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Current debt crisis merely a warm-up act

By Jamil Baz – 11 July 2012

It is sometimes possible to believe that suffering is worthwhile, a way of paying for past sins. In this light, the age of austerity in which we supposedly live has a sort of redemptive quality. Grit our teeth and we'll come out the other side, purified and ready for robust economic recovery.

However, after five years, we are in a worse place than when we started.

One would have thought that the recent deleveraging caused debt ratios to collapse. Yet, after the financial maelstrom of the last five years, debt ballooned to a weighted average of 417 per cent of gross domestic product from 381 per cent in June 2007 in the 11 economies most under the market microscope.

Strikingly, in each of Canada, Germany, Greece, France, Ireland, Italy, Japan, Spain, Portugal, the UK and the US, the ratio of total (public and private) debt to gross domestic product is now higher than it was in 2007.

There are variations, and it is notable that debt in the US has increased the least, from 332 per cent of GDP five years ago to 340 per cent today – although we shouldn't draw too much consolation from that, as the statistics do not include social entitlements such as Medicare or Social Security. Add in these off-balance sheet items and the ratios would look much worse.

Deleveraging is proving impossible to execute. The world is still staggering under a mountain of debt, the costs of which extinguish the "animal spirits" which ought by now to be coming to the rescue. Based on this analysis, we can make five predictions.

First, as deleveraging has not even started yet, the crisis of the world economy has not begun either. All the perceived unpleasantness of the past few years is merely a warm-up act for the greater crisis still to come. The need to get debt levels down is as pronounced as ever in the eurozone, particularly in southern Europe, but also in the US and Japan.

Second, it will take a minimum of 15 years or so for the economy to

reach escape velocity and attain a level consistent with healthy growth scenarios. This is because debt levels need to come down by at least 150 per cent of GDP in most countries. History suggests you cannot reduce debt by more than 10 percentage points a year without unleashing major social and political dislocation.

Third, when we do finally start cutting our debt, the economic impact will be massive. Countries such as Japan and the US need to increase their primary balance by more than 10 points of GDP, in order to stabilise the ratio of public debt to GDP to 2007 levels: considering negative feedback loops between deficit cuts and growth, each stands to lose more than 20 per cent of GDP against trend.

And this does not account for the required private deleveraging. The precise level of economic devastation is a function of the so-called multiplier, which measures the impact of spending reduction on economic growth. The International Monetary Fund calculated recently that under current circumstances the multiplier can be as high as two: every dollar cut from the deficit will lead to a two dollar reduction in GDP. The multiplier is as much as four times higher than in pre-2008 conditions.

Fourth, risky assets are set to perform badly for a long period of time. Levels of corporate profits are highly correlated with changes in leverage: reduce debt to meaningful levels and profitability will fall. The equity risk premium on major indices such as the S&P 500 is at historically low levels and needs to rise dramatically in order to compensate investors for multiple market risks, ranging from sovereign default to inflation, deflation and geopolitics.

The fifth point is that there is no magic bullet. In the past, policymakers had various instruments to cushion the impact of measures taken to stabilise debt levels: they could cut interest rates, for example, or allow their exchange rates to fall, leading to export-driven recovery. But in an era of low or zero interest rates, with most countries competing to devalue their currencies, such policy tools have lost effectiveness, hence the high multiplier.

Even inflation, long touted as a backdoor solution to debt reduction, will not help. It would send bond yields sky high, compounding the costs of servicing debt and killing off any recovery. And off-balance sheet entitlements, the biggest item that needs trimming, are inflation-adjusted.

How do asset classes rank on the totem pole if this scenario plays out? Bonds of solvent governments and corporates should do well in a

deflationary environment where rates are kept lower for longer; stocks should revert to new lows; and currencies of highly leveraged, growth-sensitive markets should be sold.

In the words of an old Austrian adage, the situation is hopeless, but not serious. It is not serious, as politicians simply fail to acknowledge the elephant in the room, namely leverage, introducing instead a succession of policy gimmicks. It is hopeless, in that virtue is not likely to be rewarded for a generation.

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