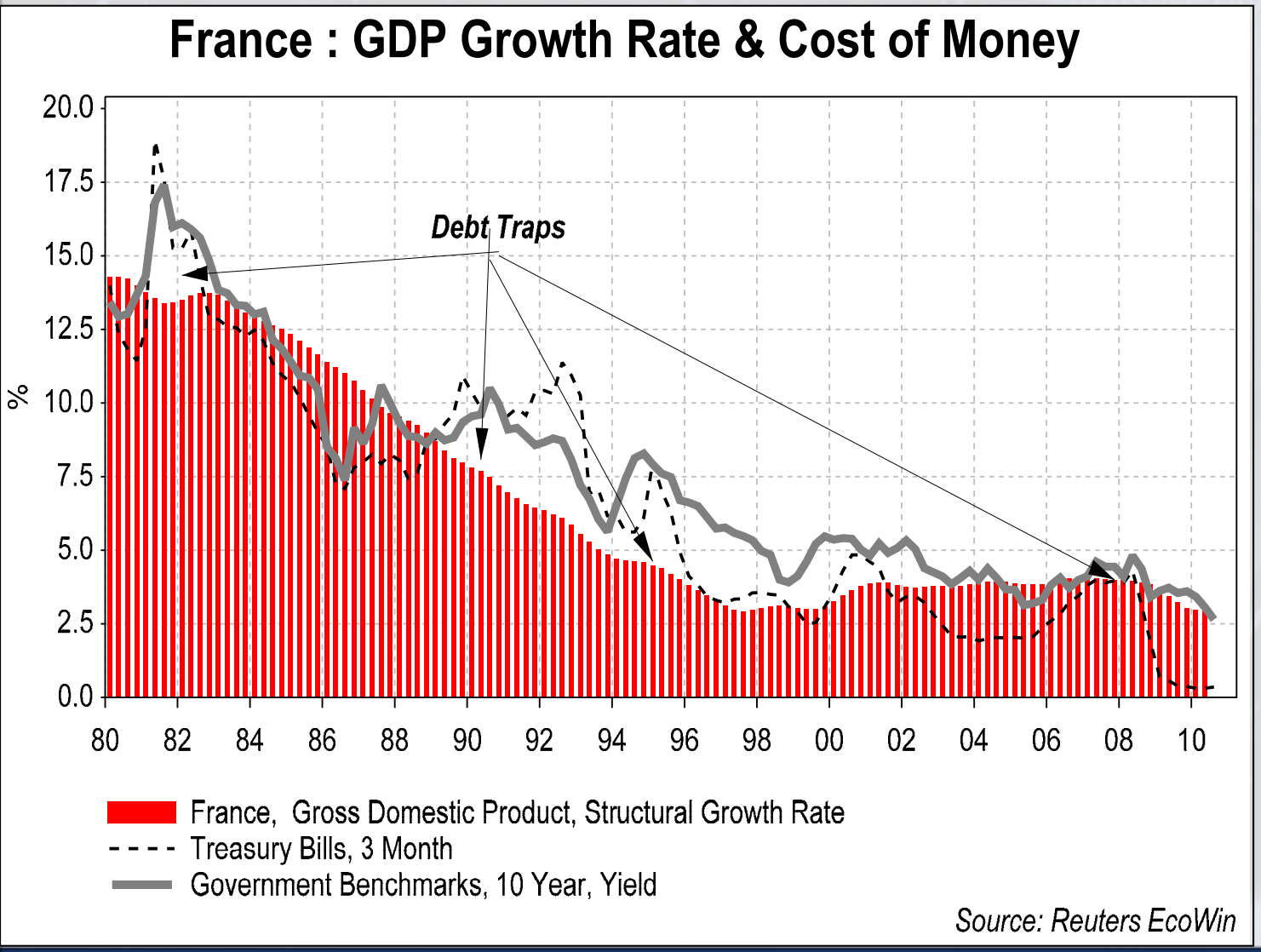
2- The Growth in Debt: France As An Example

A Rapid Increase in Debt



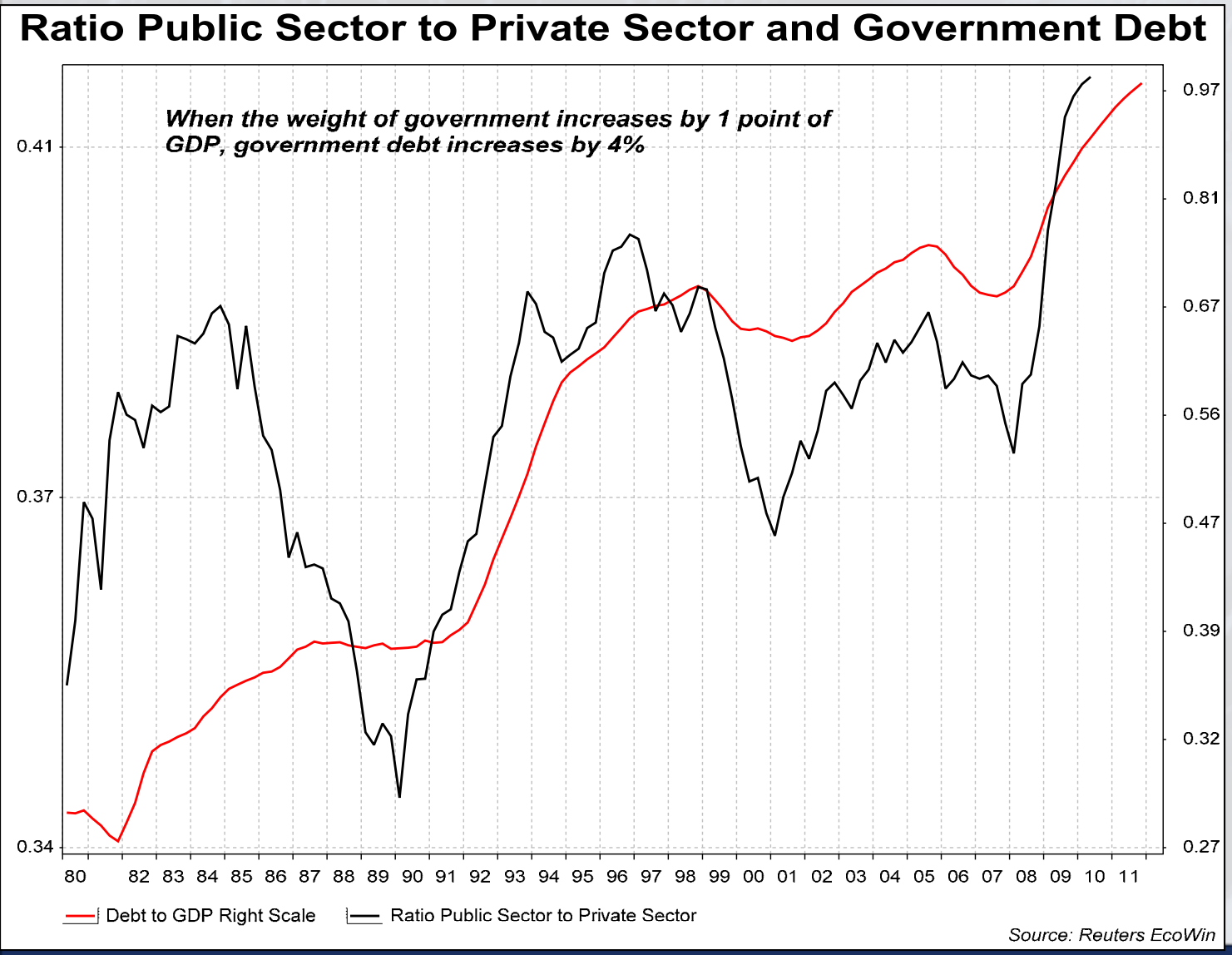
- In the past two decades, the outstanding French government debt as a % of GDP has basically tripled (without accounting for off-the-book liabilities linked to pensions, social security etc…).
- How did this occur?

Reason #1: An Inappropriate Monetary Policy



- For almost twenty years, short rates were maintained above the growth rate of the French economy. And this for a very simple reason: the goal was not to find the optimum level of interest rates. The goal was to maintain the parity with the DM.
- Unfortunately, as France embarked on its policy, Germany was hit by a massive exogenous shock (reunification).
- With interest rates basically above the structural growth rate of the French economy between 1983 to 2003, the French economy could not boom, leading to the divergence in returns between rentiers and entrepreneurs reviewed above.

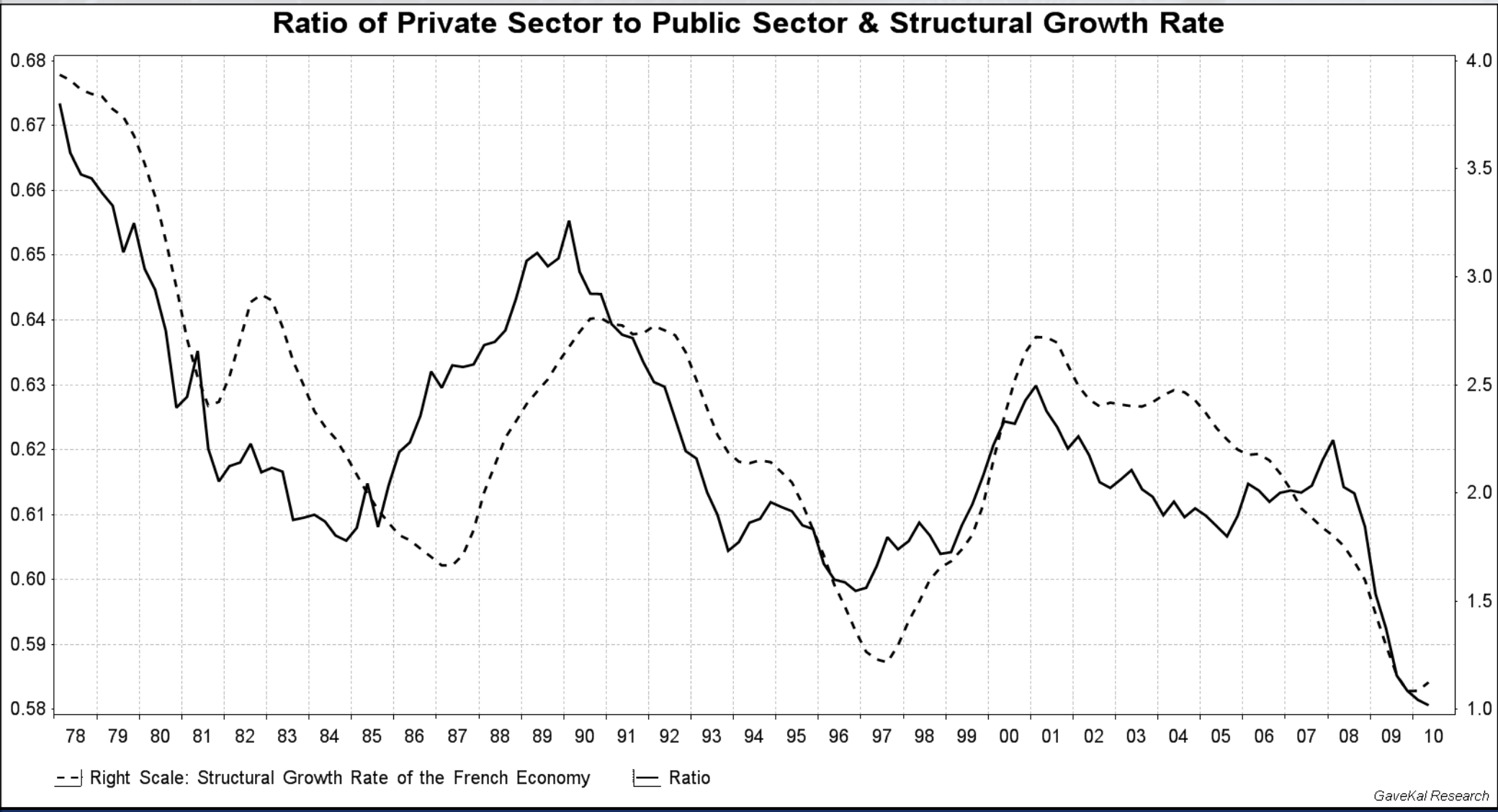
Reason #2: Turning to the State as a Saviour



