The Risks from Fiscal Imbalances
The Challenge for Central Banks
Bang, Indeed!
The Center Cannot Hold
A Decent Employment Report
Montreal and New York and Italy

By John Mauldin

Turning and turning in the widening gyre
The falcon cannot hear the falconer;
Things fall apart; the center cannot hold;
Mere anarchy is loosed upon the world,
The blood-dimmed tide is loosed, and everywhere
The ceremony of innocence is drowned;
The best lack all conviction, while the worst
Are full of passionate intensity.

- William Butler Yeats

Last week we focused on the first half of a paper by the Bank of International Settlements, discussing what they characterized as the need for "Drastic measures … to check the rapid growth of current and future liabilities of governments and reduce their adverse consequences for long-term growth and monetary stability." As I noted, you don't often see the term *drastic measures* in a staid economic paper from the BIS. This week we will look at the conclusion of that paper, and then turn our discussion to the fallout from the problems they discuss, initially in Europe but coming soon to a country near you.

But first, what a week in the markets! I'm sure more than a few investors felt like they had a severe case of whiplash. We will discuss the volatility a little more below.

First, a very quick three-paragraph commercial. In the current market environment, there are managers who have not done well and then there are money managers who have done very well. My partners around the world would be happy to show you some of the managers they have on their platforms that we think are appropriate for the current environment. If you are an accredited investor (basically a net worth over $1.5 million) and would like to look at hedge-fund and other alternative-fund managers (such as commodity traders) I suggest you go to www.accreditedinvestor.ws and sign up; and someone from Altegris Investments in La Jolla will call you if you are a US citizen. Or you'll get a call from Absolute Return Partners in London if you are in Europe (they also work with non-accredited investors). If you are in South Africa, then someone from Plexus Asset Management will ring. And in Canada it is Nicola Wealth Management. And Fynn Capital Management in South America. (In this regard, I am president and a registered representative of Millennium Wave Securities, LLC, member FINRA.)

If you are not an accredited investor, I work with CMG in Philadelphia. We have created a platform of money managers who specialize in the alternative management space. By this I mean they do not need a bull or bear market in order to have the potential for profits. (Past performance is not indicative of future results.) You can go to http://www.cmgfunds.net/public/mauldin_questionnaire.asp and quickly read about the past performance of a manager we recently added to the platform, and then sign up to get more information.

If you are an investment advisor or broker, all of my partners can work with you in providing your clients exposure to alternative-style investments and managers. Obviously, if your clients are high-net-worth individuals, then you will want to work with Altegris, ARP, or one of my other international partners; and if your clients need lower minimums, then you should work with CMG. And if you have any feedback or comments, feel free to write me. Now, on to the letter.

The Risks from Fiscal Imbalances

Today we are going to return to a paper from the Bank of International Settlements, often thought of as the central bankers' central bank. This paper was written by Stephen G. Cecchetti, M. S. Mohanty, and Fabrizio Zampolli. (http://www.bis.org/publ/work300.pdf?noframes=1)

The paper looks at fiscal policy in a number of countries and, when combined with the implications of age-related spending (public pensions and health care), determines where levels of debt in terms of GDP are going. The authors don't mince words. They write at the beginning:

"Our projections of public debt ratios lead us to conclude that the path pursued by fiscal authorities in a number of industrial countries is unsustainable. Drastic measures are necessary to check the rapid growth of current and future liabilities of governments and reduce their adverse consequences for long-term growth and monetary stability."

Let me briefly sum up last week's letter. They wrote: "Today, interest rates are exceptionally low and the growth outlook for advanced economies is modest at best. **This leads us to conclude that the question is when markets will start putting pressure on governments, not if**.

