On Target

Martin Spring's private newsletter on global strategy

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Debtphobia Threatens Economic Recovery

Debt is becoming the big issue for policymakers and investors, and the focus of heated controversy.

There is far too much of it, everyone agrees. But is this the right time to stop the continuing build-up?

Worldwide, governments have been using a panoply of aggressive measures to ward off a 30s-style depression, creating almost unlimited, nearly-free bank credit, pumping huge amounts of state capital into troubled financial institutions and industrial companies, boosting public spending, and cutting taxes.

This has prevented a major recession from morphing into a depression, by substituting public demand for goods and services to offset the contraction in private demand for them as worried people and businesses cut back on their spending and seek to strengthen their personal or corporate finances.

Trouble is, all that extra public demand is being paid for with borrowed money. There has been a rapid build-up of official debt by governments. According to the latest annual report of the Bank for International Settlements, by the end of this year debt levels as a whole in the US and major European nations outside the banking system will be 20 to 40 per cent higher than they were at the beginning of the credit crisis in 2007.

A small amount of debt reduction in the private sector has been swamped by the growth of official debt. This year the fiscal deficit of Britain is equivalent to 11.5 per cent of the nation's entire output of goods and services. The figures are almost as bad for the US (10.7 per cent) and Spain (9.4 per cent).

The fear is that official debt will rise to levels that eventually trigger a lenders' revolt and financial crises. And that the burden of interest on the debt will gobble up resources needed for important services such as health and education, especially if eventual economic recovery brings rising interest rates.

There is also the fear that if perceptions spread that public finances are unsound,

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nervous enterprises and households will cut back even more on their investing in business expansion and personal spending, while investors will demand higher interest rates.

At the recent G20 meeting there was tension between countries, led by Germany, who want to give priority to braking spiralling growth in national debt and those, led by America, who want to continue debt-financed stimulus plans till economic growth is more assured.

There are deep, genuine differences of opinion about what is the greater threat to our prosperity – soaring government debt, and the financial turbulence that could trigger, or a cut in public-sector demand before there is clear recovery in private-sector demand.

Much of this is also about political posturing and seeking to divert blame to others for past and continuing policy failures.

Germany has to position itself as the guardian of financial rectitude to prevent a collapse in confidence that would endanger European unity, the keystone of its foreign policy; to dampen its voters' hostility to bail-outs for undeserving Greeks and others (especially as more such bail-outs are likely to be needed); and to avoid potentially huge losses for German (and French) banks that have heavily invested in the dodgy bonds of Southern European countries.

America desperately needs additional stimulus for its economy, which is now visibly faltering. The administration would dearly love to provide such stimulus through another package of public spending. But there is mounting voter hostility to additional debt-financed handouts -- especially as past and current ones have largely been wasted on massive help for political favourites rather than being targeted to promote the most dynamic job-creating sectors.

Why America wants a weaker dollar

One answer for the US would be a weaker dollar, which would promote exports and shield domestic businesses against competition from imports. But its big trading partners – Europe, China, Japan – refuse co-operate by allowing their currencies to appreciate in dollar terms.

Most of the "tough guy" announcements by deficit hawks look much harsher than they really are. The strong language diverts attention from the inconvenient truth that the plans are largely no more than promises of future good behaviour, not policies to reduce debt immediately… or even stop the build-up of debt.

Germany's fiscal deficit is actually being allowed to inflate by 1½ to 2 per cent of national output this year. Britain's "emergency budget" suggests that some major areas of government spending such as police, prisons, universities, transport and housing are going to be cut by one-third – in practice, that cannot happen, as it will be politically impossible.

Current policy confusion and argument over fiscal deficits and government debt can be blamed on several factors:

It's widely assumed that this recession is just a severe normal one. It's not. It's an extraordinary "black" recession of the type experienced by America in the 1930s and Japan in the 1990s.

These rare kinds of economic failure are marked by debtphobia – debtors are obsessed with slashing their borrowings; those without much debt, frightened to take it on to finance additional spending, focus on building up their cash resources. Fear dominates.

Policies that trigger recovery in normal recessions, such as slashing interest rates, don't work in debtphobic collapses, because shocked enterprises and individuals focus on financial survival.

