CURRENCY CURRENTS

A free global-macro & market newsletter

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Quotable

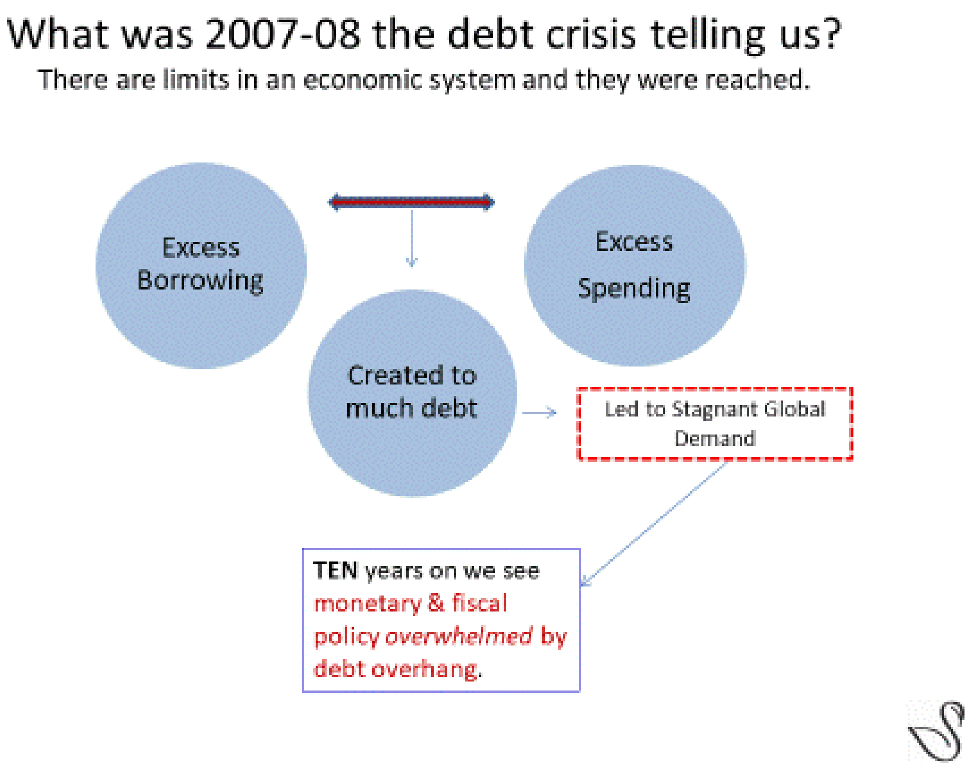
"We cannot therefore avoid the question that Hyman Minsky posed —whether a monetary economy with debt contracts and capitalist financial institutions will ever be stable, and in particular whether stability is possible as long as there are fractional reserve banks."