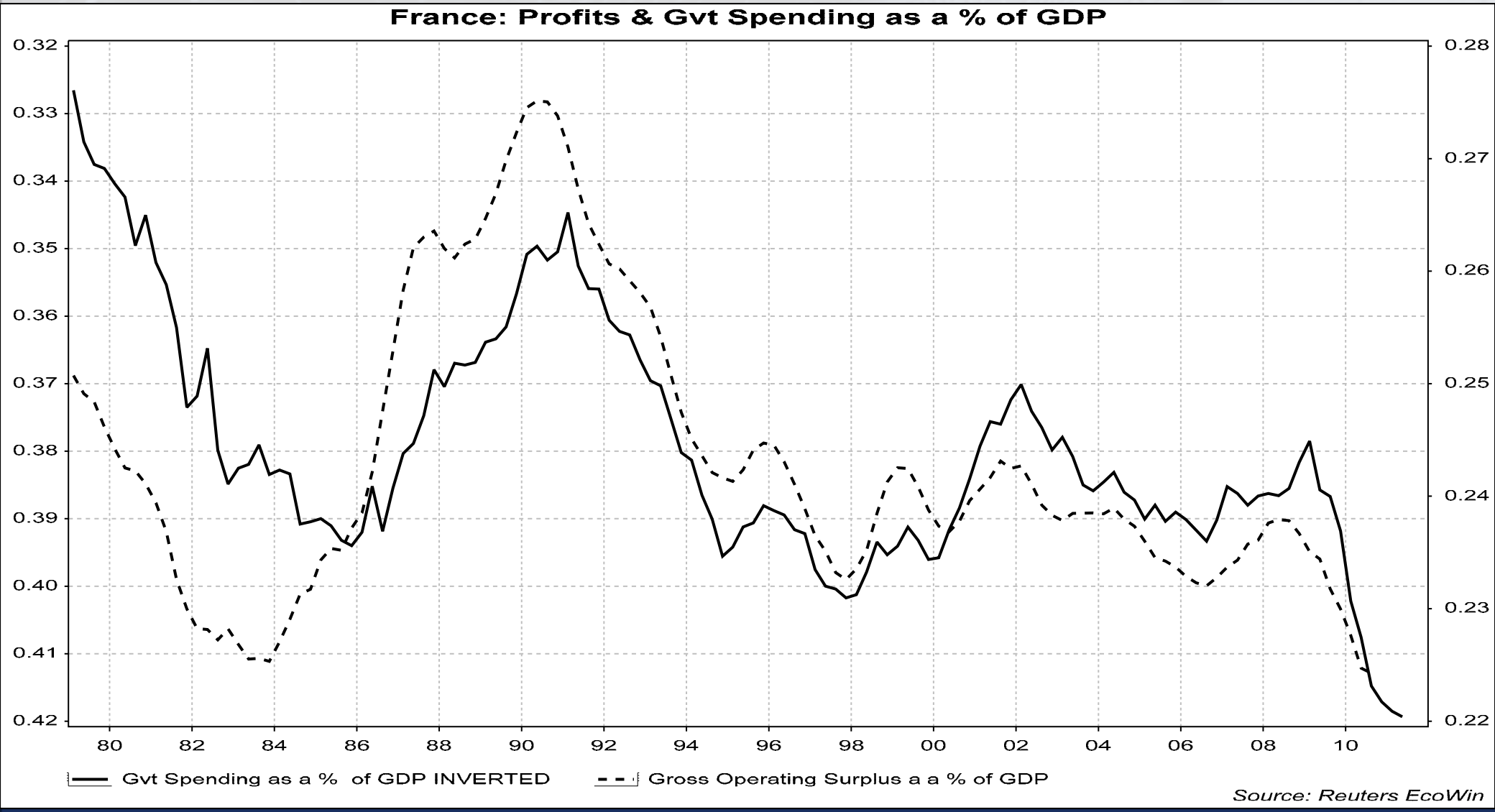
- A rise in Gvt spending as a % of GDP can be created either by a) a conscious political decision (France in 1981, US today?), b) an exogenous shock (oil shocks of 1973 or 1979) and the kicking in of automatic stabilizers or c) because of a monetary policy mistake (short rates maintained too high for too long).

- In France's case, the decline in the growth rate was most probably a combination of a culturally strong belief in the ability of the State to solve problems, aggravated by the monetary policy followed from 1983 to 2003 (twenty years), which left short rates far above their Wicksellian equilibrium.

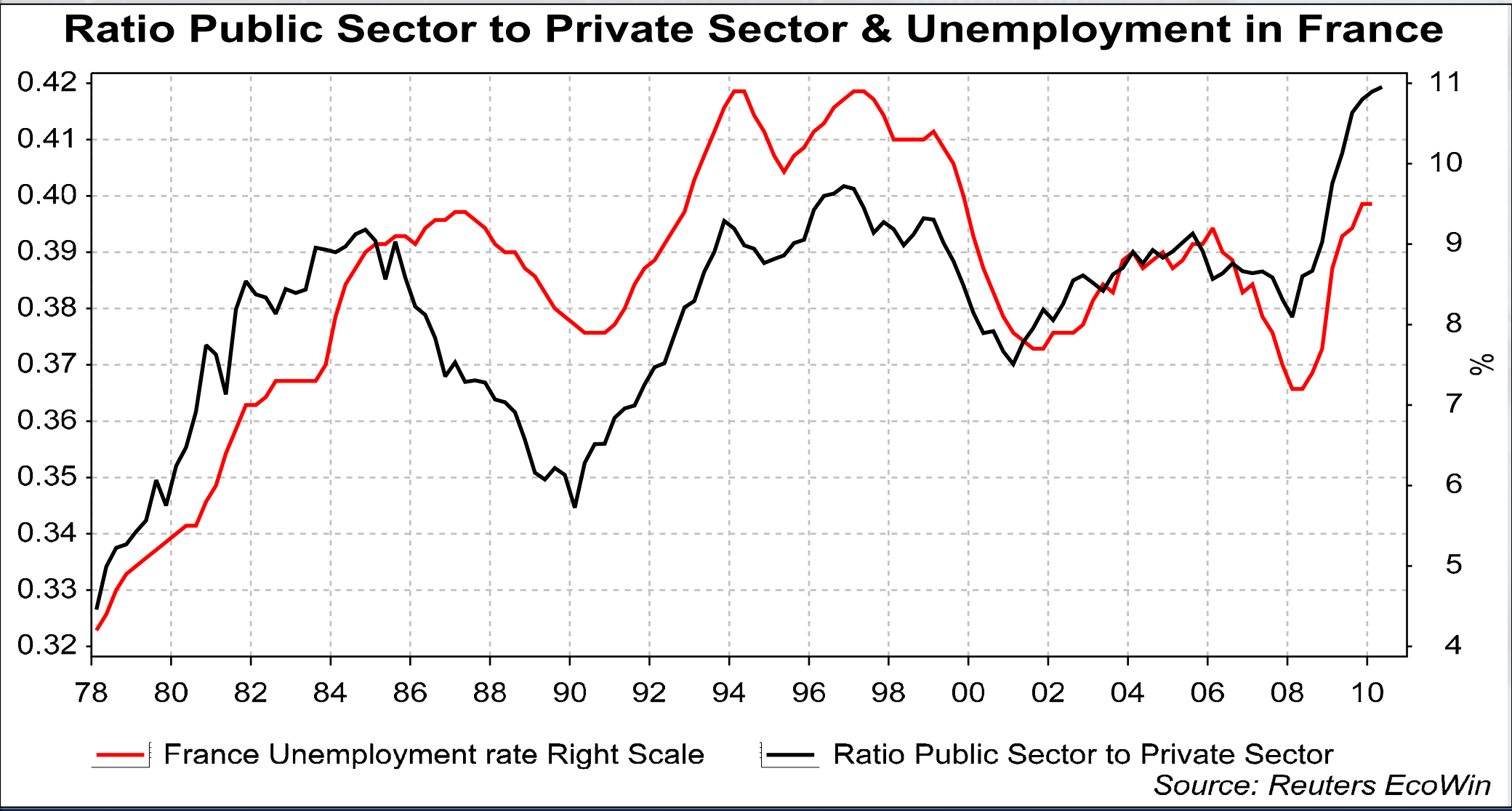
The Bad News is That Bigger Government Leads to Lower Growth