Each black recession has its particular characteristics. This one is notably concentrated in the financial sector and the state-promoted giants that inhabit it. It won't be resolved until their bad debts are recognized and written off or destroyed by inflation – ultimately the owners of capital, and/or taxpayers, will have to pay the price.

Irresponsible politicians poisoned the well

The best medicine for relieving the pain of a black recession is fiscal stimulus. But unfortunately support for the Keynesian policy approach of borrowing to spend to bolster demand for goods and services in economic downturns has been damaged by its abuse in past decades – far too much debt-financed spending has been used to promote political objectives rather than promote economic growth.

Now such spending is really needed, for the first time in several generations, public support for debt-fuelled stimulus has been undermined.

In America, fiscal stimulus is dismissed as a failure by its critics on the grounds that unemployment has soared to 10 per cent despite the Obama administration's spending package. That argument is fallacious as it ignores the near-certainty that joblessness would have been far worse without the stimulus.

Because of the rumpus over Greek government debt and its wider implications for other member-nations of the eurozone, there is now a global panic over levels of "sovereign" (national) debt.

This is totally unwarranted. Although the bonds of a handful of profligate nations are at risk, and may eventually be forced into default, those of stronger countries – even those with high debt levels – are not at risk.

There is continuing strength in government bonds generally. Prices of long-term securities of countries such as Germany and the US are hitting new highs (and

delivering major gains for those investors who got their strategy right by ignoring the pessimism of congenitally anti-bond advisers).

There is no evidence that the “sovereign debt crisis” will spread beyond a handful of eurozone countries. And there are no signs of any return to general global inflation, which would endanger bond values. On the contrary, there seems to be greater risk of deflation, which would strongly favour low-risk fixed-income securities.

Ironically, the explosion of negative publicity about national debt is promoting the very thing that the critics of fiscal stimulus fear. It’s boosting nervousness about all kinds of debt and therefore encouraging enterprises and individuals to be more cautious and to refrain from investing/spending, accelerating the downward trend in global economic growth.

My own view is that financial conservatives like myself should just hold our noses. In this global economic crisis the priority now is to support and stimulate economic growth through state spending and tax cuts, even though that means accepting major increases in national debt, rather than focus on slowing the growth in debt.

In previous black recessions, premature shifts to cutting fiscal stimulus – slashing spending and raising taxes -- produced devastating setbacks to economic recovery. It happened in the US in 1937 and in Japan in 1997.

It only makes sense to cut back on public spending when private-sector spending is growing. When the private sector is saving – that is, producing a net surplus – state demand needs to fill the gap.

Japanese policy was a success, not a failure

Stimulus in the form of government spending is the only policy that definitely works in a black recession. In Japan it has warded off another great depression, keeping the economy growing (slowly) through two decades, despite a stunning collapse in commercial real estate asset values of $15 trillion -- equivalent to three years of economic output!

In such recessions seeking salvation through provision of abundant and free or nearly-free money, such as central banks currently do, is quite ineffective, because most businesses and families want to reduce their levels of debt, which means spending less. They’re not looking to borrow more to increase their spending.

However, I do admit that there are many problems in implementing fiscal stimulus:

Politicians who authorize the handouts cannot in practice resist directing their benefits to the business or ideological interests they favour, rather than those

that would provide the strongest boost to demand. Much of America's highly-publicized 2009 stimulus plan was wasted in this way, dissipating its impact.

There are serious time-lags in producing the desired effects. Investing in infrastructure, for example, is one of the best kinds of fiscal stimulus when properly targeted. But it can take years to implement such projects.

It is very difficult to quickly introduce such kinds of stimulus, or put a brake on them if the economy does start to pick up strongly and inflation threatens.

Some kinds of fiscal stimulus, such as tax cuts, are inefficient if the beneficiaries use the money to reduce their debts or to save, rather than to spend.

There are long-term dangers of financial imprudence. Politicians are keen to offer rewards to voters, but always reluctant to withdraw such benefits when the economy does recover and their stimulus is no longer needed, or even wise. Central banks tend to fail to act promptly as that may risk aborting a fragile recovery – and attracts the anger of their political masters.

