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As long as the US debt problem has not been addressed, eurozone woes will look like a picnic in comparison

By **JOERGEN OERSTROEM MOELLER**

THE deleveraging of debt among OECD countries will lock the global economy in a decade-long low-growth scenario. It will also change the ranking among the industrialised countries to the detriment of the US, Japan, and Britain while the eurozone, despite current difficulties, will fare better.

Debt (household + corporate sector + financial sector + public sector) amassed by OECD countries over preceding decades amounts to about 300 per cent of their GDP.

Among the top five we find the US, Britain, and Japan. The public, the households, and the financial sector all contribute to the calamities in the US.

The main culprit in Japan is the public sector, and in Britain the financial sector. The big four eurozone countries (Germany, France, Italy, and Spain) have a lower debt/GDP ratio than the US, Japan, and Britain. The debt is spread more evenly among the four sectors mentioned above.

The deleveraging has started, as it must. There is no way around it; this augurs lower growth as repayment of debt is irreconcilable with rising demand. Judging by historical experience, it will take quite a while before households and corporations feel confident enough to spend.

A number of studies are available, but are of little relevance as they suffer from the weakness of looking at isolated case such as Sweden in the early 1990s compared to the present situation of all major OECD countries in hot water. Unavoidably, the consequence is a much longer time needed because no major OECD country stands ready to act as a locomotive.

After all the rescue efforts, it would be permissible to think that the financial institutions in the US were back to form, but they aren't, acting as a serious brake on the policies to break out of the low growth debt trap.

Under normal circumstances, the money market ensures that banks loan freely among themselves using liquidity in an optimal way (a bank that temporarily has too much liquidity loans to another bank that is in need of liquidity).

Undigested lesson

Unfortunately, banks nowadays either sit on their liquidity to improve the balance sheet or put it into speculative financial derivatives. Yes, you would assume that the crisis had taught them a lesson, but they haven't digested it.

Over recent years, the US has put in place a massive public stimulus programme, but only managed a paltry growth rate for 2011 at 1.7 per cent with the prospect of the same for 2012. According to orthodox economic thinking, growth should have been higher. The fact that it isn't has puzzled many economists; some say the stimulus should have been even greater.

The explanation is found in the deleveraging process. By definition, public stimulus leads to higher public debt/GDP ratio. Households anticipating higher taxes to repay the public debt react by increasing savings so they have the money for the taxman at a later date. Private consumption is put on the backburner. The implication is that aggregate demand in the economy will not go up as much as expected.

This observation falls in line with analyses showing that if public debt passes a level of around 90 per cent of GDP, further stimulus does not work because households lose confidence in the economy. The households are no longer spending, but saving; policymakers are stuck.

The eurozone situation is almost the opposite. The public debt/GDP ratio has been stabilised through austerity. The households and the corporate sector have not really started to deleverage (their spending has not fallen much), but they do not need to do so, because their debt/GDP ratio is more favourable than for the US – especially in the case of households.

The combined result of fiscal austerity and no real deleveraging in the private sector has been a less than feared fall in demand. Last year, the eurozone managed 1.5 per cent – not much different from the US growth. 2012 will probably show zero growth.

The prospect for higher private demand is, however, brighter with falling public debt/GDP ratio, augmenting confidence among consumers and investors, making it more likely that aggregate demand will go up. Looking at the figures, it seems that the eurozone is bottoming out this summer. Thereafter, growth will begin – the official forecast for growth in 2013 is one per cent.

Figuring in the financial sector reinforces the picture of a better medium-to-long-term prospect for the eurozone than for the US. A couple of weeks ago, we learned that JPMorgan had lost up to US$9 billion on speculative trading in derivatives; it may be higher. The bank has also revealed that US$50 billion in losses could hypothetically bring it down.

Its total balance sheet is valued at about US$2.3 trillion and a good deal of it is in derivatives of doubtful quality. Bank of America has over the last four years lost US$40 billion on its failed acquisition of the mortgage lender, Countrywide.

The financial press is brimming with news about the eurozone banking system, but seems oblivious to Bank of America's losses even though they amount to about two-thirds of what is required to recapitalise the entire Spanish banking system (estimated at US$64-78 billion).

The European banking system is not in fantastic shape, but the measures agreed at the summit last week goes a long way towards recapitalising weak banks.

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Over recent years, German and French banks have reduced their exposure to the weaker European countries. Continental European banks are much less engaged in financial derivatives than their US counterparts.

Japan's problem is the public debt – close to 240 per cent of GDP and still counting. Household debt is small, while corporate and non-financial corporate debt measured in per cent of GDP is not far from the US figure.

The Japanese parliament's lower house recently endorsed a hike in the sales tax, but even if also adopted by the upper house, it will only take effect in 2015 and is already deemed insufficient to address the debt problem.

The high public debt has forced Japan to engineer a monetary policy with zero interest rates; otherwise, the debt burden would destroy public finances.

With rising debt, this will obviously not change. The role of the financial system (to channel savings into profitable investments) cannot be fulfilled with zero interest rates, given that interest rate is the mechanism used to separate profitable from unprofitable investment projects.

This cannot go on – although this has been said many times. The day of reckoning will come if or when Japan's balance of payments swing from surplus to deficit.

For Britain, the public debt/GDP ratio is still going up despite strenuous efforts by the government to turn around public deficits. Households are only just starting to deleverage.

The fact that this is only beginning now explains the comparatively well-functioning of the British economy until a few months ago when it became clear that the country is heading into recession.

The governor of the Bank of England has demanded immediate and far-reaching action to reform the structure and culture of the UK banking industry.