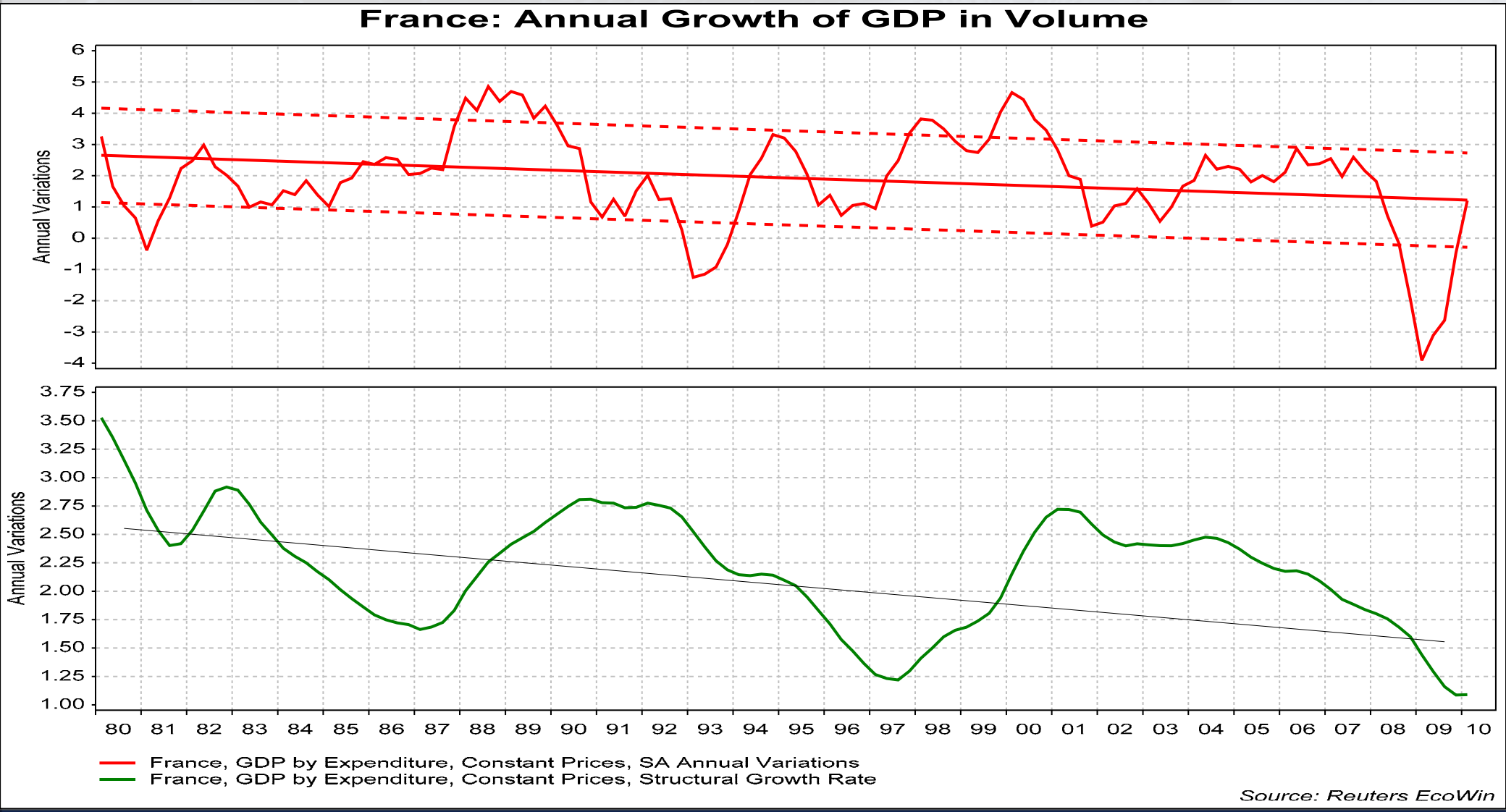
Which in Turn Leads to Lower Profits



And Lower Profits Mean Fewer Jobs…

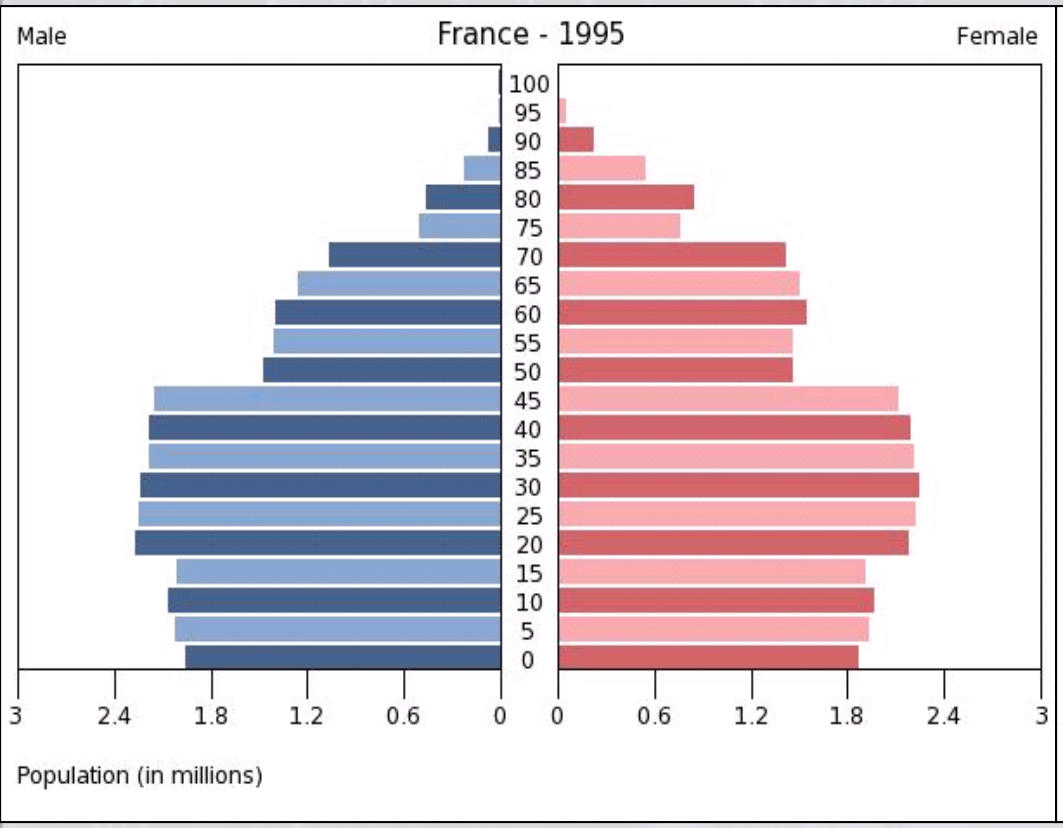


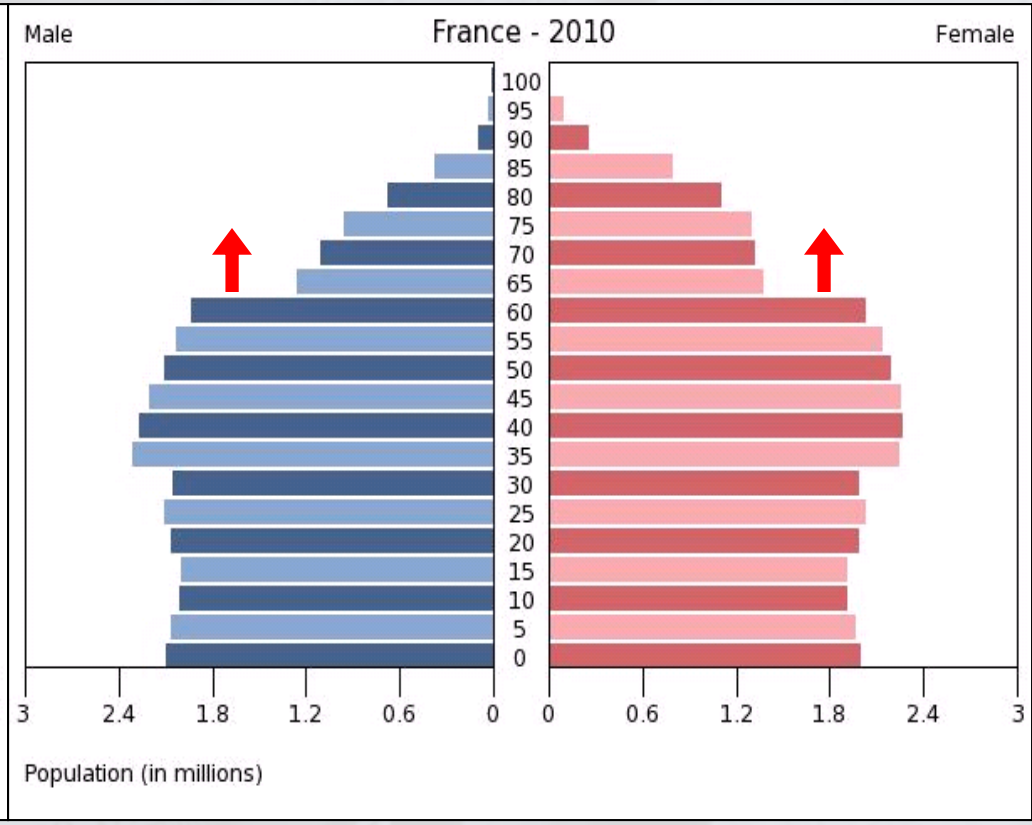
The Proof is in the Pudding: A Growth Decline of -0.5% a Decade



Source: Reuters EcoWin

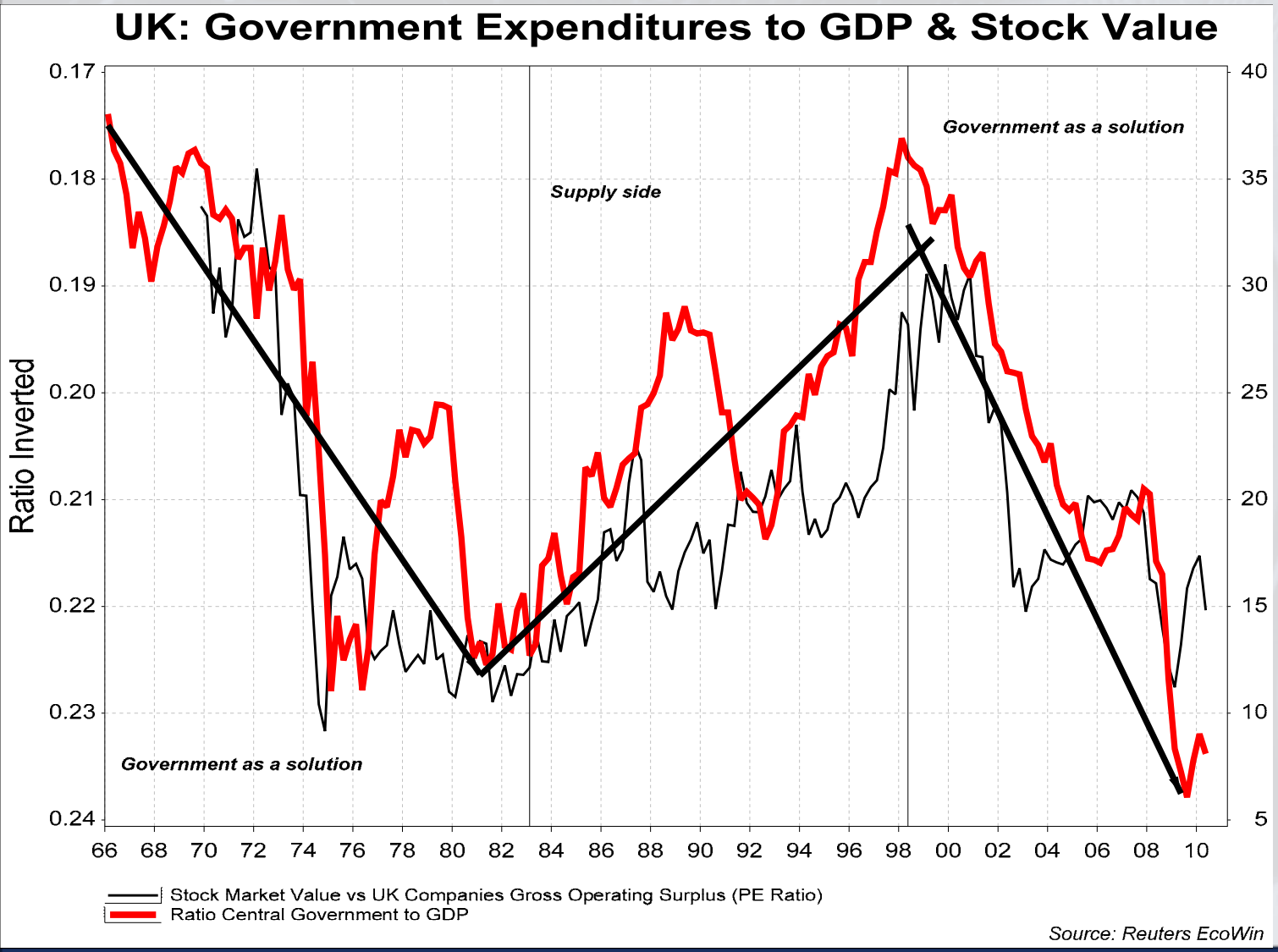
And the Decline is Not About Demographics





- In the past 15 years, the French population has grown by some 5mn people and the labor force has not shrunk.
- This means that the decline in the French structural growth rate has everything to with productivity.
- Alarmingly, a more challenging demographic situation lie ahead as the baby boomers retire.

