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TAKING STOCK: DEBT, CURRENCIES, INFLATION AND THE REDISTRIBUTION OF WEALTH

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Excessive debt, economic weakness and extraordinary levels of monetary stimulus have been some of the major stories that have dominated the headlines for the past several years. These have played a role in stock market volatility, the rise of gold, major fluctuations in currency exchange rates, and the rise and fall of various segments of the global bond market.

The United States, United Kingdom, Europe and Japan have had to struggle with high levels of government debt. The ability to support and sustain just the interest payments have called into question the credit quality of the underlying fixed income investments, resulting in several rating agency downgrades of the issuing countries' sovereign debt. We previously lived in a world where we often viewed government as the last line of defense to save the country from economic, natural or other crises generated by a variety of internal or external factors (whether caused by bad business decisions, the supposed failure of regulatory or market mechanisms, or by environmental or social factors such as earthquakes or war). Governments (through their agencies) always appeared available as a last resort to come to the rescue of the economy. Now we face a situation where many countries are in financial trouble and there are few aid options available, especially given the size of the problem. Many of the global bodies that could have helped in the past cannot effectively do so now given their limited resources and established mandates, unless there is also some major structural change in how things are financed and in the way issues are addressed (but even then, the global situation can still be an insurmountable problem given its current complexity).

GROW AND CUTBACK ECONOMICS

In its simplest terms, countries in financial difficulty today are still expected to grow out of their problems through strong economic performance while reducing expenditures at the government level. This was certainly the formula being applied to Greece throughout much of 2011 (even though many knew this was wishful thinking, given that the Greek debt burden was simply too large relative to the size of its economy and its government revenues). This grow and cutback solution can work if a country is willing to sustain pain for several years and the rest of the world is willing to pick up the slack that includes buying that country's goods and indirectly stimulating the economy, especially when the domestic country's federal government and local consumer are now less active (some have cited how Canada had similar financial problems in the 1990s, but its fiscal restraint and relatively low currency helped it grow out of its problems, and with large thanks during those years to its wealthy and prosperous neighbor, the United States).

Unfortunately today, we have too many countries in the same financial dilemma while also having a dominant position in the world economy. For example in terms of currencies, the United States cannot truly depreciate its dollar too much (through various indirect policy actions) to help its domestic economy via exports, since it is such a major player in the global economy. It cannot be expected that a large number of smaller countries can help the United States grow out of its problems, especially when the role was the opposite not too long ago. Also too many countries may want to adopt a similar strategy (whether it be the United Kingdom or the Eurozone), so it becomes a competing race to weaken a currency, with the only beneficiary truly being gold, as investors want to seek an investment that can preserve value. Japan has also wanted a weak yen to help counteract its regularly contracting economy, but this has often been met with very limited success due to other factors (i.e., the yen has often behaved as a safe haven currency in times of global economic crisis, thereby negating any currency devaluation strategy). And as we have seen with individual European countries, the currency devaluation option is no longer available given that this part of their national sovereignty was surrendered to the Euro regime. I am not implying that currency devaluation is a primary tool or policy used by most governments, but it is something that can arise as a byproduct of any policy action, and may be desired under certain circumstances.

Austerity measures that try to balance a budget through reduced expenditures also pose many difficulties, because such policies will inevitably slow the local economy unless something else takes the government's place. Investor confidence spurred by government action can also be short-lived and it does not often translate to better economic performance. And poorer economic performance will cause a balanced budget to become unbalanced once tax revenues fall. We also often forget the painful human consequences that may arise, such as public despair and protests that can occur from tough austerity policies. Negative public reaction and social unrest can wear on the emotions of government officials, and can result in deviations from previously agreed promises to keep government costs in line (as we saw with Greece when the national referendum idea was temporarily being floated—a referendum would have been a good means to shift the pressures elsewhere given the public resentment to austerity).

The big question currently is whether any proposed growth and fiscal restraint economic strategies will work for many of the national economies that have embraced them. For some countries it may, and for others (probably many) it will not, at least not completely. The magnitude of growth and fiscal restraint required is often just too large, and government projections of a future balance between government revenues and expenditures tend to be overly optimistic. And unfortunately, too many countries are trying to do the same thing at the same time today, in turn hurting each other and the global economy.

CURRENCY WEAKNESS ARISING FROM BAILOUTS

A good currency as I would define it would be one that preserves its value relatively well over time, and this can occur when the economy is stable, the country's debt is very manageable, government spending is not too high relative to the size of the economy, and there is little inflation.