"**When, in the absence of fiscal actions, will investors start demanding a much higher compensation for the risk of holding the increasingly large amounts of public debt that authorities are going to issue to finance their extravagant ways?"**

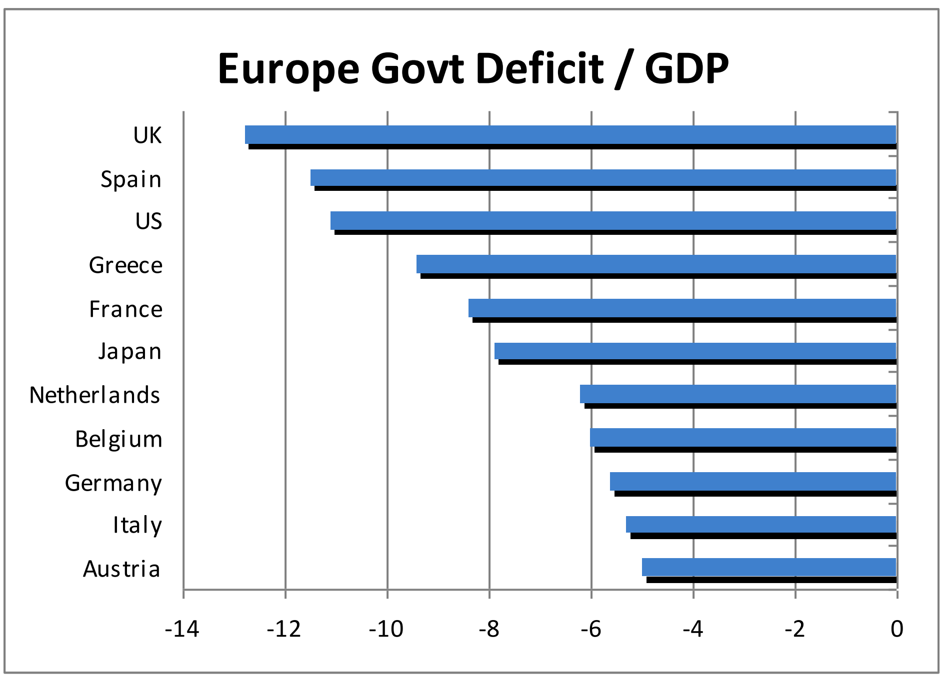
I reproduced graphs that projected interest-rate payments as a percentage of GDP rising rather dramatically over the next 30 years, to levels that, quite frankly, cannot be tolerated by the markets. Long before we get to the place where we in the US are paying 20% of our GDP in interest (which would be about 80% of our tax collections, even with much higher tax rates) the bond market, not to mention taxpayers, will revolt.

The paper's authors clearly show that the current course is not sustainable. And to get back to a level of debt-to-GDP that countries "enjoyed" as recently as 2007 requires such massive structural surpluses as to boggle the mind. And that is with rather optimistic growth assumptions that, as I will show in a few pages, are not very likely.

You can read last week's letter at http://www.2000wave.com/article.asp?id=mwo043010. The discussion of the BIX paper is in the last half of the letter.

Now, we come to the section where they talk about the risks associated with the fiscal deficits. And by the way, we should note that 25 of 27 European countries are running deficits in excess of 3% of GDP. Ireland has a deficit of 14.3%. Portugal is at almost 10%. Greece is almost 14%.

Here is a table from my friends at Variant Perception in London, from data from *The Economist*. Notice that France is over 8%. Germany is almost 6%. Wow. We'll look at the implications of this later.



The first risk is of course, higher interest rates brought about by what they term increased risk premia. In essence, investors want to get paid more for their increased risk. Interest on Greek debt for 5-year bonds is now 15%. There is no way for them to grow their way out of the problem if interest rates are at 15%, up almost fourfold in less than a year. Rates are rising for other European peripheral countries as well.

The second risk "… associated with high levels of public debt comes from potentially lower long-term growth. A higher level of public debt implies that a larger share of society's resources is permanently being spent servicing the debt. This means that a government intent on maintaining a given level of public services and transfers must raise taxes as debt increases. Taxes distort resource allocation, and can lead to lower levels of growth. Given the level of taxes in some countries, one has to wonder if further increases will actually raise revenue.

"The distortionary impact of taxes is normally further compounded by the crowding-out of productive private capital. In a closed economy, a higher level of public debt will eventually absorb a larger share of national wealth, pushing up real interest rates and causing an offsetting fall in the stock of private capital.

"**This not only lowers the level of output but, since new capital is invariably more productive than old capital, a reduced rate of capital accumulation can also lead to a persistent slowdown in the rate of economic growth.** In an open economy, international financial markets can moderate these effects so long as investors remain confident in a country's ability to repay. But, even when private capital is not crowded out, larger borrowing from abroad means that domestic income is reduced by interest paid to foreigners, increasing the gap between GDP and GNP."