A Negative Secondary Effect



- It seems that as the overall weight of government in the economy increases, the average growth for the economy falls over time.
- But that is not all. If we assume that that an increase in government debt renders the overall system more fragile, then we should probably expect the combination of lower growth and increased macro-fragility to impact asset valuations?
- And sure enough, contrasting changes in PE ratios with changes in government debt, one finds a decent correlation.

Why the Arithmetic View of Economics Dooms the System

- If an increase in government spending triggers a structural decline in asset prices, then we should expect the private sector to feel more impoverished and strive to rebuild its savings. In turn this triggers a fall in private consumption, etc.

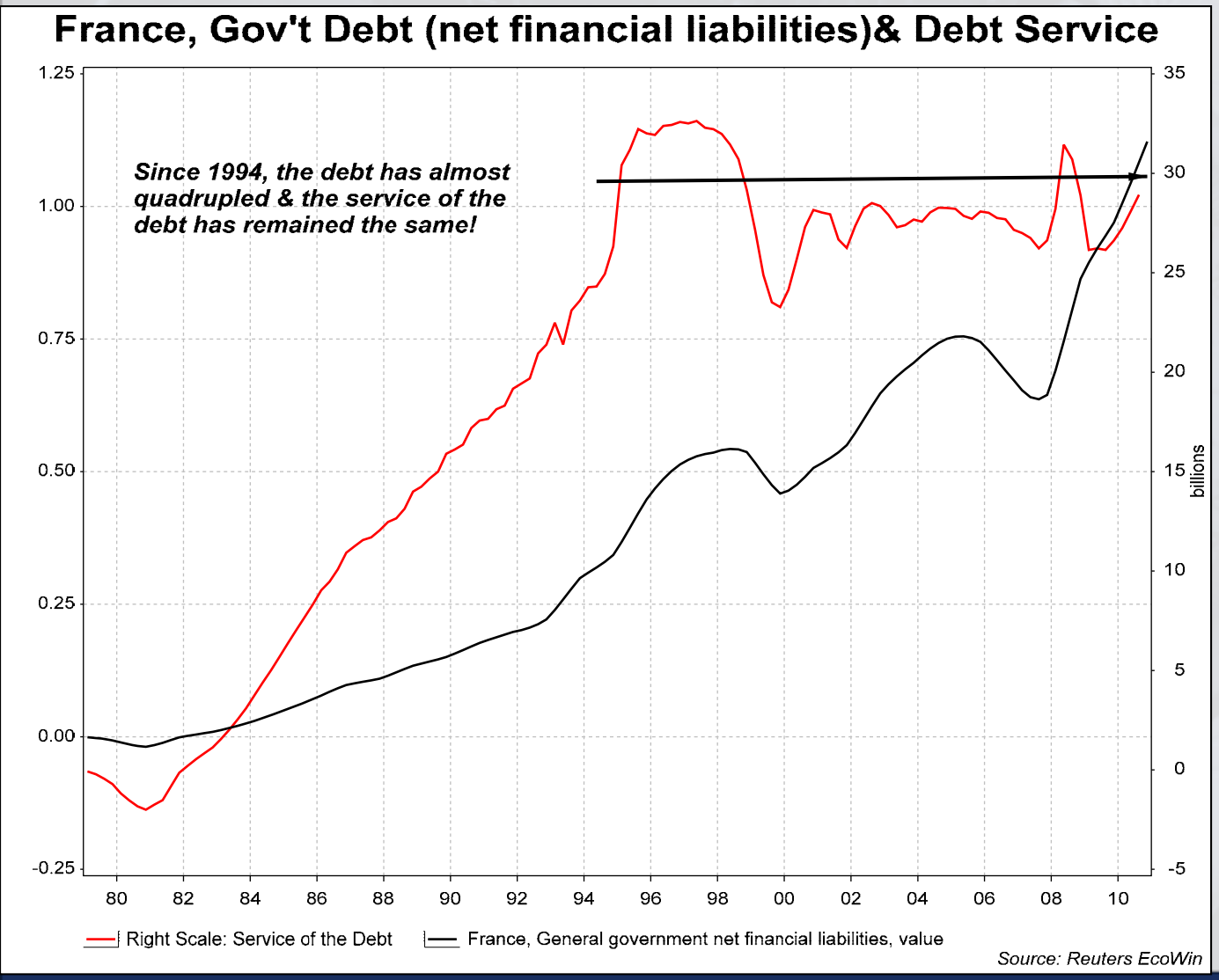
- This is the law of unintended consequences at work: if an individual receives US$100 from the government, and at the same time the value of his portfolio/house falls by US$500, what is the individual likely to do? Spend the US$100 or save it to compensate for the capital loss he has just had to endure and perhaps reduce his consumption even further?

- The only way that one can expect Keynesian policies to break the 'paradox of thrift' is to make the bet that people are foolish, and that **they will disregard the deterioration in their balance sheets and simply look at the improvements in their income statements**.

- This seems unlikely. Worse yet, even if individuals are foolish enough to disregard their balance sheets, banks surely won't; policies that push asset prices lower are bound to lead to further contractions in bank lending. This is why "stimulating consumption" in the middle of a balance sheet recession (as Japan has tried to do for two decades) is worse than useless, **it is detrimental to a recovery**.

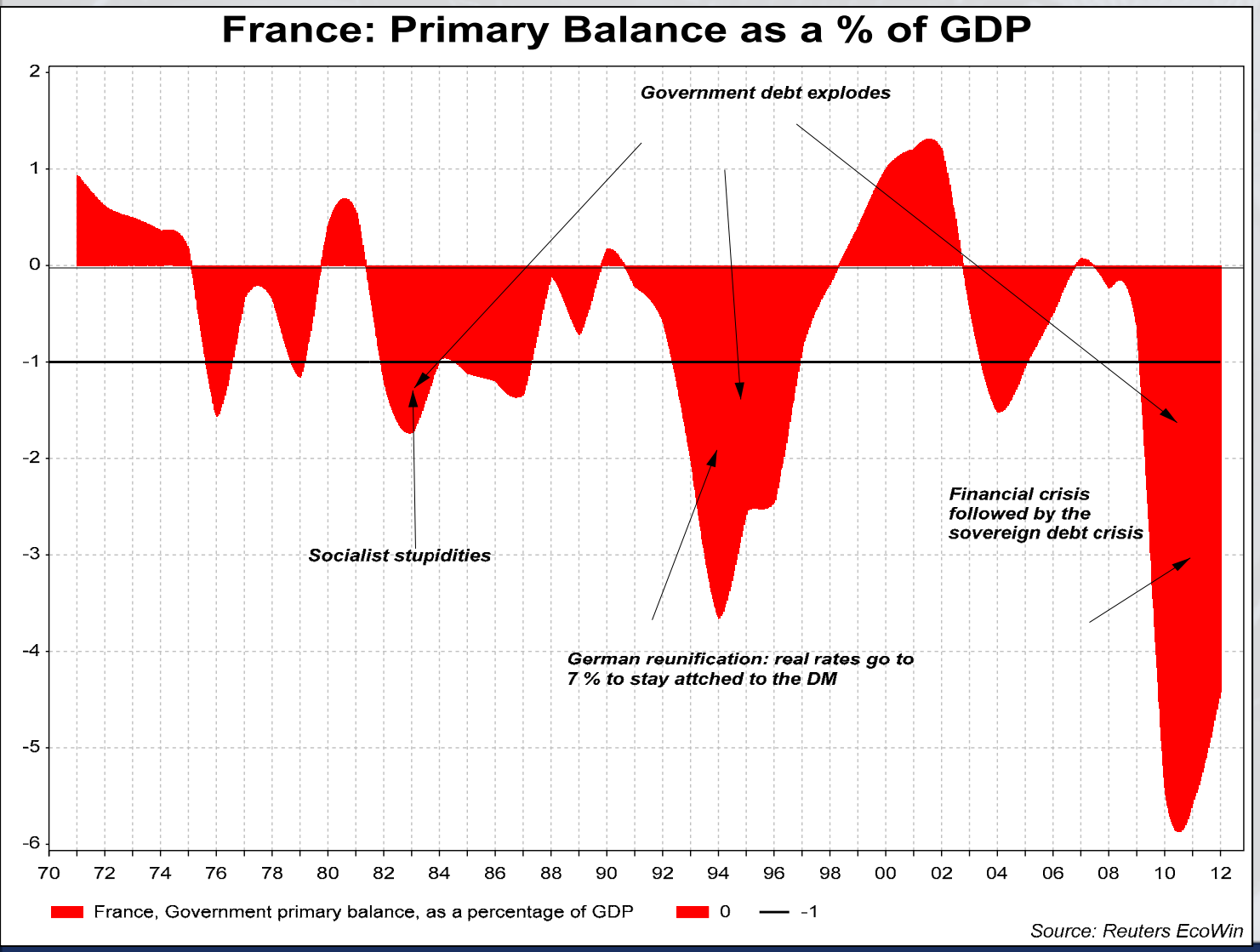
- With fragile balance sheets the main issue in most markets today, the last thing OECD governments should want to do is to boost income statement at the expense of balance sheets. This probably explains why, the more the US administration talks about a second stimulus bill, the weaker US retail sales, US housing and the US$ are likely to be. It probably also helps explain why US retail investor confidence today stands at a record low?

But Why Aren't Bond Vigilantes Disciplining Governments?