When the U.S. Federal Reserve adopted monetary expansion policies aimed at buying assets and increasing the money supply (often cited as Quantitative Easing programs, named successively as QE1 and QE2, running from Sept./Nov. 2008 to March 2010, and from Nov. 2010 to June 2011 respectively) some voiced concerns that it would raise the likelihood of inflation. Higher inflation expectations made sense—more money in the system meant more cash was going to chase fewer goods. This never truly happened—many organizations and investors did not spend the cash, but either saved it, paid down debt or invested it in vehicles such as the stock market (Technically, some described what had occurred as a decline in the velocity of money, as the increase of cash in the economic system did not produce an increase in the demand for goods and an extension of credit to borrowers as was previously hoped. Commercial banks actually held on to much of the cash rather than lending it, negating much of the U.S. Fed's intended financial stimulus.).

The other concern was that any monetary expansive policies would devalue the U.S. currency. QE1 and QE2 did fulfill this expectation as we witnessed foreign currencies performing better relative to the U.S. dollar, but with also a dramatic rise in commodity prices. Ironically, the rise in the price of commodities likely resulted in some economic drag on the U.S. economy, but that is another story.

Europe to date has not adopted any direct monetary expansive policies even though the trend or long-term expectation appears to be in that direction, as central authorities seek to buy sovereign debt and improve liquidity. Europe originally relied on internal funding sources (e.g., Germany, France, Italy, Spain) to keep economic partners such as Greece afloat. However, several of these major contributing countries may now need some sort of bailout themselves, and countries such as Germany are not an endless source of cash to help its European partners.

In October 2011, global stock markets rallied sharply when it was announced that agencies such as the European Financial Stability Facility (EFSF), which was created in the spring of 2010, were being expanded to include greater financial resources to buy assets, similar to what the U.S.

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Fed had done several years ago (to about $1 trillion in U.S. dollar terms, see table below), with additional help to come from the European Central Bank (ECB) in various forms as needed. But with countries such as Italy subsequently raising worries (which had debt itself of more than $2 trillion in U.S. dollar terms) the EFSF was not always considered to be big enough to cover all potential claims. In addition, the seed money to support the EFSF appeared questionable given that such large amounts are required, and few countries can truly be involved as large net contributors. Germany cannot be expected to carry a larger part of the EFSF if things get significantly worse. The additional strategy of selling bonds in the bond market to fund the EFSF was also not successful, and this is a rather awkward strategy to say the least, since this bond money will be used to buy other bonds of lesser quality (and, of course, with the serious credibility problem surrounding many European bonds today in terms of being secure, it was not surprising

EFSF issues are backed by guarantees given by the 17 euro area Member States for up to €780 billion in accordance with their share in the paid-up capital of the European Central Bank (see table below)

	New EFSF Guarantee Committments (€m)	New EFSF contribution key (%)	EFSF Amended Guarantee Committments* (€m)	EFSF amended contribution key* (%)
Austria	21,639	2.78	21,639	2.99
Belgium	27,032	3.47	27,032	3.72
Cyprus	1,526	0.20	1,526	0.21
Estonia	1,995	0.26	1,995	0.27
Finland	13,974	1.79	13,974	1.92
France	158,488	20.31	158,488	21.83
Germany	211,046	27.06	211,046	29.07
Greece	21,898	2.81	-	0.00
Ireland	12,378	1.59	-	0.00
Italy	139,268	17.86	139,268	19.18
Luxembourg	1,947	0.25	1,947	0.27
Malta	704	0.09	704	0.10
Netherlands	44,446	5.70	44,446	6.12
Portugal	19,507	2.50	-	0.00
Slovakia	7,728	0.99	7,728	1.06
Slovenia	3,664	0.47	3,664	0.51
Spain	92,544	11.87	92,544	12.75
Total	779,783	100	726,000	100

* The amended contribution key takes into account the stepping out of Greece, Ireland and Portugal.

Source: "European Financial Stability Facility", <www.efsf.europa.eu> [path: http://www.efsf.europa.eu/attachments/faq_en.pdf], November 9, 2011

> THE BEST OPTION FOR AN ENTITY TO TRULY DEAL WITH SUCH A MONUMENTAL DEBT PROBLEM MAY BE TO MANAGE ITSELF OUT OF IT THROUGH MONETARY EXPANSION AND BY THE RESULTING INFLATION.

