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RODNEY'S RAVINGS

Governments are laying the groundwork for the next crisis

EXECUTIVE SUMMARY

To rescue us from an international financial and economic meltdown of Depressionary-scale governments in the major countries most impacted by the crisis – the US, the UK and the Eurozone - have borrowed truckloads of trillions to pave over the crisis. The USD 1 trillion Greek rescue package announced earlier this month is the most recent truckload of government debt to be used to fill a gigantic pothole in the road to global economic recovery.

This Raving looks at what caused the financial crisis. It reveals that the global economy and especially the US economy are lurching from crisis to crisis, with the solution to one crisis laying the groundwork for the next crisis.

The current solution is “quantitative easings” (i.e. central banks printing money) and truckloads of government debt. More like super tankers of government debt! The normal consequence of which is inflation. The best way for a government to solve the constraint imposed by a mountain of debt and crippling interest payments is to adopted pro-inflation economic policies. The more prices in general increase the more the real value or purchasing power of the debt falls and the sooner politicians can get back to doing what they do best (i.e. using taxpayers' hard-earned dollars to buy votes in election years).

The inflation threat is not imminent, but it needs to be taken serious by businesses and investors making decisions that are impacted by inflation outcomes over the next 5-10 years. When even the Australian central bank Governor, Glenn Stevens, arguable one of the best central bankers we have seen, is warned that politicians will try and screw the scrum, this issue needs to be taken seriously even though the end game is some years away.

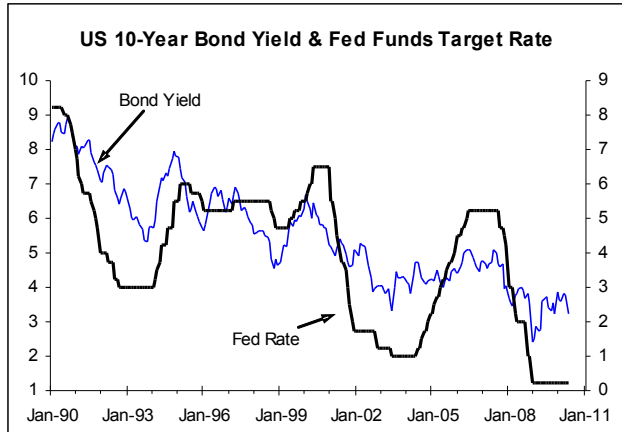
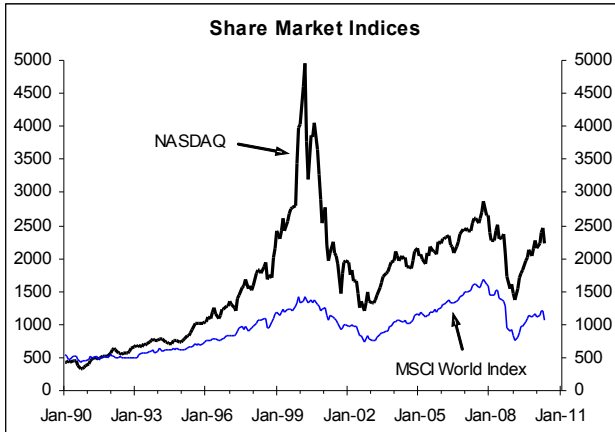


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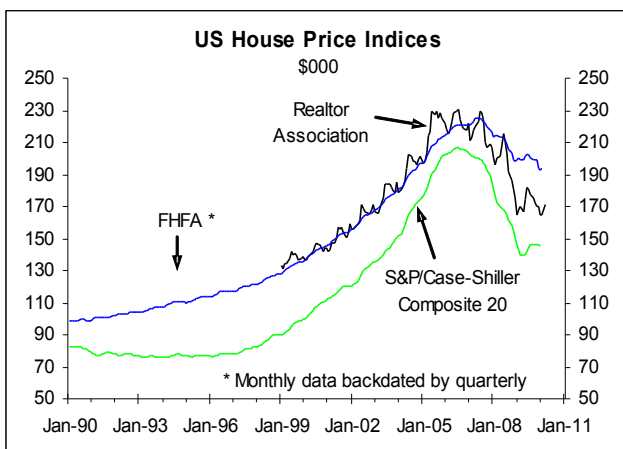


Lurching from crisis to crisis

The global financial crisis that erupted in late-2007 was in many respects the inevitable consequence of a series of events. The best starting point to put the latest crises in perspective is the information, communications and technology (ICT or IT) boom in the second half of the 1990s. This boom initially had a real or fundamental basis, being a technology-driven boom in productivity. However, despite initially having solid fundamentals this boom turned into a speculative bubble, with investors scrambling to make a killing, reflected in the US Nasdaq share market index of list IT-related companies increasing 550% between January 1995 and the peak in March 2000 (left chart). In part associated with the technology boom was a period of strong US and global economic growth, with this reflected in the MSCI world share market index increasing 135% over the same period (left chart).