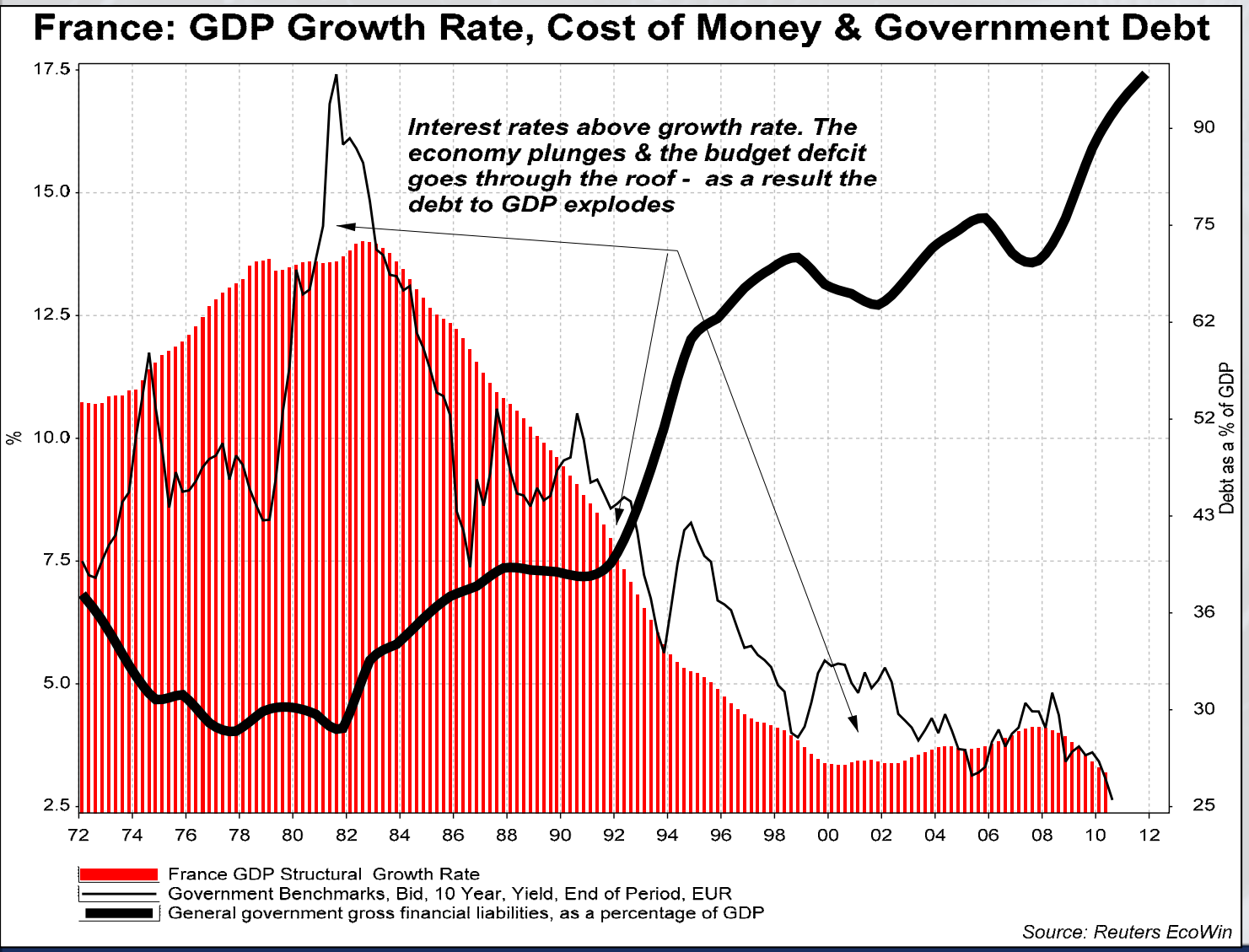
- Superficially, one would expect the increase in government debt to lead to higher interest rates. After all, with a higher demand for money, why shouldn't its price rise?
- Unfortunately, the logic of this reasoning is about as sound as the (French) idea that to reduce unemployment, one should reduce working hours.
- In the real world, interest rates follow the structural growth rate of the economy lower. At least, as long as the structural growth rate of the economy is positive in nominal terms.
- In fact, we may even see interest rates decline faster than the economy's structural growth rate. And as a result, the cost of servicing the debt goes down; which then allows for more borrowing to happen at no visible budgetary cost.

This May Not Last Forever



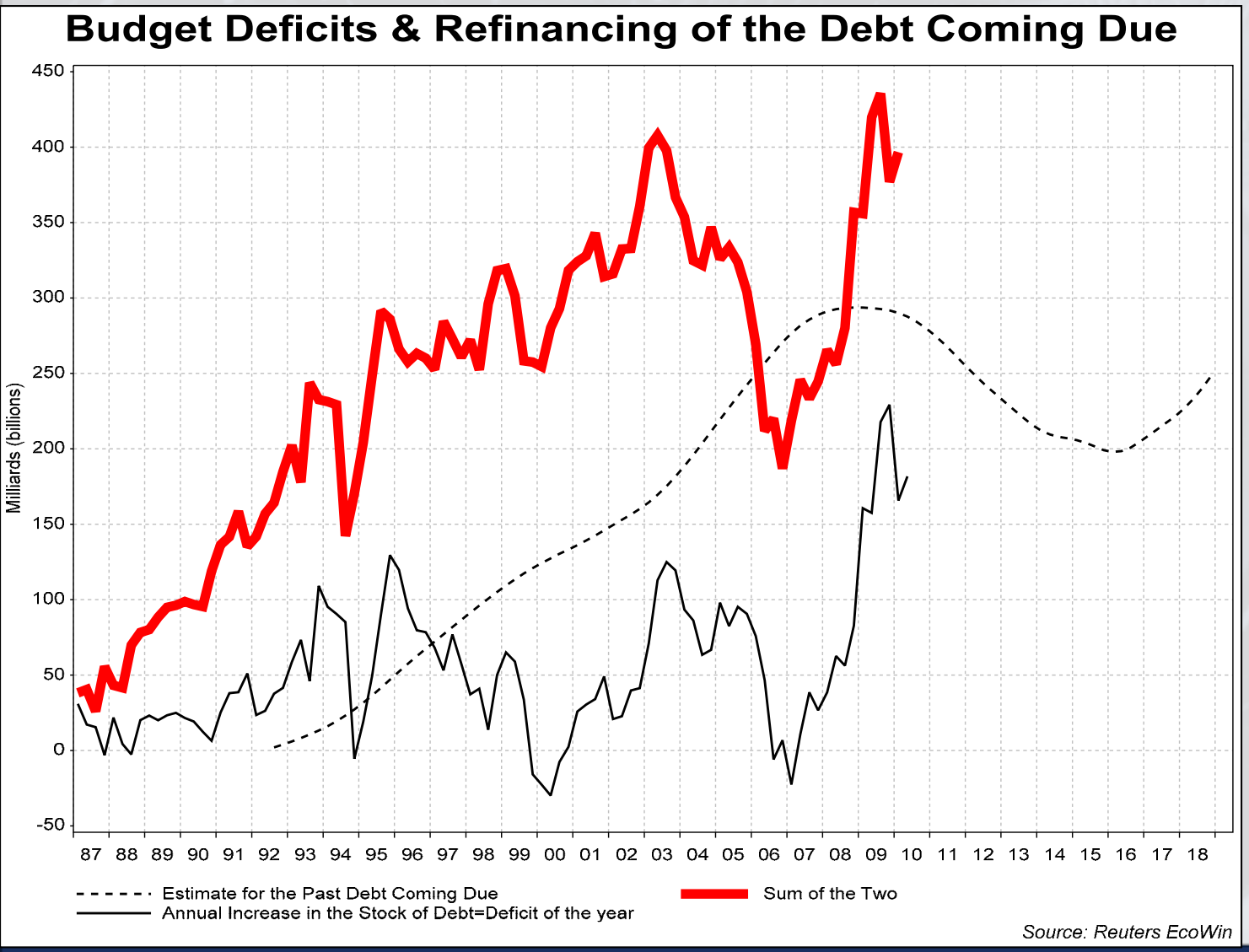
- However, some structural issues are starting to be visible. One of them is the emergence of the so-called "primary deficit".
- The debt-to-GDP ratio stabilizes when the primary balance is in rough equilibrium. But when we have a huge primary deficit, the debt rises almost exponentially.
- This is where France is now at. Thus, simply to stabilize the debt-to-GDP ratio, France needs an improvement over three years of roughly 10% of GDP, or 3 % per year for three years in a row.
- **France has never achieved this kind of debt reduction in the past.**

Rising Debt and Lower Rates… Until a Risk Premium Emerges



- At this point, the risk for the French economy is thus not a rise in interest rates; it is the emergence of a risk premium on French government debt (similar to what has happened in Greece, Spain…).
- Such a risk premium is now very likely to appear if the French government does not legislate a massive decrease in government spending.

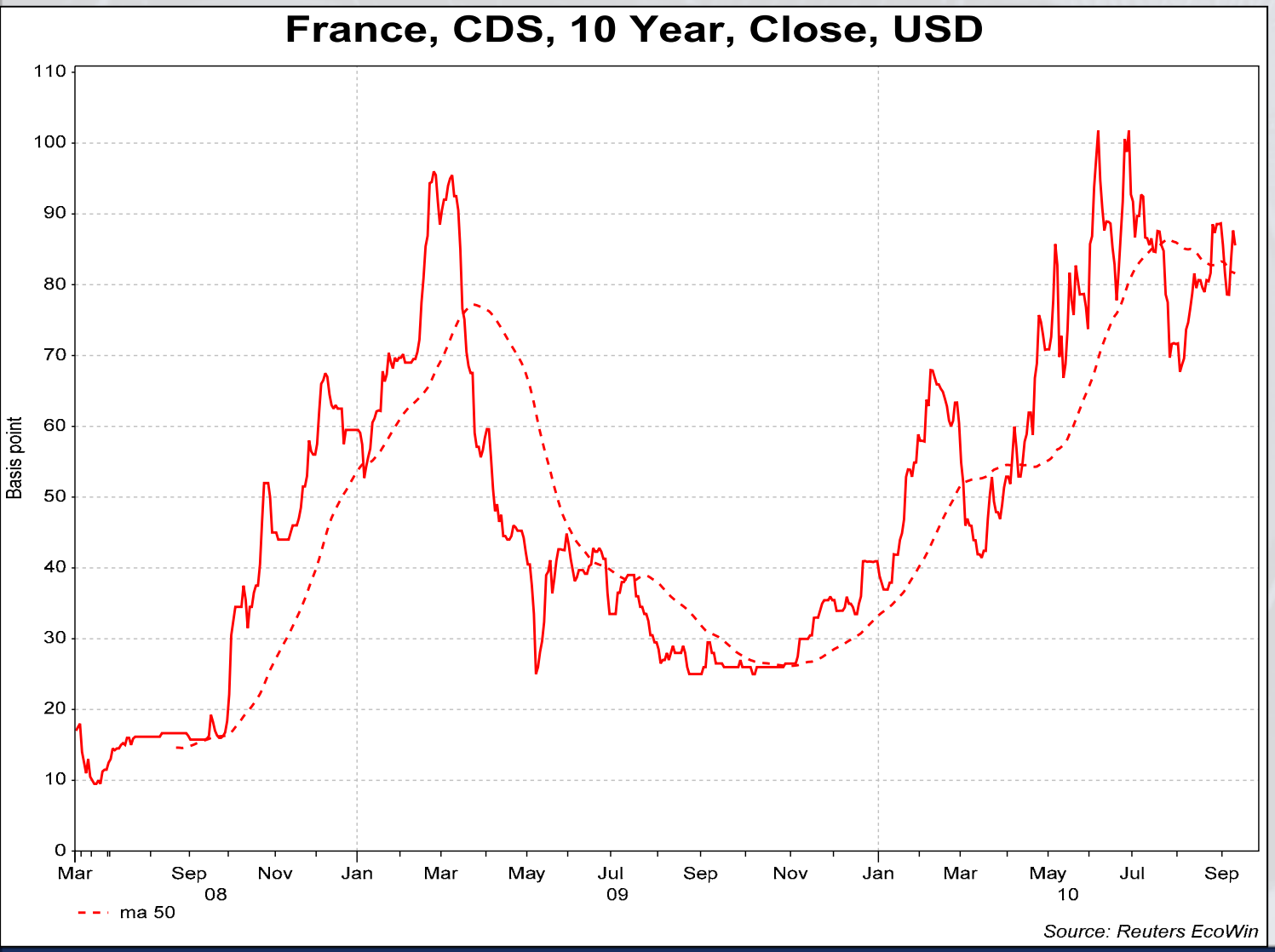
A Looming Debt Re-Financing Problem



- France has a window of two to three years during which the refinancing of past debt actually trends down. After that, the country's refinancing needs shoot up. Hopefully, the government will seize this window of opportunity to slash deficits.