Government boosts must be carefully targeted

Because of all these difficulties, it is important for governments providing fiscal stimulus to shape their plans for maximum and immediate impact on demand, and/or to put resources into kinds of spending such as infrastructure that will deliver long-term economic benefits.

It is also essential that governments keep a close watch for early signs of a major surge in inflation, and have the courage then to slam on the brakes – with sharp increases in official interest rates, for example.

It is fears about the long-term implications of the mounting government borrowing to pay for fiscal stimulus that has triggered the current outbreak of panic over "sovereign" debt.

Starting in Greece, that panic has spread across Europe, and now to Japan and to American tea parties. It is coming to dominate the thinking of financial policymakers.

This is dangerous nonsense.

It is normal and healthy in serious recessions for governments to borrow private savings and to spend them on sustaining demand and economic activity.

Historical experience is that high levels of national debt are eventually eroded by strong finances generated by economic recovery, unless destroyed by war or inflation. The best policy is not to worry too much about current excessive borrowing but to focus on strong, long-term policies to promote economic growth. In time, that generates the revenues to restore public finances to good health.

High levels of debt can be sustained for a long, long time. Japan has experienced them for several decades, but the Japanese state is still able to borrow long-term at interest rates below 2 per cent. The level of debt, and even the rate at which it continues to grow, is not straining the system.

Published figures of national debt seem much scarier than they really are. When you see statistics such as 200 per cent for Japan's ratio of debt to annual economic output, be aware that about half that debt is owed by one state agency to another. It is intra-government accounting, and that portion of the national debt is no burden requiring future repayment. It can be serviced by printing money, or simply be written off.

Most of the rise in public debt is not due to over-spending, but to the collapse in government revenues and the rise in welfare costs such as unemployment benefits due to the recession. When recovery comes, revenues will bounce back and welfare costs fall, removing much of the problem. If recovery doesn't come, there will continue to be a huge pool of savings available to buy government debt and finance supportive spending.

Is Osborne looking for a fight?

The melodramatic posturing by the new British government over fiscal deficits is particularly curious, as the UK still has a relatively low national debt ratio, no refinancing problem, and low dependence on foreign support for sales of its bonds. Unlike eurozone countries, it has the flexibility that comes with control over its own currency.

Could it be that new finance minister George Osborne's over-the-top focus on fighting the build-up of national debt, including proposed savage cuts in state spending that are forecast to cost 700,000 public-sector jobs, is really primarily a ploy to precipitate a politically-advantageous war with the labour unions – which the government would undoubtedly win?

When you study the history of various countries' financial and economic crises, it is clear that, although tough domestic policy measures such as state spending cuts and tax increases are important, they do not produce sustainable economic recovery. The real source of lift-off always seems to come from exports, with or without the boost of currency devaluation.

The problem with this great recession is that is affects so much of the world economy, offering little opportunity for stricken nations to grow out of their problems by increasing exports to others.

I can't see where that growth in foreign markets is going to be found this time around. China will do its bit, but it is still a relatively small part of the entire global economy, and the stimulus it provides will primarily benefit producers of natural resources, and its developing regional neighbours.

Adverse circumstances that are likely to persist for a decade or more make it important for policymakers to focus on radical reforms to make their national economies more efficient – and to deal with some serious longer-term problems, particularly the future increase in age-related expenditures such as pensions and medical services.

This isn't the right time to be distracted by worrying about public deficits and debt. The focus should be on sustaining and promoting the dynamics of the private sector, which is unable to print its way out of trouble, yet offers the best prospects for economic growth.

A Doomsday Machine with Little Social Value

Our policymakers give every impression of being completely out-of-touch with ordinary people and their suffering – unemployment, collapsing small businesses, falling personal incomes, and the prospect of savage cuts in public services – as the global economy loses momentum and threatens another failure.

One obvious example is their obsession with and arguments over how the banking system is to be reformed through tighter regulation, greater capital requirements and/or punitive taxation – all measures supposedly designed to prevent another credit bubble.

What makes it all absurd is that the bubble came about because of the abject failure of regulation and political encouragement of bad lending policies.

None of that is being addressed by current proposals. Indeed, some of those most guilty of creating the bubble, such as state-sponsored financial giants and the biggest private-sector banks, continue to be protected and rewarded rather than punished.