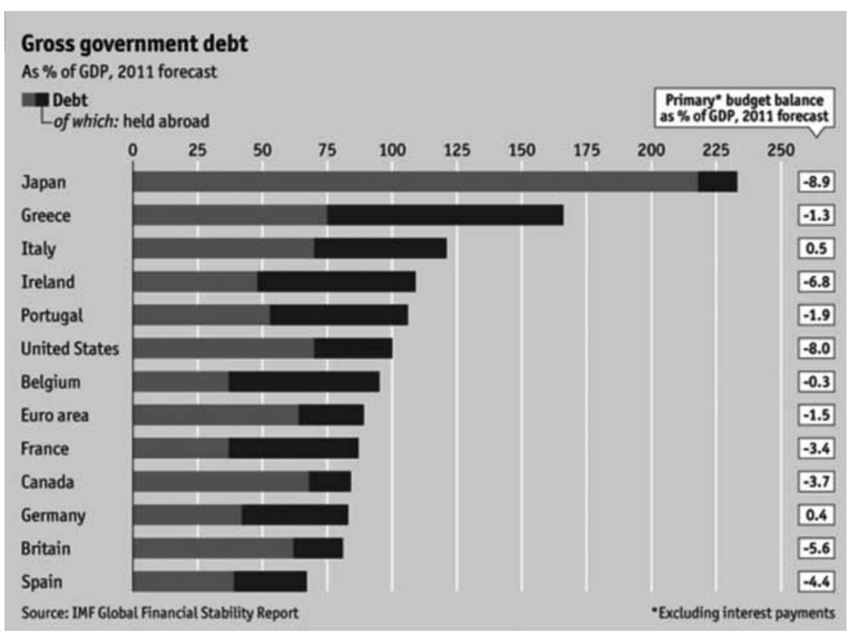
that the EFSF bonds received poor investor demand). Ideas were also circulated to sell some other type of European bond, but in the end it will be the same old thing, just with different packaging. The use of the International Monetary Fund (IMF) has also been put forward as an additional means of alleviating the stresses of the current financial situation, but the question still remains as to where is all of this new money going to come from, especially given that the IMF itself is significantly funded by the regions which are now facing difficulty, and it also has other priorities.

It is not completely clear if there will also be a need to tap into newly created fiat money through the ECB as the U.S. Fed did to pay for its additionally assumed obligations, but it should be expected given that all of the other strategies currently being used are proving unsuccessful to date (And once this approach of monetary expansion is taken, we suddenly have a new large pool of financial reserves to use to buy assets without the need for countries to contribute real money.). Such an approach can probably solve many of Europe's short-term problems while creating large risks for future generations to address.

The best option for an entity to truly deal with such a monumental debt problem may be to manage itself out of it through monetary expansion and by the resulting inflation. This course is increasingly being seen as where things are ultimately headed for continental Europe, unless countries are allowed to default and leave the Euro currency (currently considered to be a much more disastrous alternative). The best option does not mean it is an attractive option, but rather the best of a long unpleasant list of choices, with each choice expected to produce a different set of bad consequences.

WEALTH REDISTRIBUTION AND THE LIKELY RETURN OF HIGH INFLATION

Inflation ultimately solves problems, but rather painfully as history has shown. To get rid of, reduce or manage overly-large amounts of debt, one has to default, devalue or postpone paying at least part of it. A default hurts many investors since capital (the principal) is lost. Postponing the payment of debt can be perceived as a partial default, as the terms of debt repayment are violated and the payback schedule is less attractive than previously agreed. A debt devaluation can occur by not paying the debt completely dollar-for-dollar. But an artificial debt devaluation through an inflationary spiral (which may be less visible initially) can accomplish much of the same thing that all of the current global policy jockeying is trying to achieve, and it can be a better way to relieve the stress on segments of the global economy. Currently there is no appetite to allow countries such as Greece to default, given the potential domino effect it can have on Europe and the rest of the world (The world saw the "unexpected" damage created when the firm Lehman Brothers was allowed to go down, and it does not want to venture into that territory again.).