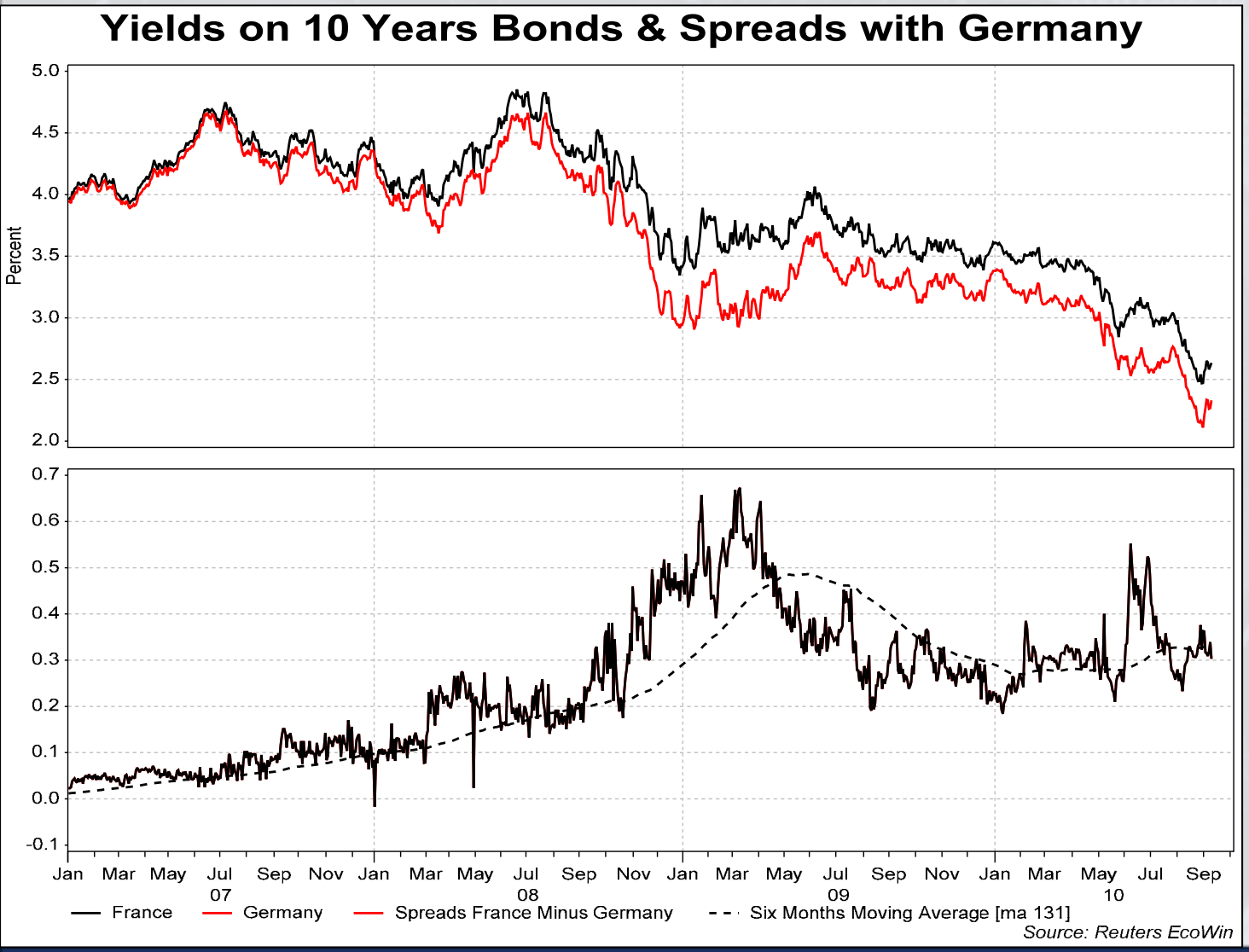
- If it does not, and if the red line is perceived by the markets as going up again by 2015, or in other words, if the annual budget deficit has not been curtailed massively by that date, then a financial panic could well be on the cards.

Leading Indicators of a Panic: Watch the French CDS



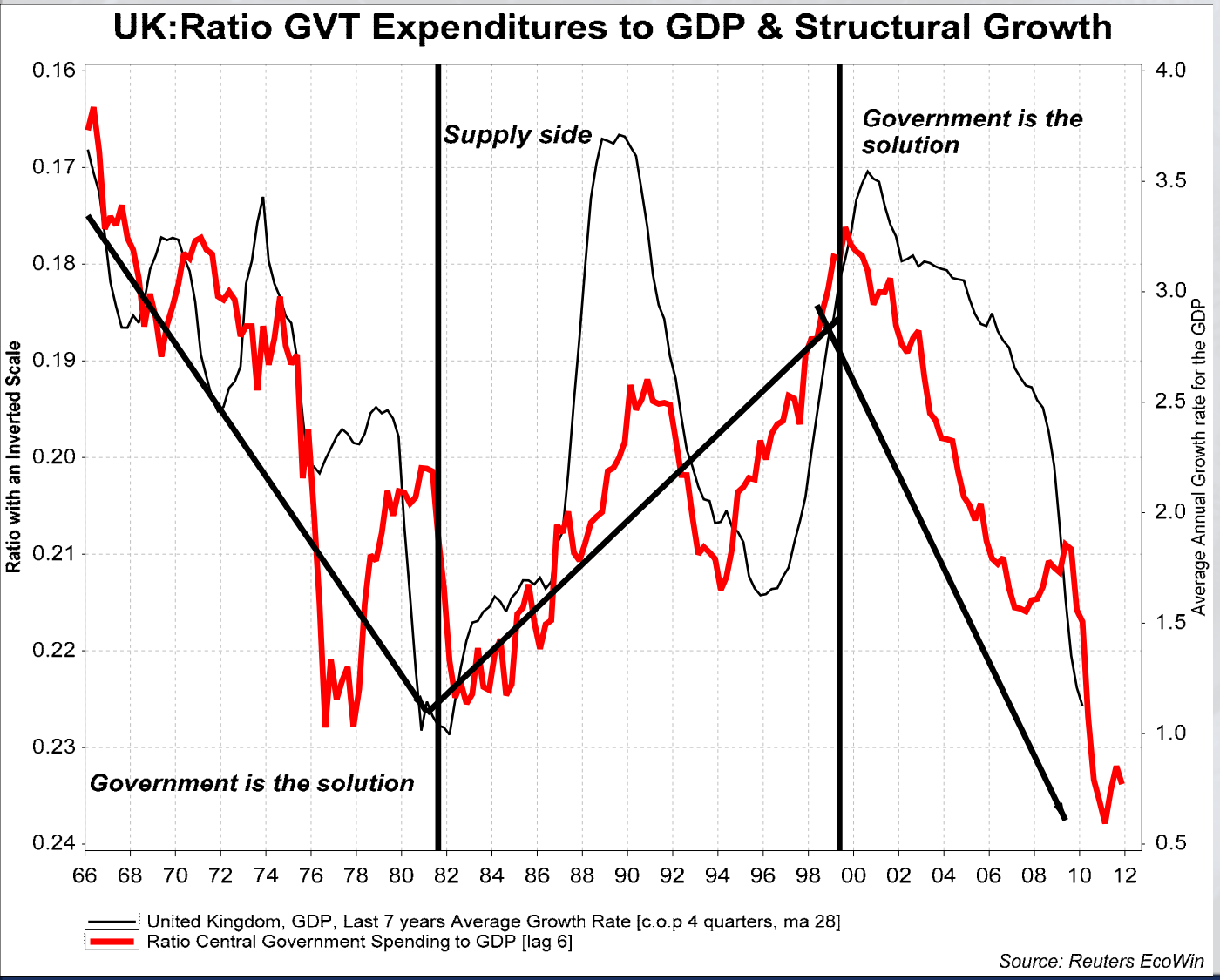
- It would seem that the French CDS is making a nice double-top.
- Hopefully, the market is sensing that the government will get serious about tightening its belt.
- If it's not, French CDS should move much higher.

Watch the Spread Over Bunds



- One of the clear conclusions of the recent EMU crisis is that Germany is serious about cutting government spending. So serious that reducing public debt was made a constitutional law!
- This should put a lot of pressure on other EMU governments, France amongst them, to either put up or….

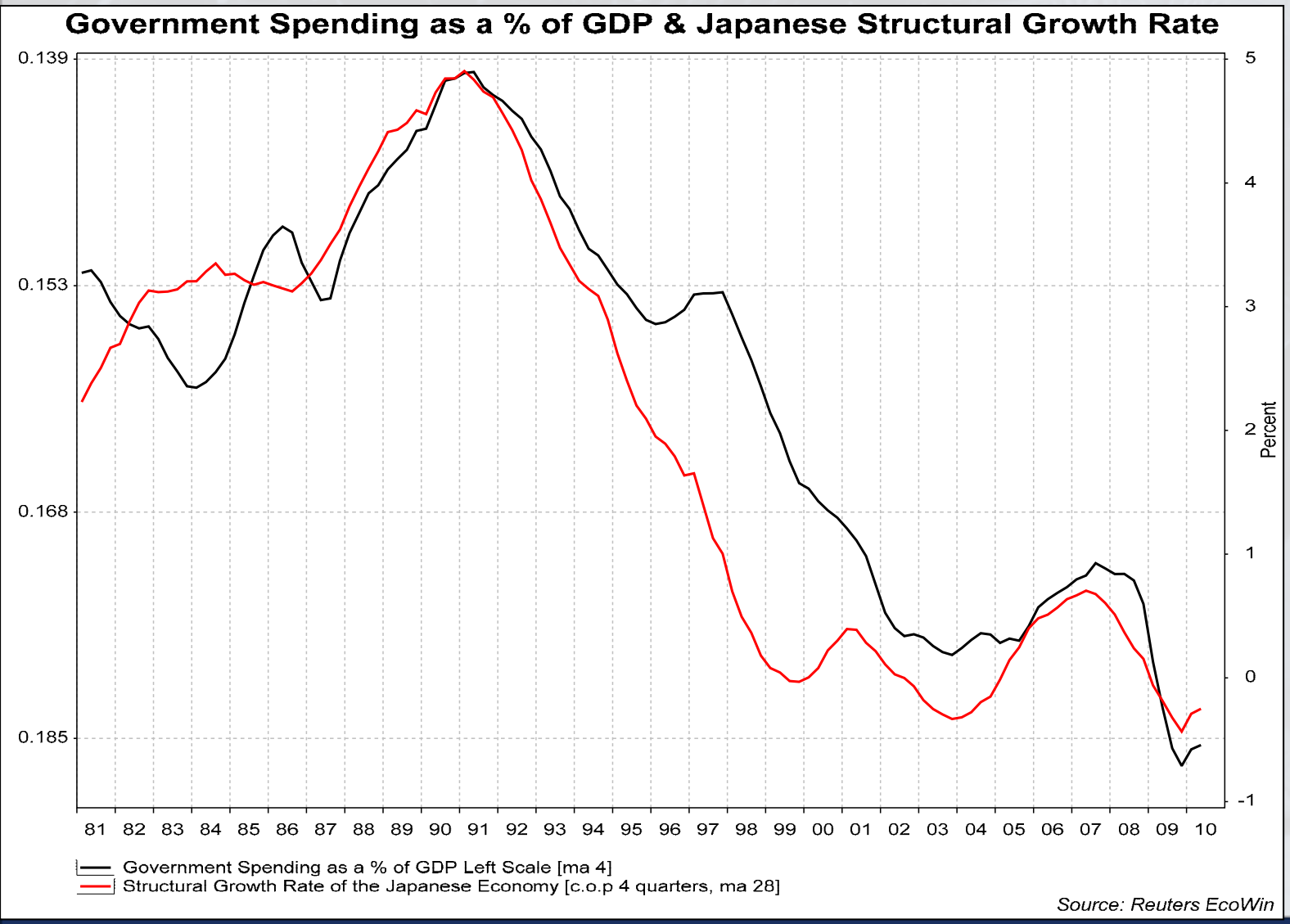
The Big Question For France (& the UK, & Spain, &…)