The latest financial reform bill passed by the US Congress specifically excludes tougher regulation of the two leviathans mainly responsible for the sub-prime scandal, Fannie Mae and Freddie Mac, which continue to lose billions of taxpayer dollars every quarter.

As *The Wall Street Journal* says: "The bill greatly increases the power of politicians and regulators without addressing the real causes" of the financial crisis.

Even worse is the fact that all this backward-looking focus on "reform" diverts attention from the important forward-looking issues of sustaining economic growth.

A particular characteristic of the latest recession has been the obsessive focus of policymakers on rescuing the financial sector – including saving nearly all its

worst bits on the dubious grounds that they are too important to be allowed to fail – instead of focusing on underpinning demand in the real economy.

The bloated giants of the financial sector, stuffed with their toxic debt, have been saved by government loans, guarantees and takeovers, as well as virtually unlimited, almost-free central bank credit.

This abundant generosity with publicly-owned resources is defended on the grounds that the banks are essential. In fact, essential services are a relatively small part of what they do, and one they have long neglected.

The financial sector constitutes an unbelievably huge aggregation of public and private enterprises mainly devoted to their own survival and gain. They shuffle around the cash electronically, advancing their own interests. Very little of that vast wealth actually passes into the real economy to generate business growth, create jobs and improve personal incomes.

The *FT*'s erudite commentator Martin Wolf speaks of our world being burdened with a "financial doomsday machine."

He says banks are actually encouraged to do riskier business based on ever-greater leverage (use of borrowed money) by government support, including cheap credit and guaranteeing retail deposits, and the protection for their shareholders provided by limited liability.

In Britain their assets ballooned over four decades from 50 per cent of national output to 550 per cent. Yet "a large part of their activity seems to be a machine to transfer income and wealth from outsiders to insiders, while increasing the fragility of the economy as a whole."

When credit bubbles burst, governments seek to combat their impact on economies by creating new ones.

"It is hard to see any substantial benefit from the massive leveraging up of the economy and, above all, the real estate sector, that we saw recently. This just created illusory gains on the way up and real pain on the way down," Wolf writes.

Governments divert voter anger to side-issues

It is unlikely that better regulation could have prevented the credit bust or will do so in future.

"It is hard to regulate finance against the incentives of those who run it. Fixing the problem has to include changing incentives in simple and transparent ways. To put it bluntly, participants have to fear the consequences of making serious mistakes, not just be told to stop."

Voters resent the obvious, sometimes blatant, privileges of the financial sector and those who inhabit it, allowing their disquiet to be diverted to side-issues such as bankers' bonuses.

I hope in time they will come to realize how fundamental and large-scale are the policy actions required to cut the financial sector down to size.

They also need to mobilize their political power to ensure that most public support is directed to where it is really needed -- to the poorer sectors of the community and smaller enterprises, not to the fat cats favoured by political elites.

Preparing for Another Mideast War?

The Israeli Air Force has been granted access to a corridor of air space across Saudi Arabia and offered the use of a base there that could act as a staging point for an aerial assault against Iran, according to reports in *The Times* of London and Mideast media.

In itself, this does not suggest that an Israeli attack against military targets in Iran is imminent. It could be part of long-term plans being implemented by Saudi Arabia to counter the growing threat to its security from a more militant Iran. The two countries are divided by the hostility between their predominant rival sects of Islam, the Sunni and the Shia.

However, US defence minister Robert Gates told the Senate this month that Iran could develop nuclear weapons soon, perhaps within one year, and already has the missiles to deliver them. The US Navy has recently moved additional firepower to the region, including nuclear submarines.

These developments do raise the possibility that a combined Israeli-American attack on Iran to pre-empt its acquisition of nuclear weaponry is much closer than experts generally expect, perhaps before the end of this year.

That would be a potentially catastrophic event for world oil supplies, a third of which have to pass through the narrow, shallow strait of Hormuz between Iran and the Arabian peninsula that could be easily, if only temporarily, blocked by sunken vessels.

It would certainly have major implications for a world economy now threatened by double-dip recession -- Karl Marx long ago suggested that capitalist economies escape from their "internal contradictions" by going to war.