On 5 December 1996 US Fed Chairman Greenspan spoke about the markets exhibiting “irrational exuberance” (see <http://www.federalreserve.gov/boarddocs/speeches/1996/19961205.htm>). The speech was well before the Nasdaq got a real head of steam up. In “good” central bank tradition Greenspan later downplayed the irrational exuberance comments and even helped fuel the speculative bubble by cutting the Fed Funds Rate from 5.5% in August 1998 to 4.75% in November 1998, where it remained until June 1999 when he/the Fed realised that inflation was a concern and subsequently hiked it to 6.5% by May 1999. The speculative bubble was doomed anyway because it became founded on greed and ignorance rather than being based on the earnings of the listed IT companies. Just before the crash, while working as the NZ Strategist at ABN AMRO, I wrote a report comparing the IT/Nasdaq bubble to the various agricultural bubbles NZ had experienced (e.g. ostriches, angora goats). However, the hiking of the Fed Funds Rate accelerated the inevitable and between March 2000 and September 2002 the Nasdaq fell 75% and the MSCI World Index fell 48%.



Again in “good” central bank fashion the Fed, still with Greenspan as Chairman, cut the Fed Funds Rate from 6.5% in December 2000 to 1% in June 2003. It remained at 1% until the first hike was delivered in June 2004 (black line, right chart). The aggressive reaction by the Fed reflected a concern that the IT sector and equity market collapses could result in a great recession, with the aggressive rate cuts ensuring this didn’t happen. However, it should be no surprise (and not just in retrospect) that the super low interest rates in the US and globally fuelled booms in the most interest sensitive industries, most notably housing markets.

Even before the cuts in the Fed Funds Rate US house prices were moving up at a solid rate (e.g. 32% between January 1995 and December 2000 based on the FHFA Index and 45% based on the S&P Chase-Shiller Index of 20 major markets - chart above). However, fuelled by cheap money these

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indices increased 55% and 85% respectively between December 2000 and when they subsequently peaked in June 2007 and July 2006, respectively. To save the world from the collapse of the IT/equity speculative bubble the Fed (and other central banks, including the RBNZ) fuelled a speculative bubble in the housing market.

The speculative bubble in the US housing market had other friends. The conspiracy theory is that Fannie Mae and Freddy Mac, the giants of the US mortgage market, implement aggressive “social” lending policies (i.e. lending lots of money to people who would have no way of paying the interest on the loans when interest rates inevitably returned to more normal levels) for “political” reasons, with other lenders having their arms twisted to do likewise. And, of course, the greedy bankers and investment bankers helped by bundling, gearing and reselling the junk mortgages as if they were prime corporate debt, which happened under the nose of the regulators. While many professional investors from all over the globe scrambled to buy the repackaged junk mortgages because they offered higher yields in a world with super low interest rates thanks to the aggressive rate cuts delivered by the Fed and to a lesser extent by other central banks.

The super low interest rates also inevitably (and again without hindsight in my case) resulted in more general inflation problems, which the Fed and other central banks around the world responded to with major interest rate hikes. The Fed hiked from 1% in May 2004 to 5.25% in June 2006, while the RBNZ hiked the OCR from a low of 4.75% in February 2002 to a peak of 8.25% in July 2007. Just like the collapse in the Nasdaq before it, a collapse in US house prices was inevitable because the boom in prices was fuelled by a speculative frenzy that drove prices well above levels justified by fundamentals like income levels. However, interest rate hikes by the Fed etc again played a part in the timing of the inevitable crash, with the S&P Case-Shiller and FHFA house price indices falling 30% and 14%, respectively, from the peak levels.

To rescue the world from the collapse in US house prices and much more so from the international financial meltdown the Fed Funds Rate was cut to 0.25%, the Fed and other central banks delivered massive “quantitative easings” (i.e. printed money), while governments in especially the US, the UK and the Eurozone have racked up debts of mind-boggling proportions. The USD 1 trillion Greek rescue package is the latest in the saga of government rescue packages and builds on the government debt mountain that will be the foundation of another crisis, if not the next crisis. However, the government debt-related crisis will probably have a much longer gestation period than the Nasdaq and housing/financial crises. It could be preceded by a smaller crisis, possibly triggered by a collapse of what some suggest is an emerging property market bubble in China, although I question whether a tumble in property prices in China could derail the global economy anything like the collapse of the US housing market and the associated gigantically ginormous financial deck of cards.

