CURRENCY CURRENTS

A free global-macro & market newsletter

Wednesday 11 January 2017

Quotable

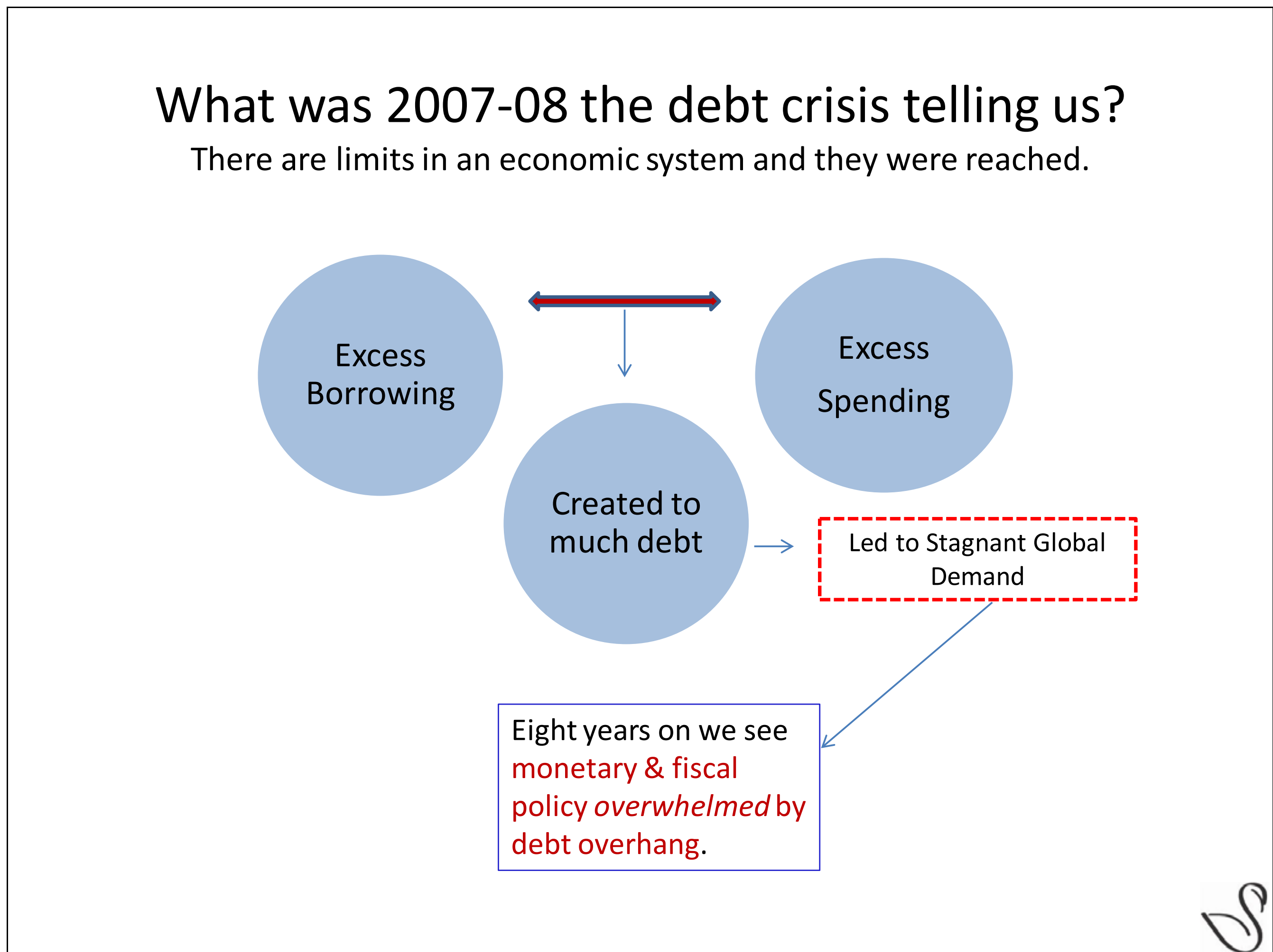
"We cannot therefore avoid the question that Hyman Minsky posed —whether a monetary economy with debt contracts and capitalist financial institutions will ever be stable, and in particular whether stability is possible as long as there are fractional reserve banks."

