June 30, 2010

In the Eye of the Storm?

After decades of financial leverage and lax fiscal regulations worldwide, the March 14, 2008 collapse of Bear Stearns and subsequent September 15, 2008 bankruptcy of Lehman Brothers ignited the sparks which brought the industrial world to the edge of a financial and economic abyss. World-wide credit collapsed and bank credit lending came to a near standstill. Only massive monetary intervention by the Federal Reserve managed to keep the U.S., and perhaps the world economy, from going into another Great Depression. (Yes, we really were in a very, very serious economic crisis.)

During the 1920s the world witnessed similar economic behavior. World War I (May 17, 1914 to September 25, 1919) had left both England and France in great financial duress and Germany bankrupt – a situation compounded by the war reparations it was required to pay to the U.S., France and England. Only the United States was spared, as it had entered the war over two years later, on January 4, 1917. Throughout the 1920s each of the central bankers of France, England, Germany and the U.S. pushed their own monetary agendas to deal with their own individual needs, ignoring the bigger picture. England was suffering from high interest rates and high unemployment, along with deflation. In Germany, increasing debt and an influx of cheap money into the country posed significant problems.

France, meanwhile, was on the road to recovery. Hoarded gold reserves in France, on which Moreau (Banque de France) refused to lend, restricted the money supply and stymied economic recovery in Germany and England. The United States enjoyed low interest rates and maintained high gold reserves as well. Low U.S. interest rates and low margin requirements, along with a strong economy and few financial regulations, eventually led to an orgy of speculation and stock market bubble. Even foreigners, hoping to make a killing, invested in U.S. stocks.

Maynard Keynes, a brilliant British economist (1883-1946), encouraged the central bankers to completely eliminate the gold standard to encourage economic growth. The concept of fixed currency exchange rates was his invention. In the 1920s, he argued for the central banks to **add liquidity to the economy during periods of crisis**, rather than restrict the money supply, in order to prevent an economic meltdown. He encouraged fiscal restraint and responsible spending by government. His advice was ignored.

The U.S. stock market, significantly overvalued, eventually crashed on October 29, 1929, and the economy soon started to collapse. The Fed chose to restrict monetary lending, causing credit to decline by 40% in the United States, and in many countries, the banking systems totally collapsed. Unemployment increased to 25% in the U.S. and was even higher in Europe. As world markets crashed, and credit became unavailable, deflation ensued and massive losses impacted the entire investment world. Commodities prices fell 50%, wages 30%, stocks 90%, and bonds, metals, real estate, all significantly declined. During the three-year period, real GDP declined by over 25% in the major economies. Germany, the world's third largest economy, along with almost every major sovereign debtor among developing countries in Eastern and Central Europe, defaulted.

Unlike their 1930s counterparts, central bankers in 2008 collaborated successfully to salvage the world economy during the latest financial crisis by adding liquidity to the system (in excess of $2.5 trillion), apparently supporting Keynes' theory. It may be too early to celebrate, however.

At the 2010 G-20 economic summit central bankers' solutions diverged, as in the 1930s, into two schools of economic thought: the Fed following a more simulative Keynesian model; and the Euro countries proposing a plan of restricted spending, increased taxes, and reduced benefits. The plans proposed by the Euro countries are eerily similar to the restrictive actions of the U.S. in the 1930s which are believed to have significantly prolonged, and even worsened, the Great Depression.

If England, France, Greece, Italy, Spain, Portugal, Iceland, and Ireland, each with very high debt as a percent of GDP (see graph below), truly implement austerity measures they are proposing, they may very well throw the whole world back into economic dislocation. The current period may well prove to have been the eye of the storm.

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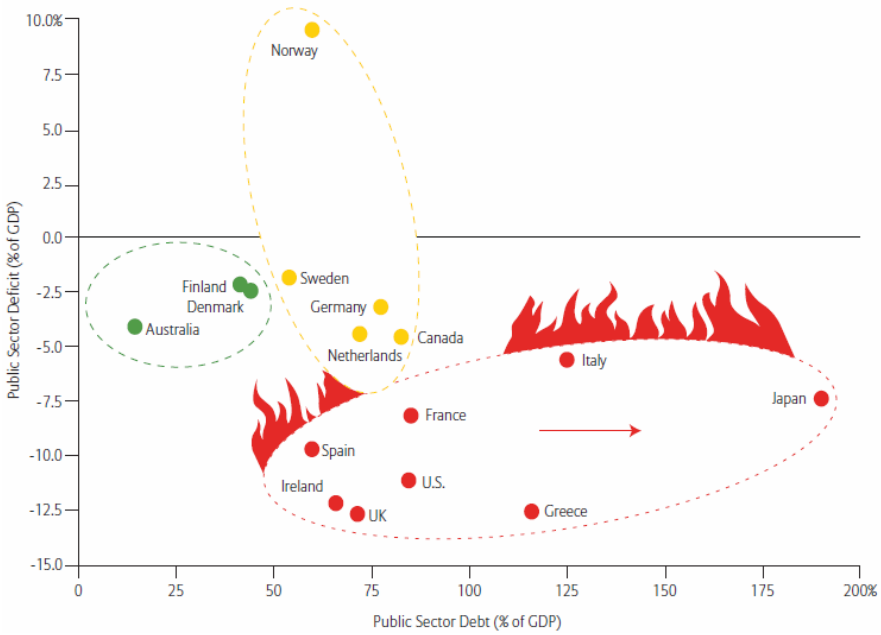
PIMCO's "Ring of Fire"



What the Chart Shows
The vertical axis of the chart plots a country's overall deficit (or surplus in the case of Norway) as a percentage of GDP. Countries that fall below zero are spending more than they are taking in, meaning they will likely have to issue more debt to operate. The horizontal axis shows a country's overall debt as a percentage of GDP. A higher debt to GDP ratio can slow economic growth. The countries in the red zone, or the "ring of fire" have public debt that exceeds 90% of GDP or have the potential to pass this threshold within a few years' time (given their deficit). The countries in the yellow and green zones are potentially more solvent.

What It Means for Investors
A higher deficit and escalating government debt can slow economic growth, which in turn can lower returns on investments. Investors may want to direct their growth-oriented assets toward less levered countries.

Source: PIMCO, Reuters EcoWin