It would also dispel boost President Barack Obama politically be dispelling doubts about his capacity to act decisively as a military commander -- he prevaricated for three months before approving the "surge" in Afghanistan, finally reaching a muddled compromise (and in my opinion, wrong) decision.

The Outlook for Gold

The price of gold is likely to reach about $1,500 in 12 months' time, or even higher if there is a sharp intensification of the sovereign debt crisis in Europe, the Swiss banking giant UBS forecasts.

There are downside risks, too. But any prices below $1,200 represent buying opportunities. "In the current environment, we prefer unhedged, physically-backed positions over equities and paper investments in gold."

The bank also comments: "Saying that gold is too expensive in US dollar terms is the same as saying that the US dollar is too cheap in terms of gold. Against a broad basket of all major currencies... gold's value has remained remarkably stable over long periods of time." In inflation-adjusted terms, the gold price today is more or less at the same level as 750 years ago.

Investors using the dollar as their reference currency and taking a view of five or more years should hold 10 to 15 per cent of a broadly-diversified portfolio in gold, UBS says.

How can one explain the simultaneous strength of gold, a defence against inflation, and of fixed-interest bonds, a protection against deflation. Martin Barnes of *Bank Credit Analyst* suggests that investors, unable to decide which of these conflicting threats is the greater danger, are just hedging their bets.

Strategist David Rosenberg says that ordinarily the explosion in the central bank's balance sheet and therefore the US monetary base from $850 billion in 2007 to $2.3 trillion today would be highly inflationary.

"But because banks are not relending that money, it has not been [inflationary]. In fact, overall credit is declining. If and when we embark on the next credit creation cycle – which is probably many years away – this monetary inflation will probably result in real inflation. But not until money moves off of bank balance sheets and into the real economy."

Now's the Time to Buy China

Hong Kong-based Aaron Boesky of Marco Polo Pure Investments expects Chinese stocks to bottom this month, with the Shanghai A-share index to rise from current levels (below 2,500 at time of writing) to breach 3,500 before year's end and soar to all-time highs above 6,000 by the end of 2012.

The Chinese economy is consolidating, with "very healthy growth targets around 8 per cent plus for GDP."

He is predicting average earnings growth of 25 to 30 per cent for this year and possibly 30 per cent, perhaps even more, next year.

When factors that have been driving down share prices, such as capital-raising issues and "soaking-up of liquidity," come to an end, the money being raised by the banks will be re-lent, after reserve ratio targets of 12 per cent of capital have been attained.

The market's price/earnings ratio is down to levels "never been seen" before, making shares "a screaming buy." Money "will come out of real estate and back into the stock market by the end of this summer."

My friend the London commentator David Fuller is not quite so enthusiastic – he still sees capital-raising issues as a negative influence on the market. But he finds Boesky's valuation argument "compelling."

The current (historic) price/earnings ratio is "just under 18 and falling as earnings increase and the stock market drifts." Similar ratios in 2005 and 2008 were followed by substantial gains.

The world's fastest-growing economy "is selling on future multiples which are competitive with those in the slow-growth West."

It Pays to be Contrarian

The *FT*s Fox column has just published the fascinating results of its contrarian research for the first half of the year. It identified the investment strategies of major investment banks from their published research, then assumed adoption of trading strategies directly contrary to that advice.

The banks predicted a hard time for US and Japanese government bonds; so instead Fox bought them, achieving a 10 per cent gain on its Treasuries and one in double digits for its Japanese securities.

The banks' currency strategists were bullish on the euro and bearish on the yen; Fox's short euro/dollar and long yen/dollar trades "were two of our best, yielding about 20 per cent."

Equities also "provided some good opportunities. Just as no one expected the Mongolian, Bangladeshi and Sri Lankan benchmarks to finish on the winners' podium, few anticipated that last autumn's correction in Chinese stocks would turn into a rout… Shorting mainland shares listed in Hong Kong returned 16 per cent."

Fox comments gleefully that in general "the advice was reassuringly poor. The markets continue to reward us for listening to the experts – then doing the opposite."

Buying opportunity

Central banks will soon “panic” again, predicts Fidelity International’s strategist Trevor Greetham.

“With economic activity well down on 2007 levels, unemployment high and core inflation rates perilously close to zero,” he says, “developed world central banks are likely to react to evidence of a slowdown by printing money again. “The tighter the fiscal policy, the more aggressive the monetary response will eventually have to be.