This squares solidly with the work done by Rogoff and Reinhart, showing that when the debt of a country reaches about 100% of GDP, there is a reduction in potential GDP growth of about 1%. As I have written elsewhere, government debt and spending do not increase productivity. That takes private investment. And if government debt crowds out private investment, then there is lower growth. And that is what the Rogoff and Reinhart study clearly shows.

And finally, the BIS authors note the risk that a government cannot run deficits in times of crisis to offset the affects of the crisis, if they already are running large deficits and have a large debt. In effect, fiscal policy is hamstrung.

The Challenge for Central Banks

Interestingly, the authors worry that one of the real problems central banks may face is that inflation expectations may become unanchored in the absence of a willingness on the part of the government to show fiscal constraint. Without some evidence of that willingness, monetary policy could lose any ability of be effective.

In other words, no matter how much the people at the Fed might like to help in a crisis, they may not be able to do anything effective if the US government does not deal with its deficits.

"A second mechanism by which public debt can lead to inflation focuses on the political and economic pressures that a monetary policymaker may face to inflate away the real value of debt. The payoff to doing this rises the bigger the debt, the longer its average maturity, the larger the fraction denominated in domestic currency, and the bigger the fraction held by foreigners. Moreover, the incentives to tolerate temporarily high inflation rise if the tax and transfer system is mainly based on nominal cash flows and if policymakers see a social benefit to helping households and firms to reduce their leverage in real terms. It is, however, worth emphasising that the costs of creating an unexpected inflation would almost surely be very high in the form of permanently high future real interest rates (and any other distortions caused by persistently higher inflation)."

The head of the European Central Bank, Jean-Claude Trichet, made it very clear this week that the ECB is not going to be buying Greek bonds. In my recent discussion with Richard Fisher, president of the Dallas Fed, it was also made clear that the current leadership of the Fed knows it cannot print money. So who is the BIS looking at when they talk about the temptation to inflate?

The Bank of England comes to mind. Also Japan. And a number of smaller European central banks. Countries that would not mind their currencies falling, especially if the euro continues to slide. As the BIS notes, the temptation is going to be large. But there is no free lunch. Such things can spiral out of control and either end in tears or in a Paul Volker wrenching the economy into serious recession. I think the final sentence of the paragraph quoted above serves as a warning that such a policy dooms a country to even worse nightmares.

Now we come to the conclusion of the paper. Normally, I do not like to quote at length, but these next six paragraphs deserve it (again, all emphasis mine):

"Our examination of the future of public debt leads us to several important conclusions. First, fiscal problems confronting industrial economies are bigger than suggested by official debt figures that show the implications of the financial crisis and recession for fiscal balances. **As frightening as it is to consider public debt increasing to more than 100% of GDP, an even greater danger arises from a rapidly ageing population. The related unfunded liabilities are large and growing, and should be a central part of today's long-term fiscal planning.**

"It is essential that governments not be lulled into complacency by the ease with which they have financed their deficits thus far. In the aftermath of the financial crisis, the path of future output is likely to be permanently below where we thought it would be just several years ago. As a result, government revenues will be lower and expenditures higher, making consolidation even more difficult. **But, unless action is taken to place fiscal policy on a sustainable footing, these costs could easily rise sharply and suddenly.**

"Second, large public debts have significant financial and real consequences. The recent sharp rise in risk premia on long-term bonds issued by several industrial countries suggests that **markets no longer consider sovereign debt low-risk**. The limited evidence we have suggests default risk premia move up with debt levels and down with the revenue share of GDP as well as the availability of private saving. **Countries with a relatively weak fiscal system and a high degree of dependence on foreign investors to finance their deficits generally face larger spreads on their debts.** This market differentiation is a positive feature of the financial system, but it could force governments with weak fiscal systems to return to fiscal rectitude sooner than they might like or hope.

"Third, we note the risk that persistently high levels of public debt will drive down capital accumulation, productivity growth and long-term potential growth. Although we do not provide direct evidence of this, a recent study suggests that there may be non-linear effects of public debt on growth, with adverse output effects tending to rise as the debt/GDP ratio approaches the 100% limit (Reinhart and Rogoff (2009b)).

"Finally, looming long-term fiscal imbalances pose significant risk to the prospects for future monetary stability. We describe two channels through which unstable debt dynamics could lead to higher inflation: direct debt monetisation, and the temptation to reduce the real value of government debt through higher inflation. Given the current institutional setting of monetary policy, both risks are clearly limited, at least for now.

