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Your Kingdom to Dust

"Sir, "Can the Fed prevent Japanese-style deflation, a period of falling prices associated with economic stagnation, from taking hold ?" is a common refrain nowadays..

The US Federal Reserve's obsession with Japan is pretty disastrous. First, Alan Greenspan opened the taps wide for too long, fearing Japanese-style deflation, which fuelled the housing bubble that led to the recent financial crisis. Now, fearing the lost decade plus, the Fed is probably going to keep easing until some different but unpleasant outcome is the result. Stagflation perhaps, or hyperinflation ?

This is so ironic, because for so long people have sneered at the Japanese for their inability to steer their economy to recovery. Perhaps because they have sneered so much, it is no longer possible to admit that after a huge housing bubble bursts, there is nothing to do except suffer many years of economic indignity.

The fixation with Japan was not helpful during Mr Greenspan's watch, nor, I fear, will it be of much use this time. The Japanese may be different, but they were not stupid."

- Takashi Ito, Tokyo, Japan, in a letter to the editor of the Financial Times, August 2010.

It is worth highlighting that phrase again: **after a huge housing bubble bursts, there is nothing to do except suffer many years of economic indignity**. The construction is wonderfully Japanese: delicate, understated, polite. As opposed to the social reality wherever austerity is now being practised or merely proposed, that is to say: riots on the streets. Not that Greece is in trouble because of frothy property prices. Greece is in trouble because of a systemic problem infecting the capital structure of the western world: too much debt, and not enough growth.

The figures are startling. In the US, for example, total debt doubled during the 1970s. By the early 1980s it had doubled again. By 1990 it had doubled once more. Total US debt doubled again by 2000. Between 2000 and 2010 it doubled yet again. The table below shows the gory details.

Total US debt, trillions of dollars

Start	End	Trillions	Quarters
1/1971	10/1977	3.29	27
10/1977	10/1983	6.47	24
10/1983	1/1990	13.1	25
1/1990	4/2000	26.2	41
4/2000	1/2009	52.9	34

Time between complete doublings of debt in quarters.

Source: Federal Reserve, cited in Chris Martenson's 'The Crash Course' (2011, Wiley)

As Chris Martenson points out,

"In the United States, total credit market debt has doubled five times in four decades. Everything that most people know about "how the economy works" was learned during a period of time when credit was doubling every 30 quarters on average."

Every dollar in circulation in the US was loaned into existence by a bank, with interest. That interest can only get paid from further loans. "With every passing year, the money supply must expand by an amount at least equal to the interest charges due on all the past money that was borrowed (into existence), or else severe stress will show up within our banking system."

Martenson goes on to cite Steven Lachance:

"A debt-based monetary system has a lifespan-limiting Achilles heel: as debt is created through loan origination, an obligation above and beyond this sum is also created in the form of interest. As a result, there can never be enough money to repay principal and pay interest unless debt is continually expanded. Debt-based monetary systems do not work in reverse, nor can they stand still without a liquidity buffer in the form of savings or a current account surplus.

"When interest charges exceed debt growth, debtors at the margin are unable to service their debt. They must begin liquidating."

The system reaches its terminal point when new debt creation fails to match existing interest charges. As soon as that point is reached, defaults will spiral through the system. "Which is why our fiscal and monetary authorities are doing everything they can to keep money / debt creation robust."

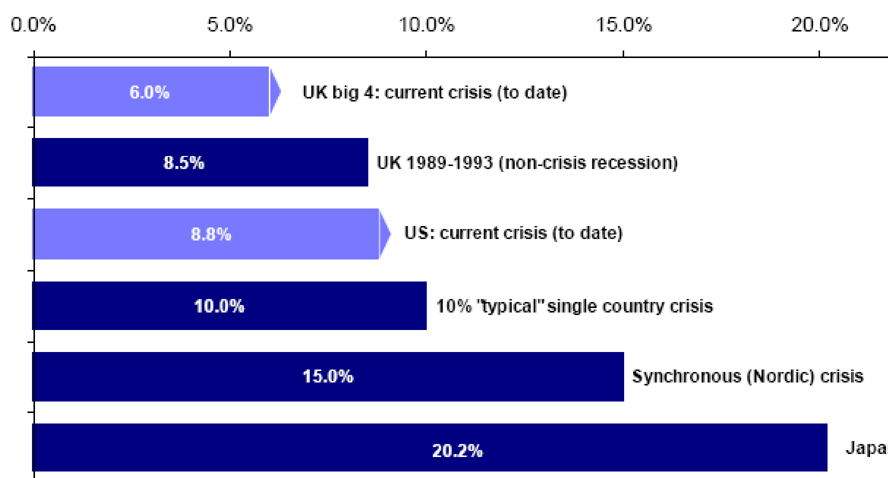
But why is this process destined to fail ? Because in Martenson's very simple telling, nothing can expand forever. Money and debt have been growing at exponential rates, but of course cannot do so indefinitely. The system can only hold together with perpetual economic growth. The last four decades of debt accumulation are not the steps toward some form of equilibrium, but rather the calm before the storm, progress toward huge disequilibrium. "The outcome is simply that a lot of what we think of as wealth simply must vanish, because the claims are too numerous and potential

future growth is too little." And debt erosion can only ever come about via two processes: deflation, or inflation.