--Adair Turner

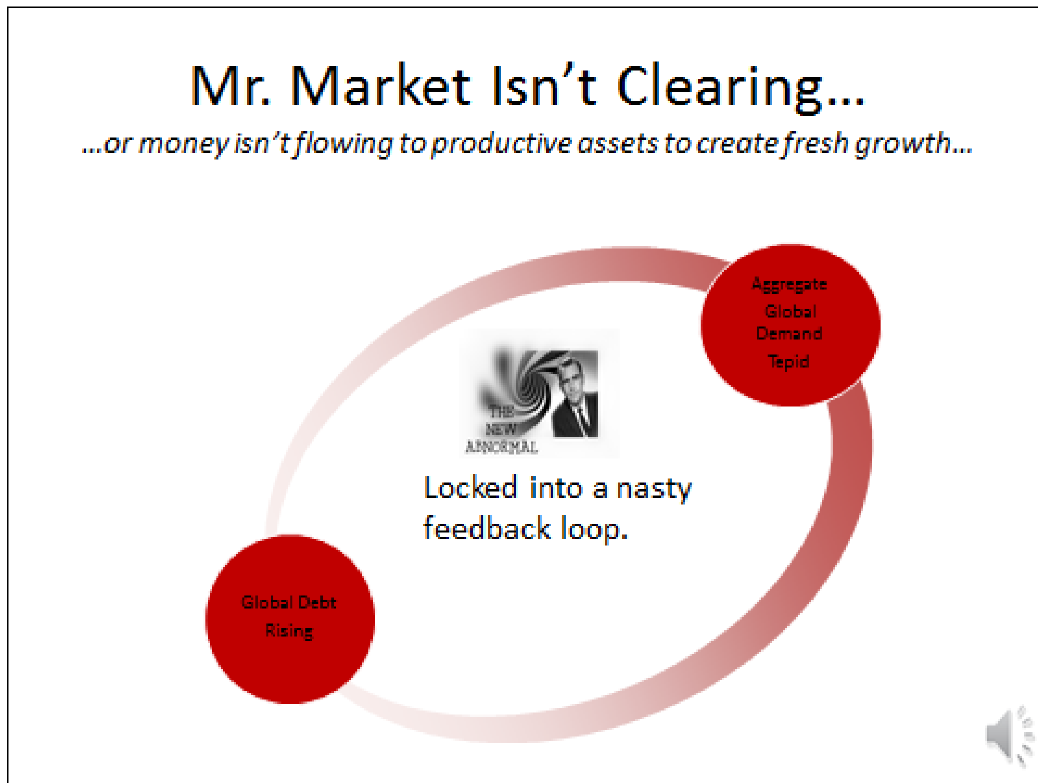
Commentary & Analysis

The four-body problem and debt in the year 2017

Different year, same problem—debt overhang!



Despite the best efforts of governments and central banks we remain stuck in the same vicious feedback loop:



Rebalancing of the global economy is critically important if we wish to breakout of this vicious circle of stagnation, i.e. the global economy is starting to look a lot like Japan.

In chapter six, "Restoring International Balance in the World," of their excellent book, *The Leaderless Economy*, authors Peter Temin and David Vines write:

> "We extend our story from the problem of Europe to those in the world in this chapter. This is a complex endeavor, the culmination of our intellectual journey. It will take three demanding steps to understand the complexity of world economic relations.
>
> "Our first step concerns the relations between China and United States. These relations resemble those within Europe to an alarming degree. In the case of Europe, our concern for internal and external balance pointed to two possible solutions: a cooperative solution sent us on a path to internal and external balance raw countries, whereas a non-cooperative solution is unpleasant. The same conclusions hold in the case of China and the United States, with one caveat. In Europe, it is clear that Germany must act as a regional hegemon to lead the way to a cooperative European solution. It is less clear who can promote cooperation across the Pacific Ocean, as both China and the United States are contending for hegemonic status.
>
> "… Asia is linked to the United States by the fixed rate between the renminbi and the dollar; by contrast, the euro floats relative to the dollar. We need to understand how external balances are managed under flexible exchange rates to expand our analysis to the world economy.
>
> "Our final step is to put these two an analysis together. To do this we consider what we might call the quote three-body problem" of the world economy. How can East Asia, the United States, in