- If politicians succeed in reducing government spending as a % of GDP two things happen: 1) the structural growth rate picks up, as evidenced by what happened in the UK (the only country to have had a very clear shift from Keynesian to supply side back to Keynesian and then back to supply side - hopefully)!
- The deficit does not matter. What matters is government spending as a % of GDP!
- What needs to be done is to cut government spending , free the private economy (privatizations), cut the marginal tax rate to stimulate the growth of the GDP.
- When this happens, PE ratios go up, real estate rebounds, and the wealth effect kicks in…

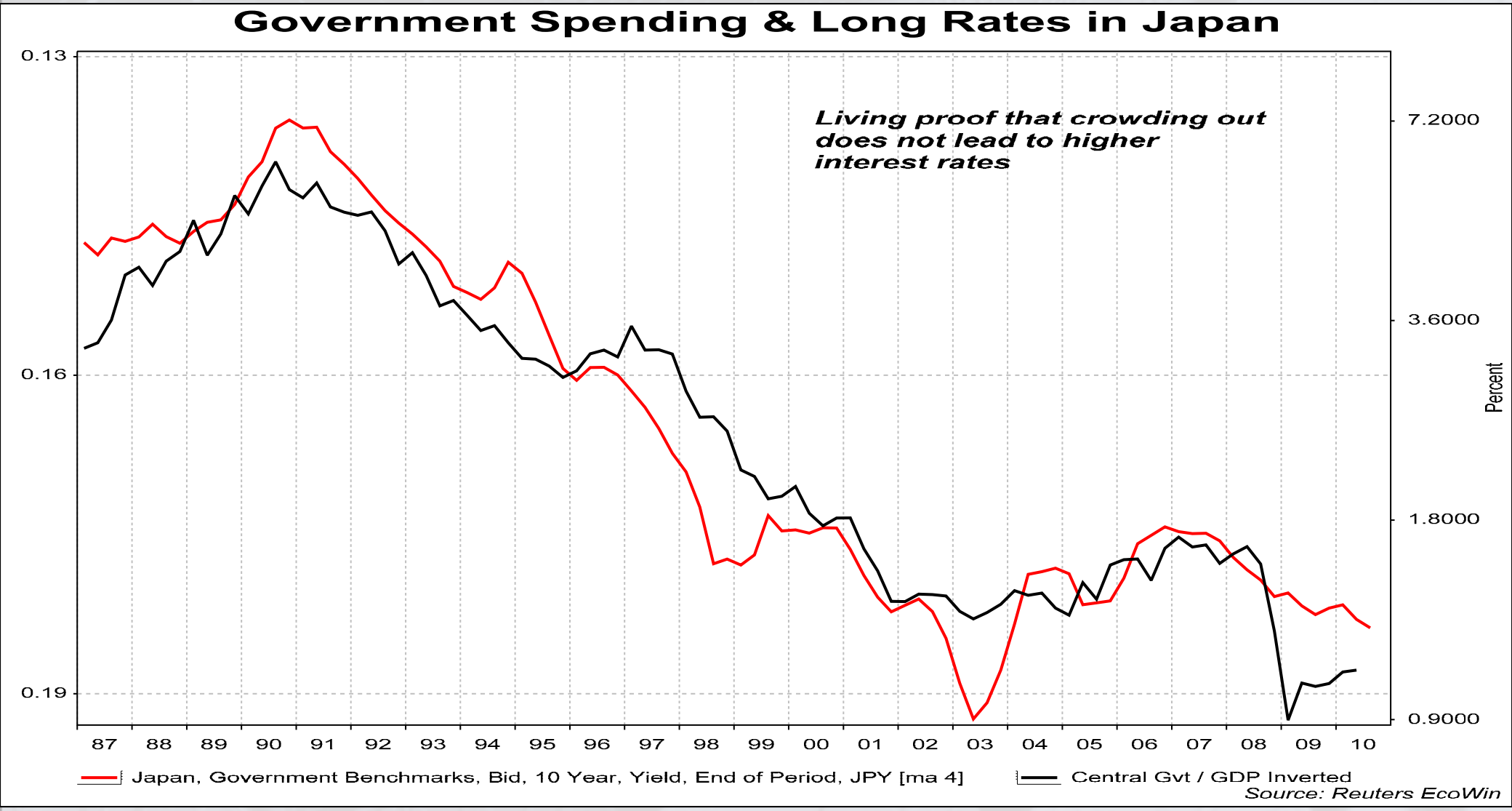
3- Lessons From Japan

'Le Cas d'Ecole' of Keynesian Spending Gone Awry



- If the political elites cannot deal with the issue of runaway government spending, growth rates fall structurally.

And With Growth Rates Heading South, Interest Rates Collapse



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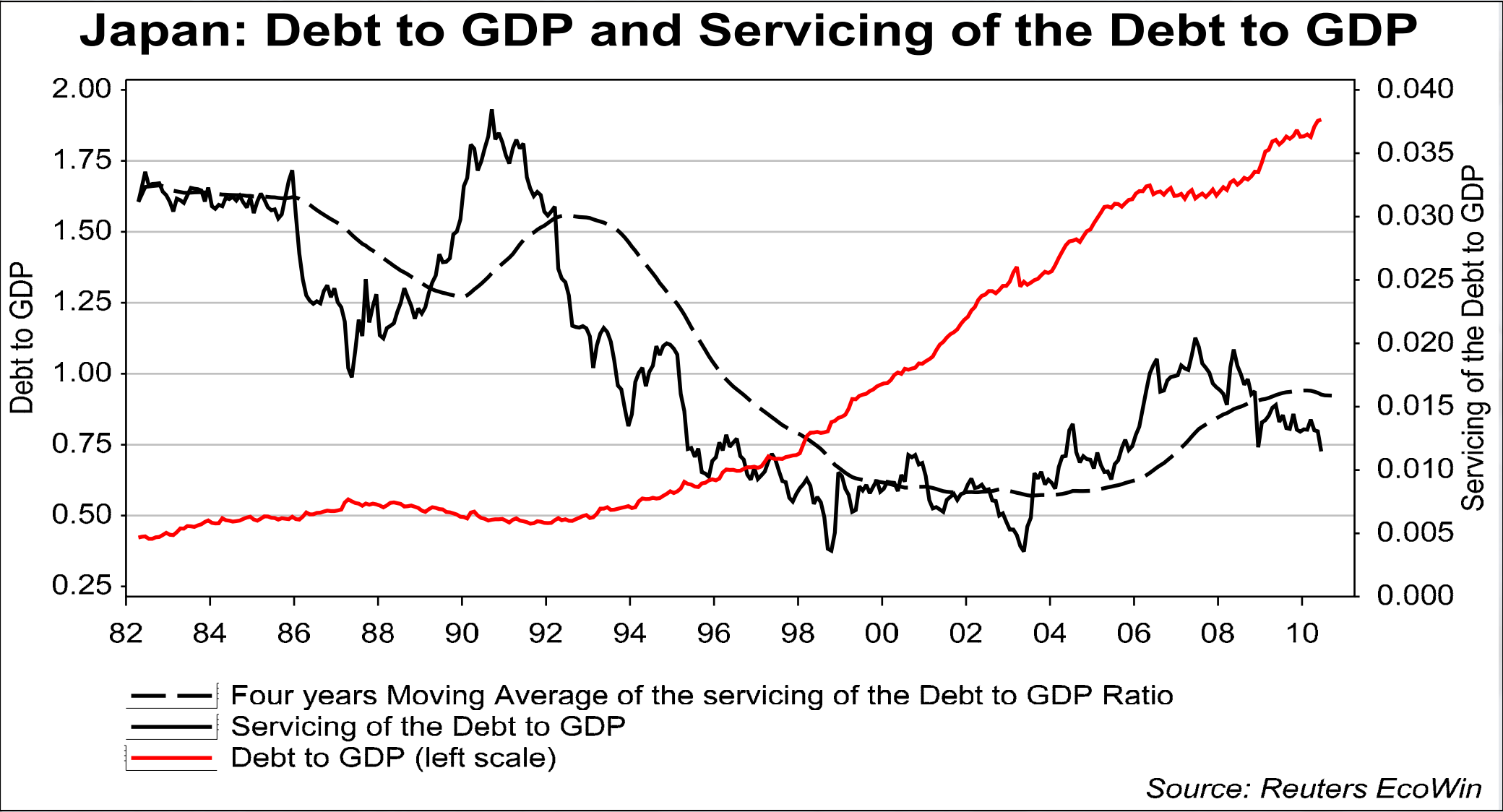
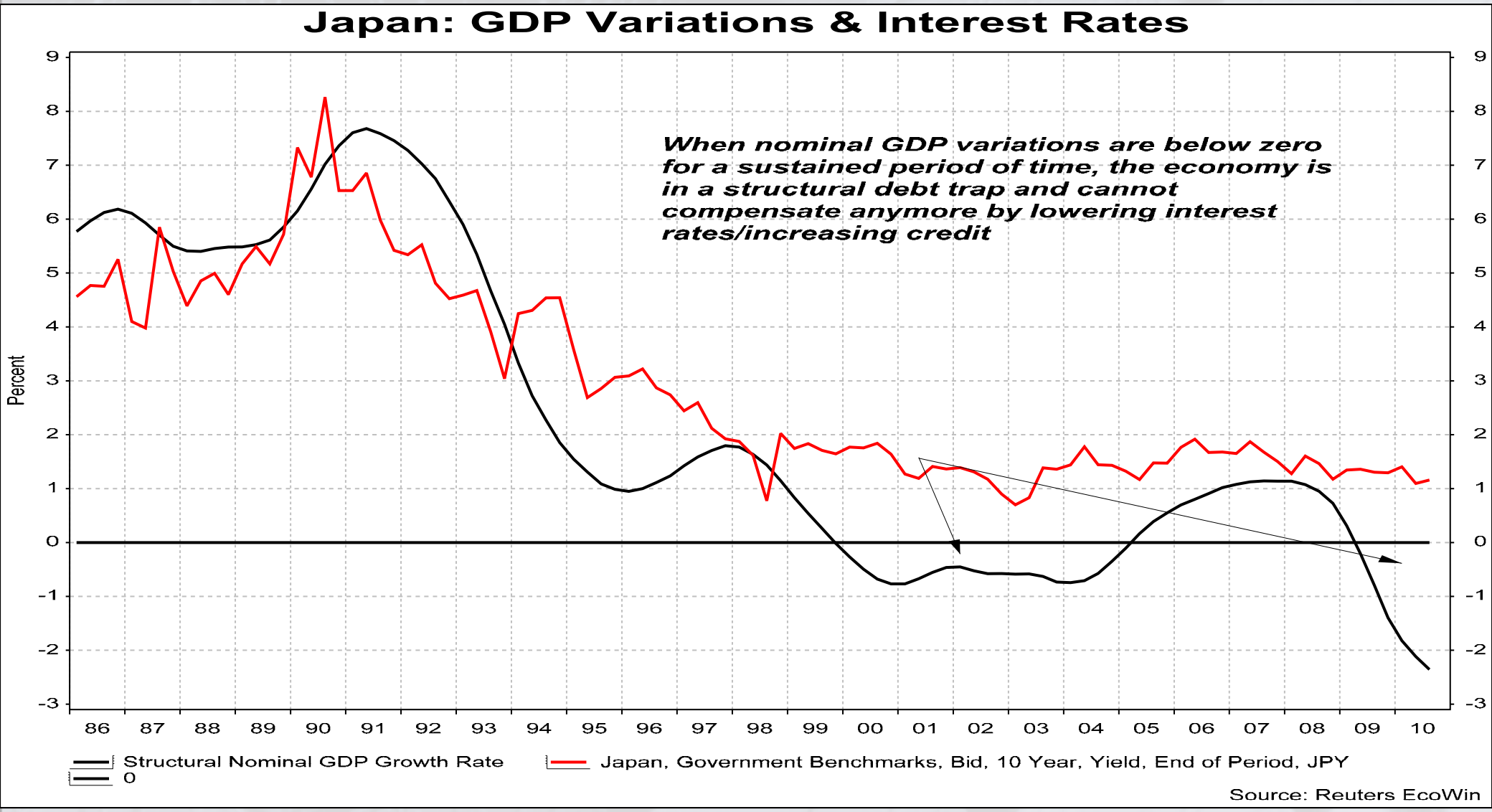
With Lower Rates, Debt Servicing Falls