"How to tackle these fiscal dangers without seriously jeopardising the incipient recovery is the key challenge facing policymakers today. **Although we do not offer advice on how to go about this, we believe that any fiscal consolidation plan should include credible measures to reduce future unfunded liabilities**. Announcements of changes in these programmes would allow authorities to wait until the recovery from the crisis is assured before reducing discretionary spending and improving the short-term fiscal position. An important aspect of measures to tackle future liabilities is that any potential adverse impact on today's saving behaviour be minimised. From this point of view, a decision to raise the retirement age appears a better measure than a future cut in benefits or an increase in taxes. Indeed, it may even lead to an increase in consumption (see eg Barrell et al [2009] for an analysis applied to the United Kingdom)."

Bang, Indeed!

I had a discussion today with Jonathan Tepper of Variant Perception in London. We agree that the risk that no one talks about is the level of foreign investment in some of these countries and the consequent rollover risk. By this we mean that when a bond comes due, you have to roll over that bond into another bond. If the party that bought the original bond wants cash to invest in something else, or just does not want your bond risk anymore, you have to find someone to buy the new bond. Greece has a large number of bonds coming due this year. It is not just the new debt; they have to find someone to buy the old debt. And that is why they need so much money.

But it is not just a Greek problem. About 45% of Spain's debt is owned by non-Spanish, and they need to roll over old debt and new debt of 225 billion euros this year alone. That is bigger than the entire GDP of Portugal. Spain cannot finance this internally. But will foreigners buy 100 billion euros and, if so, at what price if they are not convinced that Spain will enact serious austerity measures?

Listen to ECB Governing Council President Jean-Claude Trichet (hat tip to Greg Weldon):

"As regards fiscal policies, we call for decisive actions by governments to achieve a lasting and credible consolidation of public finances. The latest information shows that the correction of the large fiscal imbalances will, in general, require a stepping-up of current efforts. Fiscal consolidation will need to exceed substantially the annual structural adjustment of 0.5% of GDP set as a minimum requirement by the Stability and Growth Pact….

"The longer the fiscal correction is postponed, the greater the adjustment needs become and the higher the risk of reputational and confidence losses. Instead, the swift implementation of frontloaded and comprehensive consolidation plans, focusing on the expenditure side and combined with structural reforms, will strengthen public confidence in the capacity of governments to regain sustainability of public finances, reduce risk premium in interest rates and thus support sustainable growth."

This is a man who wants some serious austerity. No garden-variety cuts here and there. And that brings us to the heart of the problem. That chart a few pages above showed the large fiscal deficits involved. If those are tackled seriously, it will put many countries into outright recessions and reduce the growth in others. Some, like Greece, will be in what can only be called a depression.

The entire eurozone is in for a double-dip recession, if it is not there already. And one country after another is going to have to convince foreigners to buy its debt. But if they make the cuts, their GDP will fall, ironically increasing their debt-to-GDP ratio and making investors demand even higher rates, which becomes a very vicious spiral.

And the banks that do own that debt will suffer liquidity problems unless the ECB steps forward with a new program in a massive way – which Trichet is currently resisting.

As Reinhart and Rogoff wrote: "Highly indebted governments, banks, or corporations can seem to be merrily rolling along for an extended period, when **bang!** – confidence collapses, lenders disappear, and a crisis hits."

Bang is the right word. It is the nature of human beings to assume that the current trend will work out, that things can't really be that bad. The trend is your friend until it ends. Look at the bond markets just a few months before World War I. There was no sign of an impending war. Everyone "knew" that cooler heads would prevail.

We can look back now and see where we made mistakes in the current crisis. We actually believed that this time was different, that we had better financial instruments, smarter regulators, and were so, well, modern. Times were different. We knew how to deal with leverage. Borrowing against your home was a good thing. Housing values would always go up. Etc.

The Center Cannot Hold

Sovereign debt was a good idea only a little while ago. Take cheap money, lever up, and make a nice spread. And now, not so much a good idea. Credit spreads are widening all over Europe. Interest rates are rising for the European periphery.