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> Europe all coexist harmoniously? The interactions among these bodies cannot be symmetrical, as the exchange rate between United States and China is fixed [managed], or as that between the dollar and the euro is not. This is symmetry makes a three body problem quite awkward… **The conclusion from our analysis is that cooperative global policies are needed for global growth.** There are many potential problems. Starting with interest rates at zero lower bound means that monetary policy is severely constrained. China may not be able to change its economic policies quickly and abandon its export led development strategy. Europe may not expand as much as it could. The United States might be forced to continue as the legatee market until financial observers concluded that American debt become unserviceable even at lower interest rates. At that point we predict another global financial crisis."

The three-body problem is inherently difficult from a forecasting perspective, as French mathematician Jules Henri Poincaré warned, and Nassim Taleb summarized in his book, *The Black Swan*:

> "Poincare showed this in a very simple case, famously known as the 'three body problem.' If you have only two planets in the solar style system, with nothing else affecting their course, and you may be able to in definitely predict the behavior of these planets, no sweat. But at a third body, say a comet, ever so small, between the planets. Initially the third body will cause no draft, no impact; later, with time, its effects on the two bodies may become explosive. Small differences in where this tiny body is located will eventually dictate the future of the behemoth planets.
>
> "Explosive forecasting difficulty comes from complicating the mechanics, ever so slightly. **Our world, unfortunately, is far more complicated than the three body problem**; it contains far more than three objects."

When it comes to global rebalancing, we have at least a four-body problem. These critical four-bodies (as outlined in the chart below) effectively encompass the global economy; and the process of rebalancing is now reversing again as debt-GDP levels have increased dramatically since the credit crunch.

Rebalancing graphic next page

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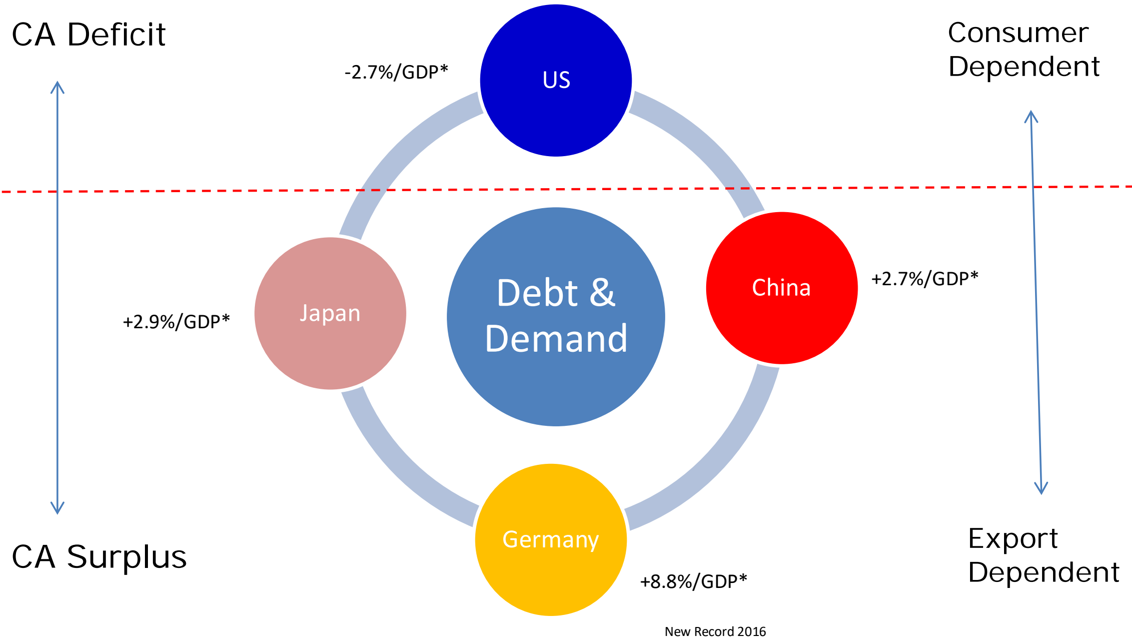
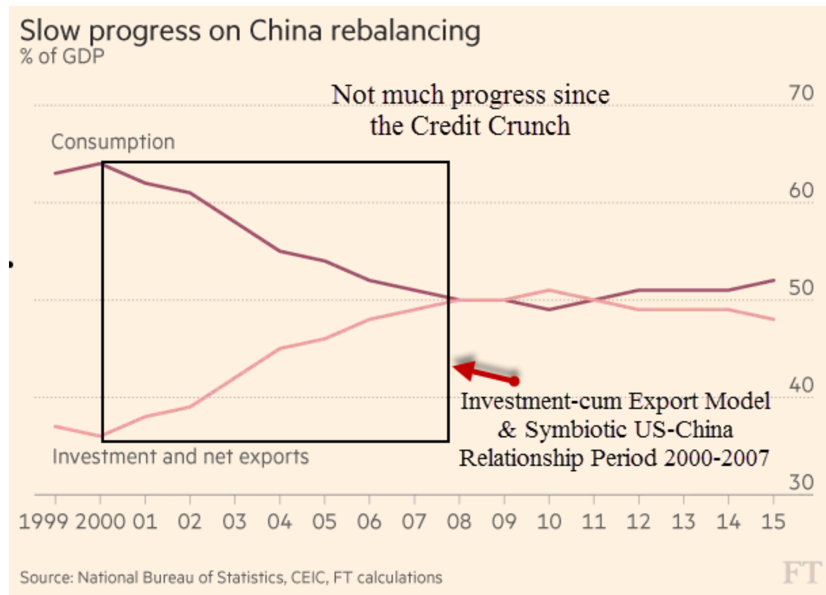