Source: Reuters EcoWin

Music Stops When Nominal Structural GDP Growth Becomes Negative



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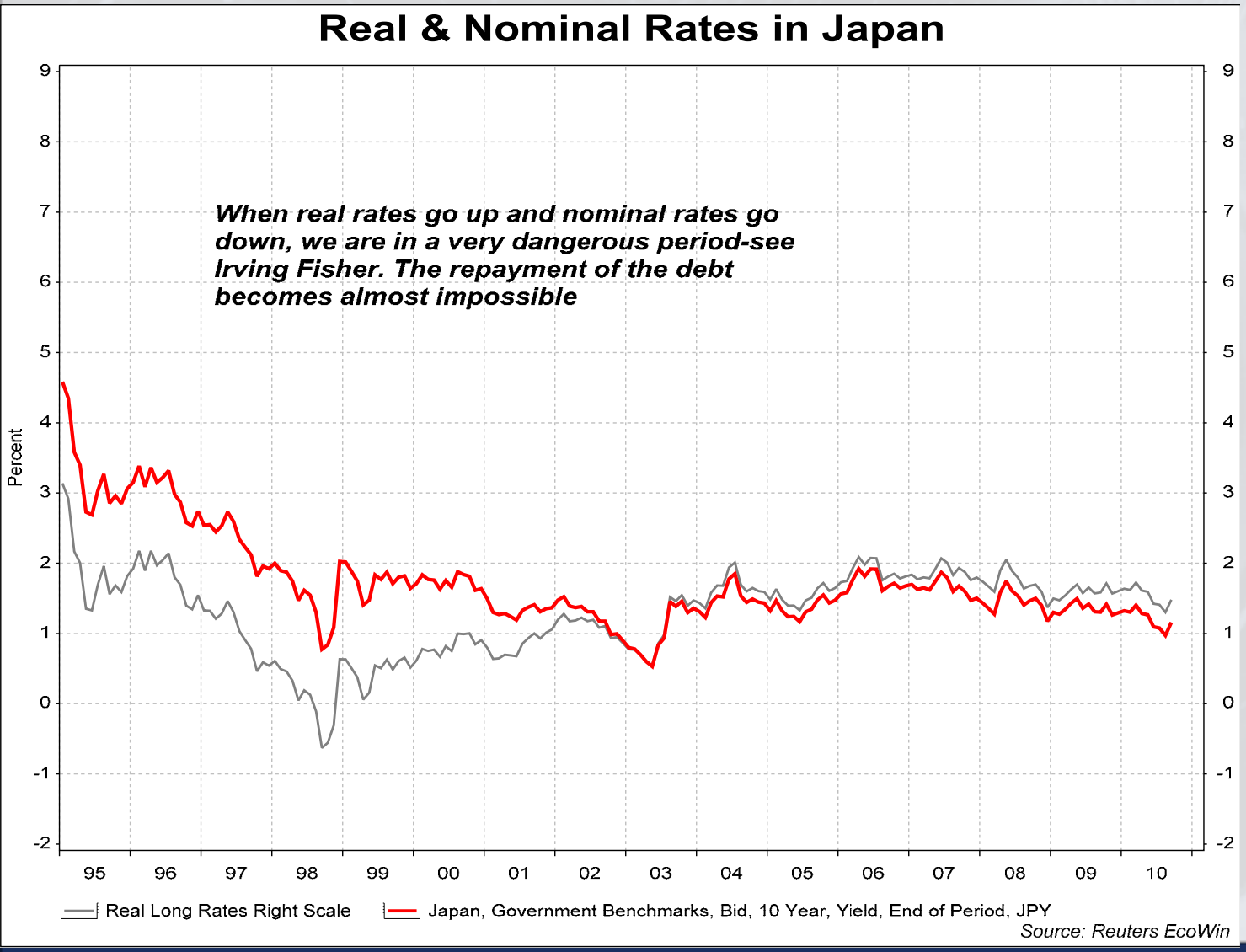
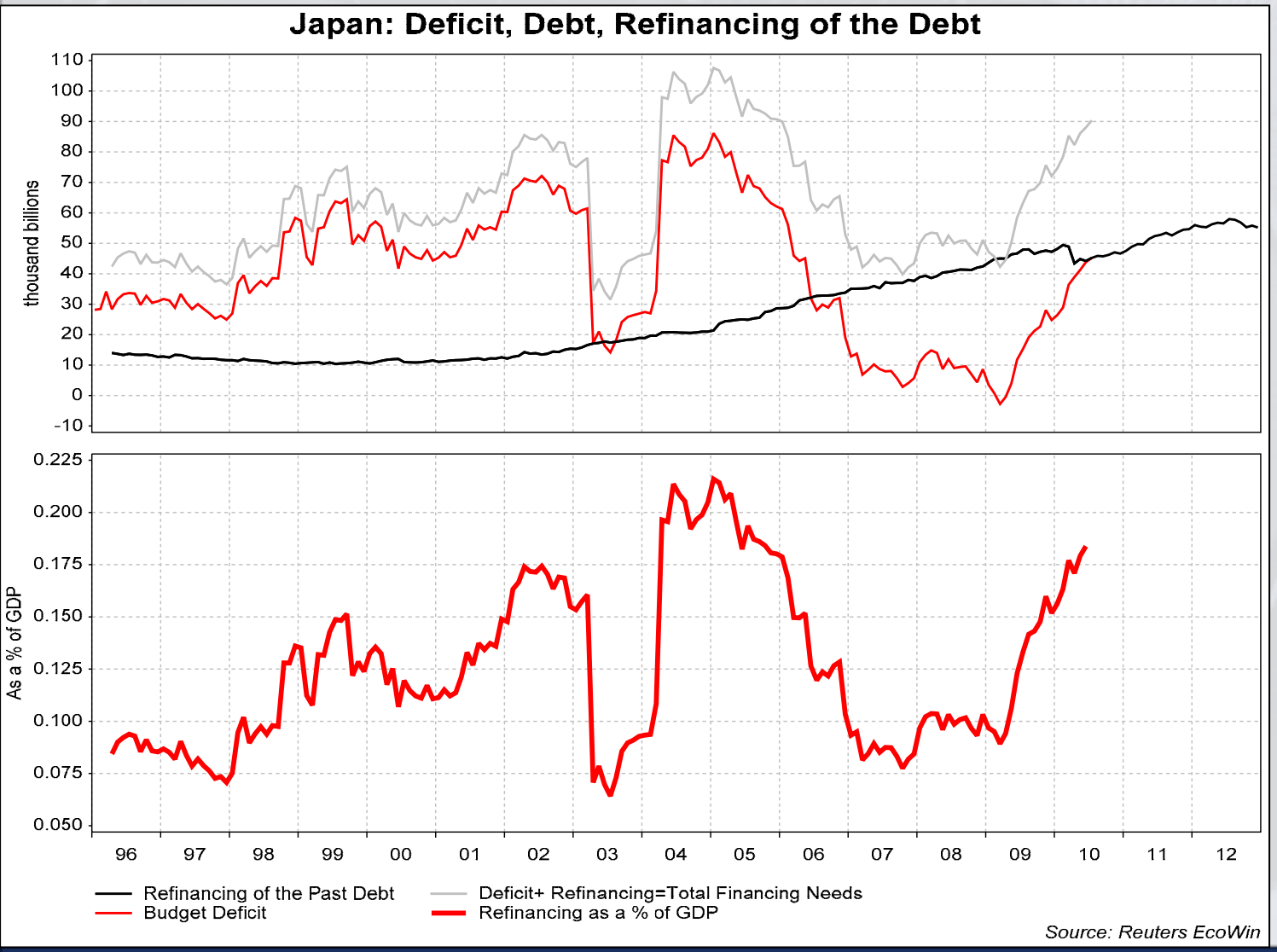
When Debt Servicing Costs Start to Rise, the Debt Trap is On



- When real rates are higher than nominal rates, the purchasing power of the debt inventory rises, thereby making debt repayment very challenging (see Irving Fisher).
- Unsurprisingly, this makes the refinancing of debt very challenging.

Japan is Rapidly Approaching this Tipping Point



- With GDP falling in nominal terms, the weight of the debt as a % of GDP is going to shoot up, and the servicing of the debt also.
- It is a well-worn story but could the crunch time for Japan actually be around the corner, maybe around 2012-2013?
- We were once told by one of the most famous macro traders: '*you have not been a macro trader until you have lost money shorting JGBs*'. But it seems that the time for the trade may soon be approaching!

Conclusions

- Using the above simple approach, we could rank countries in different categories:
  1. **Countries that do not need to make a fiscal effort**: Sweden, Canada, Switzerland, Denmark, Finland, Singapore, Malaysia, Australia, New Zealand….
  2. **Countries that have understood the challenges and are obviously trying to redress the situation**: Germany, the UK, Holland, Spain, Ireland, Italy…
  3. **Countries that may not have gotten the message**: France, Belgium
  4. **Countries that simply don't get it:** US, Japan
- Hopefully, this latter part changes soon. One obstacle in Japan is that with half of the voters retired, or within five years of retirement, there are clear obstacles to reform. Meanwhile, in the US, the upcoming election should witness a swing away from outright Keynesian stimulation, to fiscal restraint.

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