--Adair Turner

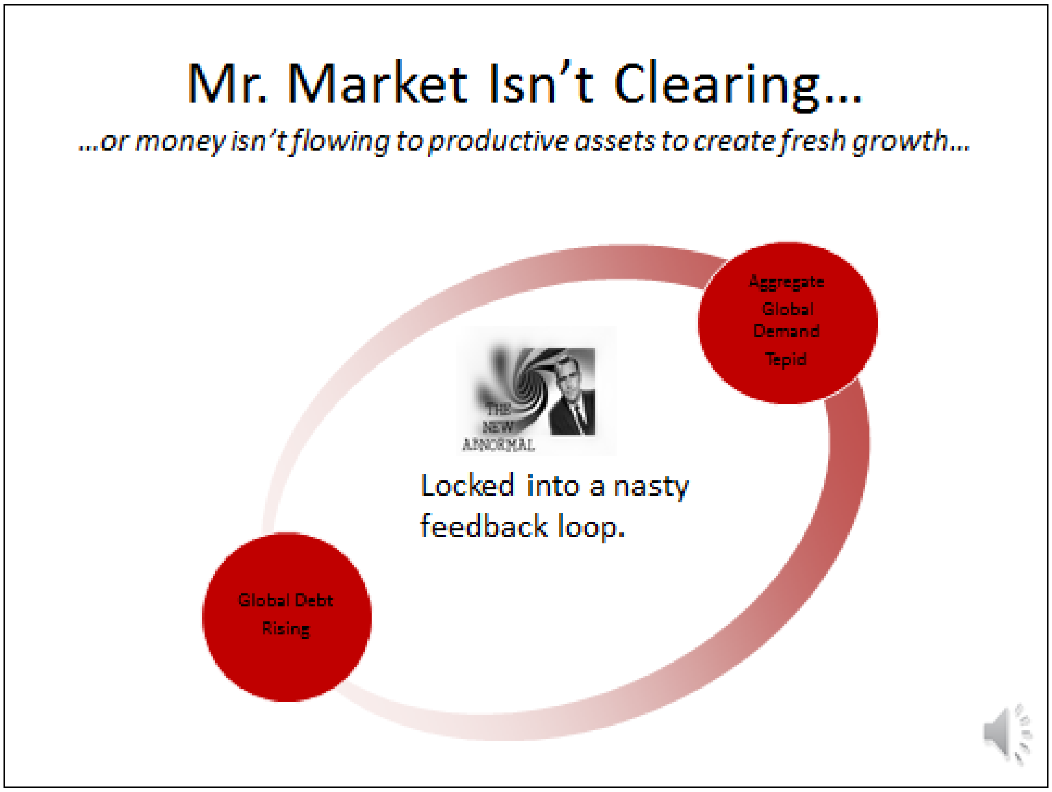
Commentary & Analysis

The three-body problem and debt in the year 2018

Different year, same problem—debt overhang!



Despite the best efforts of governments and central banks we remain to a large degree mired in the same trap thanks to global supply exceeding demand in manufactured goods and commodities. Though we see it in all economies where legacy assets are protected by crony capitalism, the poster child is China whereby much of their debt build has been funneled into unproductive assets in the absence of real demand, all in an effort to keep nominal economic growth numbers on track.



There are many moving parts in the global equation of rebalancing. Let's break it down into three bodies—the United States, Europe, and China—three big developed consumer and capital markets. Just three bodies should make the analysis that much easier. Not!

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 indefinitely 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."

With the growth of the US economy, thanks to President Trump's tax and regulation cuts, the outlook for the global economy appears less dire than it did just a few years ago. But, a lot of the stimulus to the US economy has created more debt and higher Federal deficits. So, despite some real positive changes taking place in the US, one continues to wonder once the US slows and global debt problem is still with us—what next. Well, what next will not be pretty unless the other two bodies make significant improvements in both their debt profile and ability to generate real growth. So a three-body problem where forecasting confidence is minimal, but one has the gut feeling the probability of a very bad outcome is rising.

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

> "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.
>
> "<u>Our first step concerns the relations between China and United States</u>. 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 sends us on a path to internal and external balance for all countries, whereas <u>a non-cooperative solution is unpleasant</u>. 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.
>
> *[No one is the answer. And with China now in the midst of its own Monroe Doctrine as it relates to the South China Sea; the great game has become even more dangerous.]*
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> "… 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.
>
> *[Add to the complexity of a managed Chinese currency based on the whims of Chinese leaders—no longer can the Chinese renminbi be considered "fixed" to the dollar. This adds further complexity to our rebalancing problem. Note: the renminbi is at its weakest level against the dollar since December 2016, which isn't helping its case as China is now running its biggest trade surplus ever with the US (see chart below).]*
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> "Our final step is to put these two an analysis together. To do this we consider what we might call the quote <u>'three-body problem of the world economy</u>. How can East Asia, the United States, and 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. <u>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.</u>"
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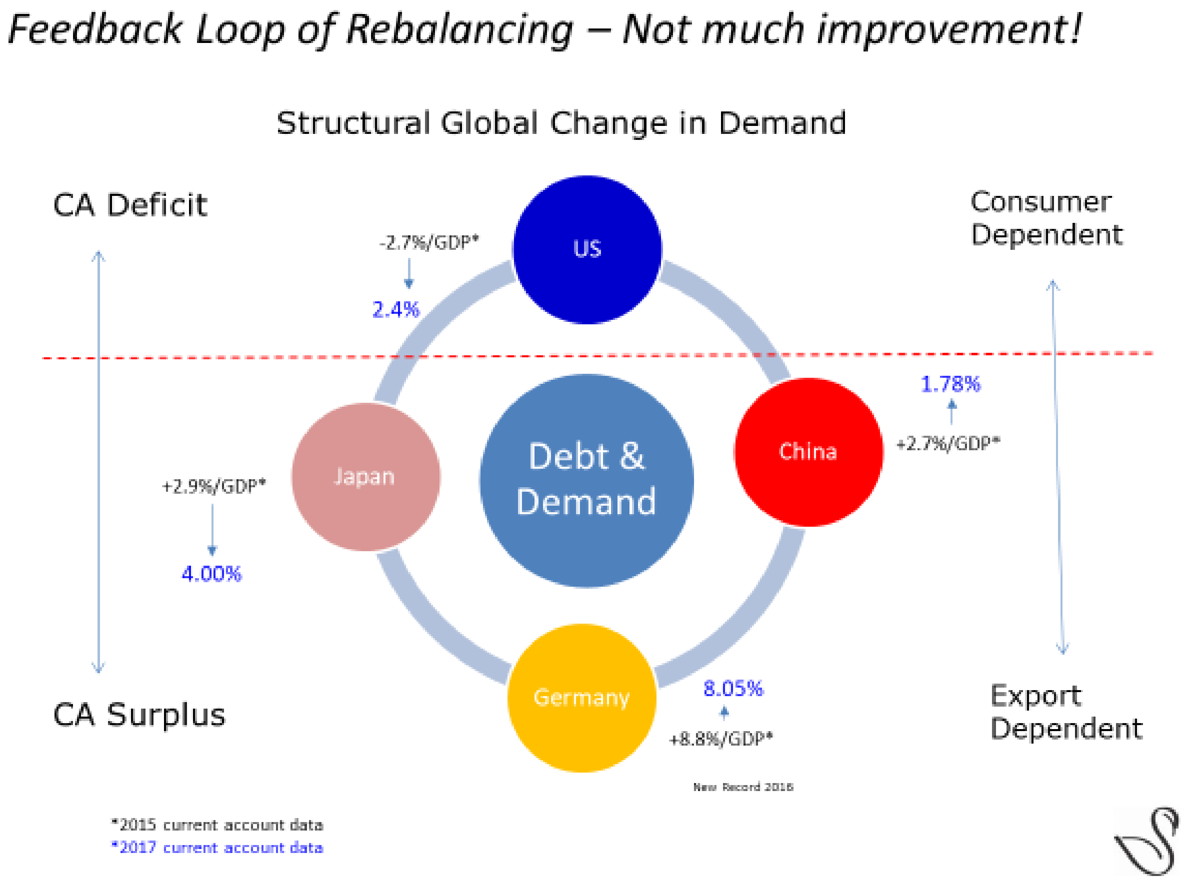
> *[The US federal deficit is soaring, and another massive spending bill is about to be signed by the President. In addition, the US is moving quickly off the zero bound interest rate policy (creating a widening spread between itself and Europe; and creating a dollar funding problem which threatens all emerging economies and could trigger a self-reinforcing move into the dollar as a haven—not exactly the stuff of rebalancing.]*