China rebalancing is most critical for the global economy…yet, there has been little progress since the credit crisis as you can see in the chart below:



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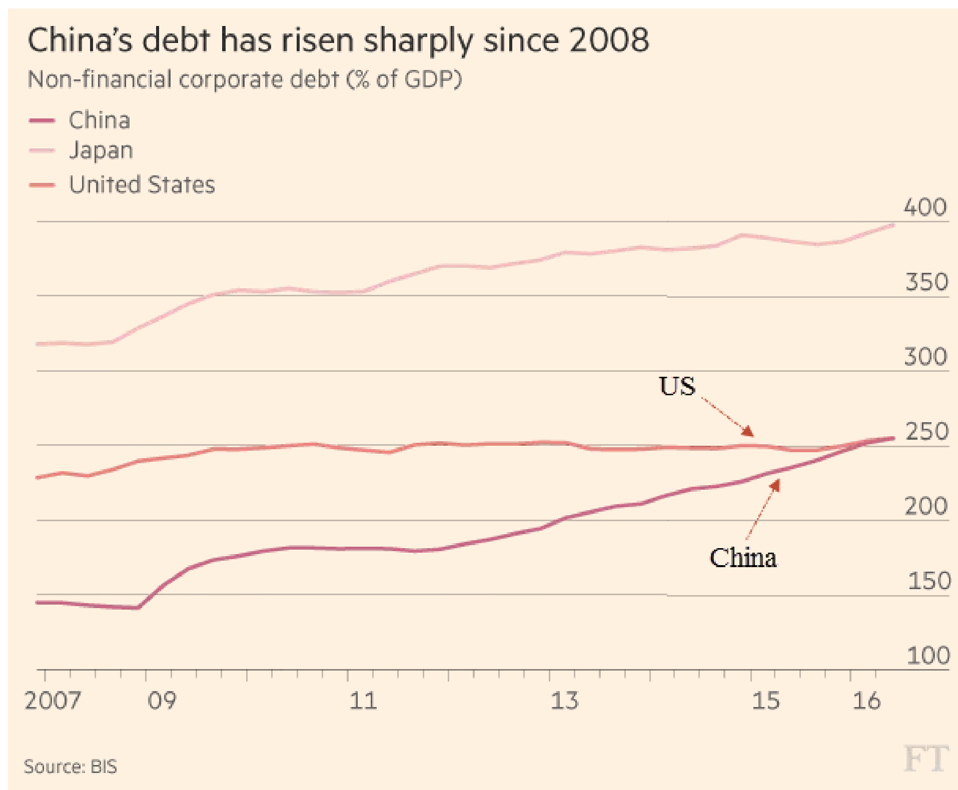
A bad omen, especially juxtaposed against this warning from Adair Turner, taken from his exelent book, [Between Debt and the Devil: Money, Credit, and Fixing Global Finance]:

> "Achieving that shift is essential. For if China continued to grow in its recent credit-intensive fashion, its debt stock would become daunting, not only in relation to China but also with respect to the whole world. By the early 2020s, China could have a nominal GDP of $ 20 trillion. **If by then it had a nongovernment debt to GDP of 250% that would be $ 50 trillion of debt, 3.5 times the size of the U.S. mortgage markets which played such a major role in the origins of the 2007–2008 financial crisis.** And while China's debt mountain is today owed almost entirely within China —and largely by banks, companies, and local governments all ultimately controlled or owned by the state— the more that China progresses toward a more normal market economy and the more that it liberalizes its capital account flows, the greater will be the danger that instability in the Chinese financial system is transmitted to the rest of the world."

Guess what? China is now at the 250 per cent debt-to-GDP level, as it quickly caught up with the United States, adding credit as a replacement for the fall in global demand:



China Treadmill of potentail pain:

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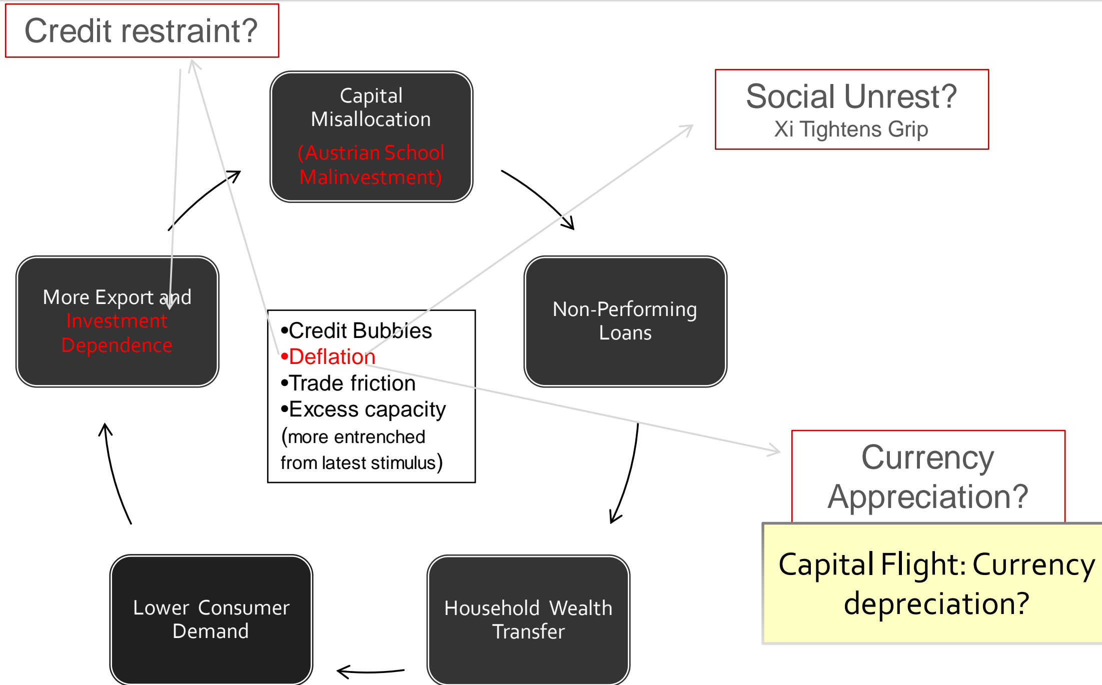

Adding to the worries, it seems global cooperation on debt and rebalancing problems is all but non-existent. Heck Germany can't even cooperate with its own union. This from the *Financial Times* [my emphasis]:

Germany's chief economist hits back at IMF, EU over spending calls

A big fat "nein" from the German treasury. **Berlin's chief economist has firmly rebuffed suggestions that Europe's largest nation should spend more** in an attempt to lift growth across the continent, accusing some of the world's foremost economic institutions of being "short sighted".