He said: "That goes to both the culture in the banking industry and to the structure of the banking industry, from excessive levels of compensation, shoddy treatment of customers, to deceitful manipulation of one of the most important interest rates and now this morning to news of yet another mis-selling scandal."

Dysfunctional US

The statement came after Barclay's bank was fined £290 million (S$576 million) for manipulating a key interest rate.

The medium-term outlook for global debt deleveraging will be strongly influenced by what happens to the Bush tax cuts in the US. They expire at the end of 2012 unless a decision to the contrary is made by a political system that truly deserves the label "dysfunctional".

The US is caught between the devil and the deep sea. If the tax cuts are extended, surely public demand will go up, but so will the public debt/GDP ratio with the result being households and maybe the corporate sector would deleverage even more, keeping aggregate demand low, preventing full positive effect on growth.

If they are not extended, public demand will fall and even if it is difficult to gauge the reaction by households and corporations, it looks unlikely that they would step in to compensate for the falling demand, raising the prospect of a recession. There is no way out of this trap. Damned if you do it, damned if you don't.

Of course, the US can approach its main creditors (China, Japan, and some countries in the Middle East) for a restructuring of its public debt.

Some people would call it a default, but wordsmiths will be busy inventing another word. China with allegedly US$1.3 trillion and Japan with US$1 trillion in US treasury bonds would hold the fate of the US economy, and indeed the global economy in their hands.

As long as the US debt problem has not been addressed, the world will not get back to higher growth. The risk is that it won't, which will take us into uncharted waters and make the eurozone problem look like a picnic.

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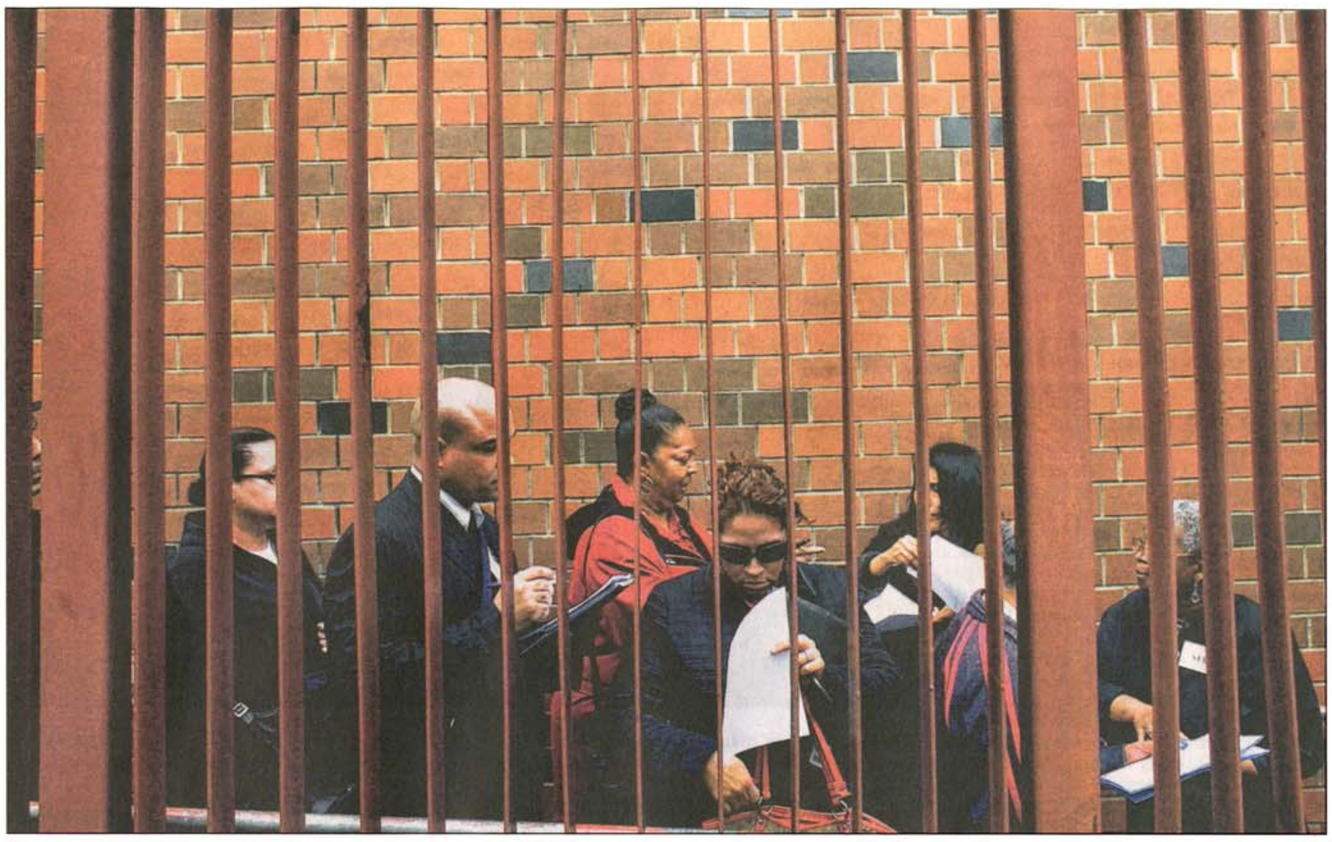

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Barring a miracle: *The medium-term outlook for global debt deleveraging will be strongly influenced by what happens to the Bush tax cuts in the US. And America is caught between the devil and the deep sea – either way, the spectre of a recession looms*