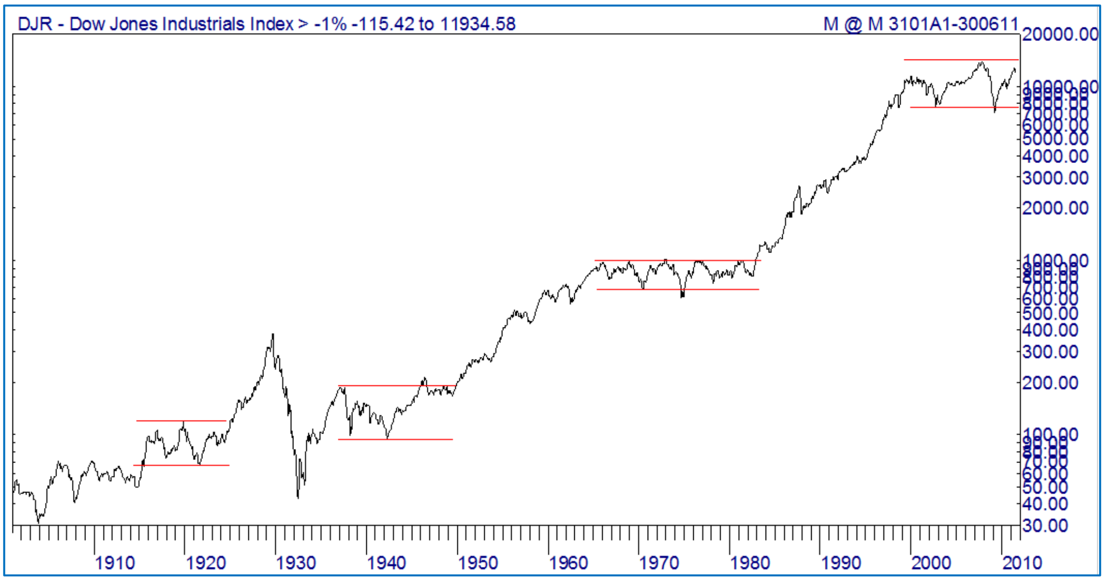
Decade of Debt

I recently read an interesting discussion paper with this title by Carmen Reinhart and Kenneth Rogoff, authors of the book *This Time is Different*. I have commented on some of the material in the discussion paper below. Readers who might like to read the entire paper may access it at: http://www.voxeu.org/sites/default/files/file/DP8310.pdf

Reinhart and Rogoff begin by giving a sobering assessment of the debt situation in the world. Their key points are:

1. Government debt in relation to GDP in developed countries is now higher than at any time since World War II. During 2010, the ratio of debt to GDP was also higher than the peaks in World War I and the great depression of the 1930s.
2. Financial institutions and households have raised private debt to all-time high levels.
3. History suggests that emerging market economies have never been able to reduce high public debt either quickly or without considerable pain.
4. It has not been possible in the past to reduce high debt to GDP levels through strong and sustained economic growth.
5. The usual mechanisms to resolve high public debt involve stringent fiscal contraction and debt restructuring, if not default.
6. Deleveraging of debt is rarely a swift process and usually averages around seven years. Debt tends to actually rise in the first few years of this process.

It is from this that Reinhart and Rogoff titled their paper A Decade of Debt, because they saw the public and private deleveraging extending roughly from 2008 to 2017. My comment is that this goes some way to suggesting why stock markets will continue to oscillate in a basically sideways pattern through this period. These charts suggest what is going on:



This chart of the US market shows the previous sideways episodes and the present one. Seven years is an average and most of the US episodes in the 20th and 21st centuries so far have been longer.