Amid **persistent calls for Germany to ramp up spending from Washington to Frankfurt,** Ludger Schuknecht said the demands were based on outmoded economics, warning instead of still dangerously high debt levels across the developed world. "Mountains of debt we see today leave public finances vulnerable to interest rate hikes and weaken their resilience to foreseeable and unforeseen events", said Mr Schuknecht in a letter published by the German finance ministry.

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> “With debt ratios averaging 120 per cent of gross domestic product (GDP), the Group of Seven (G7) economies have accumulated the highest levels of sovereign debt since the Second World War”. The economist said it was inconsistent for the International Monetary Fund and the European Commission to push for looser fiscal policy having previously advocated tough limits to public spending and reductions in debt levels. His comments come ahead of the latest set of figures on German economic growth due out tomorrow and in the wake of **persistent institutional tensions between hawkish German calls for bold economic reforms and Brussels’ bid to boost spending as the best way out of the eurozone’s low growth trap.**
>
> Last month, the ECB called for a better balance of spending across the 19-country bloc, urging governments with “fiscal space” to raise spending seven years after the eurozone’s debt crisis. Mr Schuknecht also criticised record low central bank interest rates and monetary stimulus measures for creating the “illusion” that governments had healthy public finances. Instead, debt levels were vulnerable to any rise in global interest rates. “Central bankers have created windfall profits for national budgets and the false impression of ‘fiscal space’”, he said. “These fiscal illusions tempt further calls for deficit spending, as we can hardly recall the time of significantly positive nominal and real rates.”

Many find it interesting, to say the least, despite the fact Germany is sitting on a massive current account surplus (8.8% of GDP in 2015), with 2016 estimated to be at record levels, it clearly doesn’t want to spend. Instead, the country prefers to grab excess demand (which defines a current account surplus) from other countries globally.

Given the already hiked-up political and economic discontent across the Eurozone, <u>I suspect another year of stagnant growth in the Southern tier increases the probability of game over</u>. Albeit massive market turmoil initially, the suffering countries in the Eurozone would be much better off returning to their own currencies, regaining some semblance of fiscal and monetary control, and relative country competitiveness, as opposed to wallowing endlessly in secular stagnation; which now seems the order of the day.

> *"If so, it seems we must accept either the instability of credit booms and busts, or sustained low growth, too low inflation, and debt levels that are never reduced."*
>
> ---Adair Turner

There are no silver bullets of policy to extract the global economy from the current quagmire. It will not be easy to avoid secular stagnation even if things are done right. Below is a list of some choices or potentialities global policy makers face:

1) Accept regular boom/bust crisis (private credit)
2) Accept secular growth stagnation
3) Start a process of debt write-off
4) Accept government fiat money creation

Note: More on each of these in the next Currency Currents

Needless to say, I am not optimistic about the chances for robust growth in the global economy during 2017. That said, there is one possibility that could change the dynamic—the Trump Agenda.

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If the Trump Agenda is enacted in whole (unlikely) the incentives provided by lower tax rates and regulatory burden could create the incentive for more money & credit flowing into productive assets; e.g. plant and equipment, instead of speculative assets (defined as real estate and financial assets). In addition, on top of more productive use of credit, we would likely need to see a big pick-up in entrepreneurial growth, replacing the legacy assets (crony capitalism). This might just change the dynamic for the global economy; especially if replicated elsewhere.

But even if this rather "goldilocks" potential plays out, it is unlikely we will witness the benefits flow-through to the real economy until well into 2018.

With deflationary pressures still exerting the primary influence in 2017 it increases the chance of crisis somewhere. And if that crisis comes in the form of a breakup if the Eurozone the benefits could be palpable longer term, as it would likely mean a big debt restructuring and a return to more entrepreneurial style growth on the European continent. That might just dovetail nicely with the impact of the Trump Agenda in 2018. Stay tuned.

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