

## Turning Japanese January 2012

The power of self-preservation has won out once again. Just a few short weeks ago, the world was on its latest edge of economic disaster. Contagion risk had been growing more severe as the cost of borrowing continued to rise for European sovereigns. Even the mighty Germans developed a problem. Although their cost of capital didn't rise, the Germans were unable to sell out one of their sovereign debt offerings. Panic was in the air. Implosion seemed imminent.

In short order, the Federal Reserve opened up swap lines for European banks to access as many dollars as they needed while the ECB, the European version of America's Federal Reserve, came to the rescue with a scheme to resuscitate European banks. We dodged another bullet. Whew! There really is no more powerful force in our world than self-preservation. The game goes on.

Unfortunately it seems this economic policy of bullet dodging is becoming more and more common. Lehman's collapse is now three years in the rearview. Yet for some reason, every few months we still need to save the world from an even more severe economic event.

This should really come as no surprise. As the Armchair outlined last month, there are no natural growth drivers in the mature developed markets. Population growth is stagnating at best. Productivity growth is making labor ever more obsolete, yet it is labor's wages that drive consumption, which drives economy. And the liberalization of capital has long passed its point of economic efficiency.

No natural growth drivers mean we can't really pay back what we have already borrowed or pay for the social safety net promises we have already made. So if we can't grow our way out of these economic burdens, then all we can do is kick the can down the road. That is what we will continue to do until this road reaches a dead end. The 64 trillion dollar question is when that point arrives.

The latest European "solution" is another ingenious can-kicking exercise. The ECB has come to the table with a new and improved version of TARP.

We shouldn't forget TARP in the United States. That was Washington's near trillion-dollar effort to bridge loan American banks through the transition from mark-to-market to mark-to-model accounting. Since the accounting rules were no longer profit favorable for the banks, we changed them to move America's banking system from looking bankrupt to appearing healthy. TARP provided the system with liquidity to smooth over this transition. And then additional Washington monetary and fiscal stimulus provided enough boost to economic activity that America and its banks avoided disaster.

But then those darn European banks came down with a strong case of their own economic pneumonia. So like a junkie, the global financial system needed another fix.

For years, regulatory rules had been encouraging financial institutions in Europe to buy yet more European sovereign debt because historically, at least in our recent history, countries in the modern

developed world do not default. All that sovereign debt was granted the highest rating possible, so those investments by European financial institutions carried no risk...or so was thought for a good number of years.

But as Europe's socially oriented economies grew, so too did their sovereign debt. Europe's public sector has been growing much faster than its private sector for many years. Without much organic growth in the private sector, borrowing money was the only way to keep economies afloat. Somehow people seem to have forgotten that there must always be enough private sector activity to pay for those public sector services.

Now most of Europe faces an upside down economic pyramid with way too much service economy and not enough productive economy to pay for all those social services. It is as if a family of five (the PIGS) plus extended relatives (France and Belgium) must survive on the back of the only productive family member worker (Germany). Not a problem so long as the entire family can keep borrowing more money. But that ceased to be the case in Europe. That is, until the ECB's latest move.

Exacerbating Europe's debt problems is the interconnectedness of their financial institutions. Banks and insurance companies in the stronger countries (it remains to be seen how strong they really are) were loaded up on debt from the weaker countries. The French banks had too much Greek debt. If Greece defaulted, then the French banks would be toast, driving the French cost of capital so high France would then have to default on its own debt. Dominoes like this would fall all over Europe, eventually trapping the entire global financial system. As the Armchair has suggested numerous times, being so globally interconnected makes us highly globally interdependent.

Same goes for American banks. American financial institutions hold some amount of European sovereign debt, but more importantly, they have likely sold credit insurance against European sovereign debt default. So to counter contagion risk, the Federal Reserve loosened up the dollar swap market. And to help European banks fix their balance sheets, the ECB came in with cheap capital for banks to borrow while also being indiscriminate about the collateral banks can pledge to get that capital.

As the theory goes, countries in the Euro-zone can now issue new debt to replace maturing debt at more favorable interest rates because the risk of contagion has been mitigated. Banks unload risky debt as collateral to the ECB and then use very low cost funds to buy newly issued sovereign debt. The spread between the cost of capital from the ECB and the return on capital from sovereign debt provides banks with a no-lose investment option and a way to boost their significantly depleted equity base. In the process, countries can issue more debt.

Some readers may say this is nothing but a Ponzi scheme, shuffling money around and around and around without ever having to pay anything back. To an extent, they are correct. However, one thing is different with this new version of ECB-to-bank-to-sovereign-debt scheme: In theory, it will allow banks to shift their investment portfolio allocations more and more to their own sovereign issuer.

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Those French banks pledging Greek debt to the ECB are now **not** likely going to be buying Greek debt again. Instead they will narrow their focus to French sovereign debt. The same will take place all across Europe. The end game hopefully will be each country's financial services industry supporting each country's own sovereign debt, meaning any default by a sovereign will only affect that particular country and not the global financial and economic system. Voila!...The risk of contagion has now been significantly reduced.

Europe is trying to turn Japanese. Japanese sovereign debt is owned almost exclusively by Japanese financial institutions. A default on Japanese sovereign debt does not affect the balance sheet of banks around the world. The Japanese owe all their money to themselves. This has allowed Japan to grow their debt to 200% of GDP. Contrast this with the U.S. and E.U., where debt-to-GDP is about 90%. Should this new ECB scheme work, Europeans will be able to follow the Japanese model.

Who cares what the debt-to-GDP ratio is or about the risk of default if a country is just defaulting to itself? Contagion risk has been greatly diminished. And given that the Japanese have grown their debt-to-GDP to 200%, then Europe could follow suit and continue to kick the can for quite a bit longer.

Of course this obviously does not resolve the problem of too much debt, nor does it solve the problem of not enough growth, but it does allow the current economic system to continue. The reboot of our global financial system may be postponed, even possibly eliminated. When the debt chickens finally come home to roost, theoretically it will only be the French dealing with French debt, and the Italians dealing with Italian debt, and the Spanish the Spanish, etc. All will have turned Japanese.

This only leaves one more sovereign to "fix" – the United States, where debt-to-GDP keeps growing and where a significant amount of its sovereign debt is held by foreign institutions. Might we soon see the Federal Reserve and Washington come up with a new system to significantly increase the amount of U.S. Treasuries held by American financial institutions while reducing their exposure to foreign investors?

Eliminating contagion risk is a huge win for our global economic system, but in the end the story remains the same: There are absolutely no organic catalysts for economic growth in Japan, Europe or the United States. So overall GDP "growth" will continue to depend on growing debt-to-GDP. We have all turned Japanese. I really think so.



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