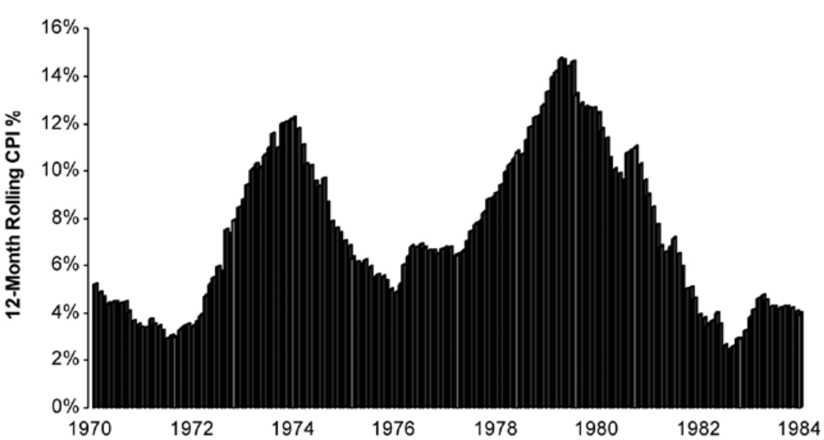


Source: "Debt, deficits and markets", <www.economist.com> [path: http://www.economist.com/blogs/dailychart/2011/09/government-debt], September 21, 2011

By decreasing the value of debt in nominal terms, a country's economy becomes relatively bigger and thereby so does its tax revenues, and it is therefore better able to sustain its debt service costs. Of course to play the inflation game, long-term investors, particularly those in fixed income securities will get hurt. Retirees could find themselves falling significantly behind as occurred in the 1970s and early 1980s (for example, during the 10-year period of Dec. 1972 to Dec. 1982, purchasing power fell by more than 50 percent based on change in the U.S. CPI). Uncertainty about the future prospects and growth of the country's businesses also increases as inflation concerns rise dramatically, making equity investors nervous.

Unfortunately certain groups of investors will have to suffer because of the past financial mistakes of others. Some will complain about this inequity as wealth implicitly becomes redistributed to some degree to other financial and market participants. But there appears to be no other feasible solution for solving the big issues facing the world today, given the magnitude of the problem and the overall goal of achieving the greater good of a domestic or global economy. If a nation's debt can be reduced in real terms by, say, more than 50 percent, this could really set the stage for a new economic boom.

U.S. Rate of Inflation 1971-1984



CONCLUSION

As some have worried, we are entering uncharted territory for countries such as the United States and the Eurozone, as large amounts of money are being expended to stave off major global financial crises. Countries and governments often hope that they can push limits of debt, monetary expansion and spending without suffering major negative financial consequences (as occurred with infamous countries such as Zimbabwe, where its money has become virtually worthless) and perhaps somehow with future stronger economic growth and fiscal restraint, things are brought back into control.

The United States has embarked on its experiment successfully so far without suffering major consequences, since the additional money in the system was not truly spent. Fear and weak economic performance has in general kept fixed income yields low worldwide, but this situation cannot continue forever. Extra money if not subsequently withdrawn from any financial system, will have to eventually move somewhere, creating either inflation or an asset bubble. The Eurozone to date has fought strongly against a monetarily expansive policy due to inflation concerns and has wanted to fund its problems through existing sources of funding, but its pools of money are not endless. If presented with a serious economic downturn and multiple pressures due to its debt burdens, Europe may have to consider additional policies that encourage cheap and new money and which are by their nature inflationary.

It is hard to envision a current scenario where many of the troubled countries of Europe can pay down their debts through austerity and economic growth. The United States, United Kingdom and Japan face similar challenges. The required magnitudes of adjustment are simply too large. Assets purchased by newly created money backed by the faith and credit standing of a country and facilitated through a government agency such as a central bank, can solve the problems in the short-term. However, for future high inflation to be avoided, any large amounts of debt created to fund expenditures have to eventually be paid back, and any new money introduced into the system has to be subsequently withdrawn.

One has to be highly skeptical that a policy unwinding down the road can be accomplished successfully, given that too many things have to go right. We are unfortunately living under a global economic system where sovereign debt has simply run too far relative to the strength of the issuing countries to support it through internal revenues, and prospects for strong economic growth in the impacted regions are not too optimistic.

Dislocations have to be remedied. The bet today is high inflation has to come back since the present course appears impossible to reverse. Yields on fixed income investments in turn will also have to go up as inflation concerns rise, which may be a good thing for those that hold high liability obligations relative to assets (such as many defined benefit pension plans).

High inflation is probably the best means to reduce global debt in real or nominal terms, and it may be imposed upon us by market forces, especially if national and government behavior is no longer considered effective or acceptable.

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