“This argues for a further substantial weakening of European currencies.

“It also suggests a big buying opportunity for stocks could present itself later this year… We could be close to the trough of the inventory cycle once more, and a new dose of quantitative easing ought to trigger a rebound in risky assets.

“Investors who missed out on the first leg of the bull market may get a second chance to buy in the coming months.”

Tailpieces

What to do now: With core inflation weak in the US and in Europe, “in the near term, bonds continue to provide diversification benefits and a protection against another deflationary shock,” advises the Swiss investment group Sarasin.

However, over the medium term it does not see current low bond yields as sustainable. There are “considerable risks of capital loss if the European crisis lessens, and long-term inflation risks if it does not and if quantitative easing is used aggressively.

“We increasingly prefer cash plus real assets (gold and blue chip equities).”

Gold remains “a core holding in balanced accounts.” Although holdings in agricultural investments are now modest, they “remain our preferred long-term commodity class, and we see ourselves adding to positions later this year.”

Global equities “remain our preferred asset class,” with European blue chips looking increasingly attractive. Sarasin also likes “key Asian and Western defence contractors.”

Deleveraging: Before the world can return to sustained strong economic growth, the huge amounts of “toxic debt” accumulated in the private sector, especially in property and corporate buyout booms in the US, Britain and Spain, have to be removed from the system.

Debtors unable to repay their borrowings or be rescued by government handouts have to be put out of business. Banks have to be recapitalized. Pension and other long-term funds have to recognize the losses on their bad investments.

According to a new study by the McKinsey Global Institute, deleveraging – the process of eliminating all that bad debt – "has barely begun" and has a long way to go, raising the prospect of "a prolonged period of austerity."

Tax holiday: Contrarian American economist Arthur Laffer, castigating successive administrations for spending about $3.6 trillion since late 2007 to stimulate the economy, yet failing so spectacularly that almost 10 per cent of the work force are unemployed, offers his own controversial alternative – it would have been best to "declare a federal tax holiday for 18 months."

This would have meant "no income tax, no corporate profits tax, no capital gains tax, no estate tax, no payroll tax… for either employee or employer, no Medicare or Medicaid taxes, no federal excise taxes, no tariffs, no federal taxes at all."

The cost would have been about the same $3.6 trillion – but the result would have been an unemployment rate now of just 2½ per cent.

Strikes against BA: In terms of safeguarding the jobs of its members, which you would expect to be first priority, the strikes by the Unite labour union against British Airways look like lunacy.

The carrier, facing huge losses, needs to reduce its staff costs to match competitors'. Average BA cabin crew salaries of £31,400 a year are more than double those of its long-haul rival, Virgin Atlantic, which pays £14,400, and well above the £20,400 paid by its budget-flights competitor EasyJet.

Disinflation continues: The US central bank's preferred inflation gauge – core personal consumption expenditure prices, which strips out food and energy – rose at an annual rate of only 0.6 per cent in the first quarter, or the slowest pace since records began in 1959.

Mobilizing backdoor support: In the takeover battle for Singapore healthcare group Parkway Holdings, it's been revealed that in addition to its four directors on the 13-strong board warranted by its 25 per cent shareholding, the Indian bidder, Fortis Healthcare, concluded a formal arrangement with three other directors giving it "the right to direct" them how to vote in return for "certain economic benefits."

Next financial crisis? Over the next five years more than $1½ trillion in commercial real-estate debt in the US will fall due, having to be repaid or refinanced.

UK dottiness diary: In the interests of "security," visitors to a day nursery will soon find themselves having to undergo fingerprint scanning at the door, banned from using a mobile phone, and only allowed entry with a "child collection password."

In Bristol a councillor representing the Liberal Democrats, renowned for their militant opposition to racism, has been found guilty of and punished for racial harassment because she called an Asian opponent a "coconut" during a political debate.

Meanwhile on the Isle of Man (not the UK, but a British dependency), an engineer commissioned to restore wooden carriages on the Manx Electric Railway has been ordered to limit fully-opening sash windows to half-opening in case a passenger should fall out – although none has succeeded in doing so since the railway opened in 1893.

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