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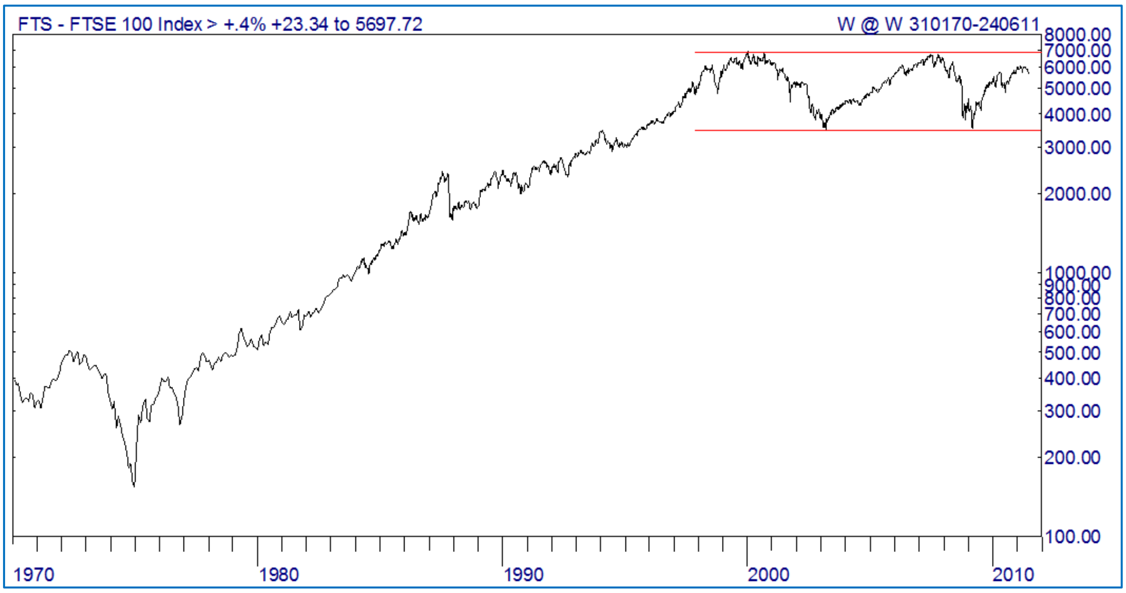
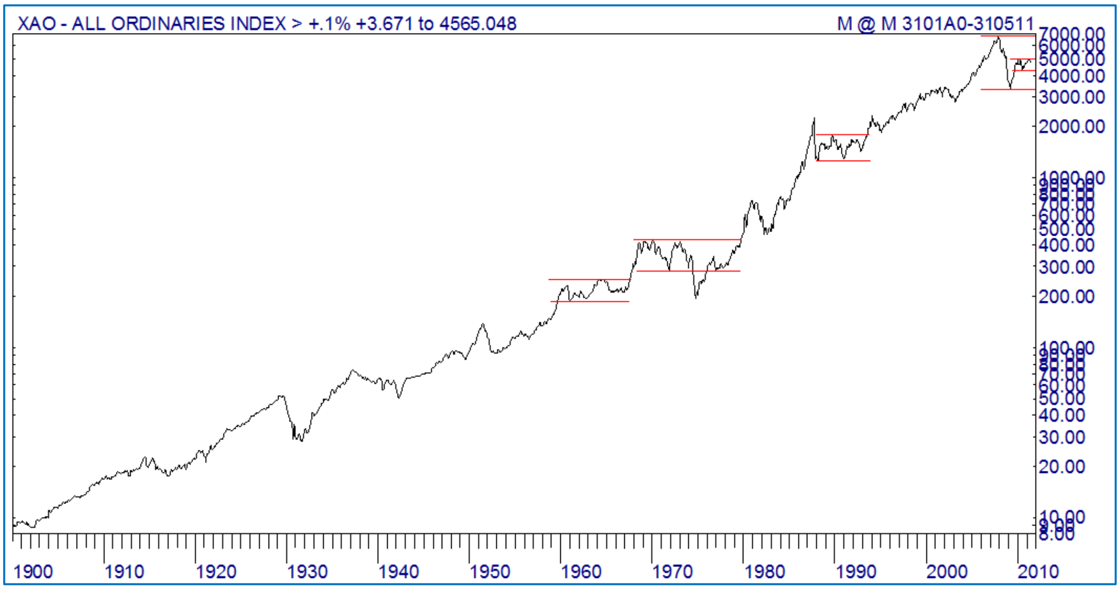


The UK experience in the latest period appears similar to the US. I do not have data for the earlier periods.



The experience in Australia in the1960s, 1970s and the 1980s-1990s is marked. The bounds of the current pattern are less clear at this stage than in the US and UK.

These charts are shown because the interpretation is interesting. However, it is highly speculative and is to some extent finding what I was looking for. Readers should make up their own mind about its value. Concluding that the charts are nonsense is a perfectly arguable conclusion. They are presented merely as thought-starters.

However, the general idea posed by Reinhart and Rogoff, from experience over very long periods, is that the unwinding of the present high public and private debt levels will take many years is the key point on which to reflect. Australia is not excused from this. Yes, public debt is already being reduced by the federal government, if not the states (note though that in the last couple of decades some state debt was in the form of private debt through Private-Public Partnerships and many of them led to restructuring, default or financial failure). Moreover, private debt levels are still very high. High credit card debt is being wound back and this has impacted strongly on the retail industry. High mortgage debt is a more intractable problem and if the doom-and-gloom merchants are right that we are at the start of the bursting of the Australian housing price bubble, then much financial pain is ahead of those who have borrowed way in excess of the normal affordability ratios. Nevertheless, banks and others are assuring us that everything is fine, but they would say that, wouldn't they?

Back to Reinhart and Rogoff, this is what they see may be ahead of us, especially in those economies with high public and private debt to GDP levels:

1. In the past, periods of high leverage have resulted in economic growth being slow. My mind immediately goes to Japan post 1990 – a tediously long bear market.
2. These periods tend to see low interest rates. This assists the process of deleveraging. However, it can also promote simply a deferral of the deleveraging into another boom, followed by an even more cataclysmic financial crisis. My mind immediately springs to the current US denial of its public debt crisis, with near zero interest rates and a strong stock market: watch this space.
3. Financial (banking) crises that are coincident with large rises in public debt have a tendency to presage sovereign debt crises where public debt is restructured or there is default by some countries.
4. This raises the issue that in the past, the restructuring of public debt has taken the form of what the authors call financial repression. This will take the general form of limiting the investment choices open to the private sector. The result is that it becomes easier to pay down public debt. Some ways in which financial repression can be carried out include:
    - Caps on interest rates, instituted in a variety of ways. This improves the capacity of governments to pay down debt by placing a ceiling on debt servicing costs.
    - Capital account and foreign exchange controls so that institutions cannot invest capital out of the country and are forced to lend to the government as the main reasonable alternative.
    - Raising bank reserve requirements, possibly to be held in the form of government debt securities.
    - Requirements that pension and other private funds hold a certain level of government debt securities.
    - Transaction taxes on equities that persuade investors to switch to government debt securities.

All of these have been seen in the past, which most people do not remember, or it was before their time. A reading of history informs us better of what could happen again in those economies that are suffering high and unsupportable levels of fiscal imbalance and private debt.

This is a summary and my comment on the introduction to this important discussion paper which goes on to flesh out all of these issues and much more. I encourage readers to study it, in that way being more prepared for what may lie ahead of us as the world works its way out of the global financial crisis of 2007-2008.

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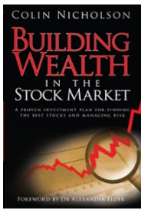

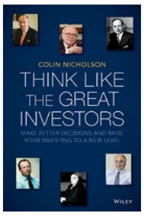

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