USD/CNY Daily: At its weakest level since December 2016…

Rebalancing the global economy is a process that in theory should help global financial stability. Many believed (us included) we would see a significant improvement in those deficit countries moving to less deficit, and those surplus countries moving to less surplus—measured in the diagram below as all the major players moving close to the red dotted line.

The numbers shown in blue are based on 2017 current account as a percentage of GDP compared to circa 2015. As you can see, there hasn't been much movement. It proves many things, including: it is difficult to change a large country's economic policies quickly even if they are trying (and not sure of that given the debt infused growth); it remains easier to take demand from another country in the form of a trade surplus than to create it locally, and in a world where the US dollar is the single dominant reserve currency, a US deficit of significant proportion is a given lest global liquidity be complete sucked out of world.

Now the US has a President who is out of patience and no longer wanting the US consumer to substitute for lack of demand in another country. Granted, there are lots of arguments against that, but the reality is the lack of rebalancing is a major driver of current trade tensions. And when it comes to trade wars, surplus countries (China, Japan, and Germany) are much mover vulnerable than deficit countries (the United States).



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 [rebalancing] 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, <u>the greater will be the danger that instability in the Chinese financial system is transmitted to the rest of the world</u>."

Guess what? China is now estimated at around 300 per cent debt-to-GDP level (public and private). This is well into dangerous territory. But short of a massive wealth transfer to its household sector in some form or fashion which continues to be resisted by the rich and powerful, local governments, and SOEs, China is finding it difficult to wean itself off the debt-for-growth game despite the fact each dollar of debt is producing less and less growth. The trade-off to not making some type of wealth transfer to increase the household share of the economy (real rebalancing) and reigning in credit growth is rising unemployment and slower growth. Thus, you can see why now is a very bad time for China to get into a trade war with the US. President Trump is well aware, especially with all the forward momentum in the US economy, the US has the dominant position in this dangerous game.

I have a quote taped to one of my screens; it reads: *Alterum diem vivere pugn*a. Another day live to fight (a maxim every trader must keep in mind I believe). It might be good advice for China at the moment. For one day, and maybe soon, they will hold the dominant position and dictate the rules of the game.

In summary, we realize it's a deplorable thing to say, but "President Trump is right about trade." And granted, he isn't big on policy discussions or nuance; but by hook or by crook his trade policies might just lead to a more balanced global macro economy, give or take a couple of minor crises along the way (assuming a crisis can ever be defined as minor).

Though I have never heard the President utter the word "rebalancing," his approach *may* actual trigger a more balanced global macro environment (and a safer one). But, if this debt as a substitute for growth continues to play out, Mr. Market will at some point usher in a swift and painful rebalancing of its own and it won't be pretty; and will likely include a major world war to boot.

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