At a MoneyWeek investment seminar last week, Arbuthnot Securities strategist James Ferguson made the deflationary case. As in other respects, Japan forms the rather terrible benchmark against which the west's future economic recovery, primarily that of the banking sector (see below) may have to be measured:

Only 3 years in suggests we're only half way to full resolution; a 6.0% cumulative loss rate still leaves plenty of work to do too

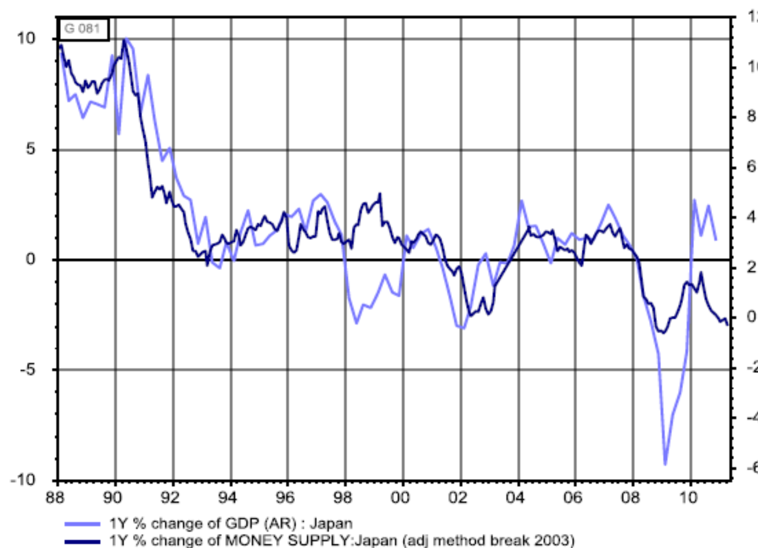
Loss rates as a % of risky assets



Source: Companies data, Arbuthnot

And the Japanese banking and economic experience, if repeated, leaves a rather dry taste in the mouth:

Flat/negative bank lending in Japan led to 18 years of low (~2%) money supply growth & zero nominal GDP growth



Source: Thomas Reuters Darastream; Arbuthnot

18 years of zero growth in GDP ? That sobering phrase again: "..there is nothing to do except suffer many years of economic indignity."

Covering the market's response to the uncertainty over the status of Greek government debt last week, Mark Gilbert and Liz Capo McCormick for Bloomberg News wrote of Europe facing its 'Lehman Moment', and of fears that debt contagion would spread across the Euro zone periphery. This is hardly a bond market development coming out of a clear blue sky. Yet as before, previously somnolent ratings agencies trampled over each other in their speed to disseminate bad news once the crisis was alive and brewing. S&P cut Greece's rating from B to CCC. Not to be outdone, Moody's responded by placing ratings for BNP Paribas, Soc Gen and Credit Agricole on review for potential downgrade. As with the dispersion of subprime credits before the first financial crisis, banks are again the plague carriers. Yet it is German banks who are actually the biggest foreign holders of Greek government debt, with $22.7 billion "worth" of holdings as at 2010, according to the Bank for International Settlements. No doubt it will be Europe's taxpayers eventually left holding the bag. And as Chris Clarke of Lawrence Clarke Investment Management highlights, the contagion has already spread to Spain, in the light of a disappointing bond auction on Thursday. Spanish borrowing costs are now also going through the roof. Whereas the Greek economy is only the size of that of Rhode Island, in a European context, Spain actually matters.

Do not be misled by political smoke and mirrors over any (further) Greek bailout. How can an insolvent country be brought back to health by being lent more money ? By the same token, how will austerity right the ship in a country plagued by fiscal non-compliance ? Greece will default. Barrons asked fund manager Felix Zulauf what the aftermath of a Greek default might entail.

"Greece is bust but it isn't allowed to default. If it does you could see a bank run throughout the European and the global banking system. The ECB and Germany are trying to force a Teutonic fiscal program on Europe. They are on a collision course with economic reality. If Greece defaults, the ECB probably will lose 30 billion to 50 billion euros. The bank's equity capital is €10 billion. The Irish and probably Portugal and Spain would default. Germany's Bundesbank owns more than €300 billion of European debt. A default would be worse than the collapse of Lehman Brothers."

And as Zulauf indicates, there is no painless solution.

The inflationary resolution is impossible within the Euro zone, in no small part because the Bundesbank rightly nurses the collective German race memory of hyperinflation nearly a century ago. So painful debt deflation mixed with the inconsistent application of austerity, spiced with the sporadic threat of outright default, seems to lie ahead for Europe. The US, on the other hand, seems more interested in the inflationary outcome, if monetary and currency policy (if any) are any judge. Hardly an auspicious investment landscape for the bulls.

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