We once again find ourselves on a Minsky Journey to a rather fraught Minsky Moment. Hyman Minsky famously taught us that stability breeds instability. The more things stay the same, the more complacent we get, until ***Bang!*** We always seem to think this time is different, and it never is.

The Minsky Journey is where investment goes from what Minsky called a hedge unit, where the investment is its own source of repayment; to a speculative unit, where the investment only pays the interest; to a Ponzi unit, where the only way to repay the debt is for the value of the investment to rise.

Greece is now at its Ponzi moment of financing. As John Hussman pointed out this week, if interest rates are at 15% when you roll over debt, and your country is not growing, you have no way to actually service the debt. And thus, the Minsky Moment when the markets walk away. ***Bang!*** From Hussman's letter:

"The basic problem is that Greece has insufficient economic growth, enormous deficits (nearly 14% of GDP), a heavy existing debt burden as a proportion of GDP (over 120%), accruing at high interest rates (about 8%), payable in a currency that it is unable to devalue. This creates a violation of what economists call the "transversality" or "no-Ponzi" condition. In order to credibly pay debt off, the debt has to have a well-defined present value (technically, the present value of the future debt should vanish if you look far enough into the future).

"Without the transversality condition, the price of a security can be anything investors like. However arbitrary that price is, investors may be able to keep the asset on an upward path for some period of time, but the price will gradually bear less and less relation to the actual cash flows that will be delivered. At some point, the only reason to hold the asset will be the expectation of selling it to somebody else, even though it won't be delivering enough payments to justify the price.

"Unless Greece implements enormous fiscal austerity, its debt will grow faster than the rate that investors use to discount it back to present value. Moreover, to bail out Greece for anything more than a short period of time, the rules of the game would have to be changed to allow for much larger budget deficits than those originally agreed upon in the Maastricht Treaty."

And if Greece has further problems, the market will look at Spain (and Portugal and Ireland). In order for Spain to continue to get financing, the market must believe they are going to make a credible effort at austerity measures. And because they need so much foreign financing, that moment may be sooner than we now think, as their rollover risk is massive. If Spain gets slapped, then who will be next?

There are examples of countries that have worked their way out of even worse problems and have done so without default. But those examples always came with currency devaluation and higher inflation. The eurozone countries cannot devalue their currencies. The risk in Europe is that the austerity measures bring about deflation, which makes the debt an even greater burden.

Look, I want the eurozone to succeed. I love Europe and look forward to my family vacation in Italy this June. But I think we have to be realistic and acknowledge that the European leadership has a very tough set of problems. As does Japan, as does Great Britain, as does the US, etc.

To argue that the US can decouple from Europe’s problems doesn’t hold water with me. We are clearly in recovery, but we are going to need all the help we can get. And a Europe falling into what could be a serious recession is not a Europe that buys our goods. And with the euro on the way to parity (along with the pound) we will have to compete with their exporters. The latter half of this year, I think the US slows down. Then the 2011 tax hikes kick in.

I still think there is at least a 50-50 chance of renewed recession, and with it a serious bear market and rising unemployment. I hope I am wrong but, as I have been writing for some time, you should see this as a trader’s market and, with a few exceptions, be wary of being long only.

Montreal and New York and Italy

I am home for most of May. I have a 24-hour trip to Montreal to be with Tony Boeckh for his private Club X conference. Tony will be the author of next Monday's Outside the Box, where he will discuss the themes of his new (and should-be bestseller) book, *The Great Reflation.* I also get to go out and party when I land there with David Rosenberg. That should be fun!

The following week I am back in New York for a day, then two nights in Stamford, Connecticut, speaking to Pitney Bowes execs, and then home, where I will stay until June 3, when the whole family (seven kids and spouses, grand-babys) takes a vacation to Italy for two weeks.

I am going to stay over and speak at the Global Interdependence Center Conference in Paris June 17th and 18th, with my good friend David Kotok and other luminaries. There will be a lot of central banker types, and if you want to get a feel for what's happening in Europe you should come. Information is at www.interdependence.org.

We have been planning (or Tiffani has) for the Italy trip. I really can't wait, as it's going to be a ton of fun. It has been over 25 years since I was in Italy, and that was just a few days in Rome and Venice. This time it's two full weeks, with a week in Rome and Venice and then a week in Tuscany, then to Paris, and then back to Tuscany and Milan.

Your ready for a vacation analyst,

John Mauldin