The inevitable “solution” to the government debt crisis

The fundamental supporting a government debt mountain is the ability of tax payers to at least fund the interest payments on the debt. This means the latest bubble has, for the moment at least, more support than the Nasdaq or the housing market bubbles. However, I believe the government debt mountain is best viewed as constraint on the ability of politicians to buy votes in future elections. Even RBA Governor Stevens, who is one of the sharpest central bank governors around, warned of this risk in a speech on 28 July 2009:

“The higher debt burdens will limit the extent to which worthwhile structural spending levels can be maintained for other things – like in health, education, urban infrastructure and so on. Moreover, the capacity to respond with fiscal policy to another economic downturn, should there be one, would be much more limited.

“Over time, these constraints will tend to become more apparent. Of course they might be disguised for a while under conditions of higher inflation. Indeed, the potential attraction of the ‘inflation tax’ as a fiscal device is precisely why some worry about inflation, given the size of budget deficits in some countries.



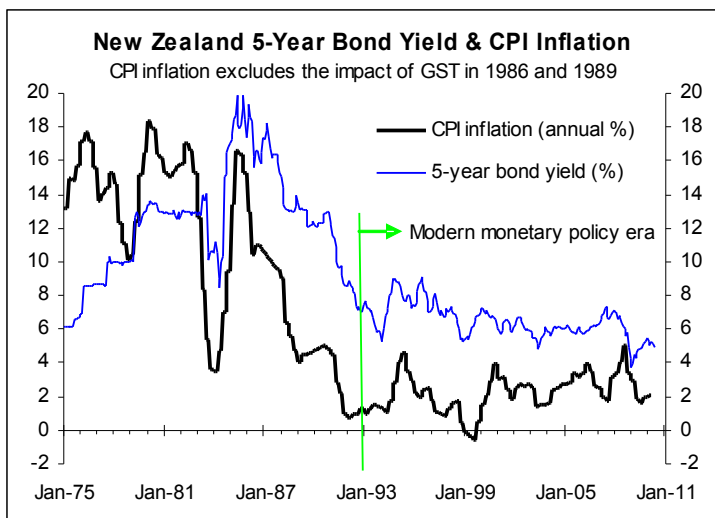
“The main safeguard that stands between debt holders and that outcome is the agreed framework for monetary policy, which is, with some differences in detail, in place pretty much everywhere. Its key components are a strong focus on medium-term price stability and sufficient operational independence for central banks to pursue that goal.”

Source: <http://www.rba.gov.au/Speeches/2009/sp-gov-280709.html>

Governor Stevens wasn't warning about an imminent threat, but rather that “Over time, these constraints will tend to become more apparent.” And he means more apparent to politicians, who are the very people who will bring the government debt crisis to fruition. A simple example shows the major incentive governments in the likes of the US, the UK and Euroland will have to inflate away their debt mountains.

Consider the example of a country that has interest costs on government debt equal to 33% of total government spending and 10% of GDP. If the debt was all currently funded by 10 year government bonds issued to the market with fixed coupon/interest payments and inflation over the next 10 years was 2% per annum, at the end of 10 years the interest payments will have only fallen to 27% of government spending and 8% of GDP (this assumes that GDP and government spending increase at 2% per annum relative to the fixed interest costs/payments). However, if inflation runs at 10% per annum the interest cost will at the end of 10 years have fallen to 13% of government spending and 4% of GDP. This is an extreme example, but it shows the major incentive governments have to beat up on central banks in pursuit of higher inflation, with the ultimate goal being to remove the constraint imposed by the mountain of debt and massive interest payments.

History is littered with examples of governments trying to inflate their way out of debt burdens, with the German hyperinflation in the 1920s (see <http://mises.org/daily/2347>) and the much more recent Zimbabwe hyperinflation (see http://en.wikipedia.org/wiki/Hyperinflation_in_Zimbabwe) being two extreme examples. But I am not warning about the risk of hyper-inflation in the likes of the US, more the risk that inflation will head to levels not seen in recent years. In that context NZ is a good example, with our own mini-version of hyperinflation in the 1970s and 1980s resulting from governments trying to solve fundamental economic problems by printing money.

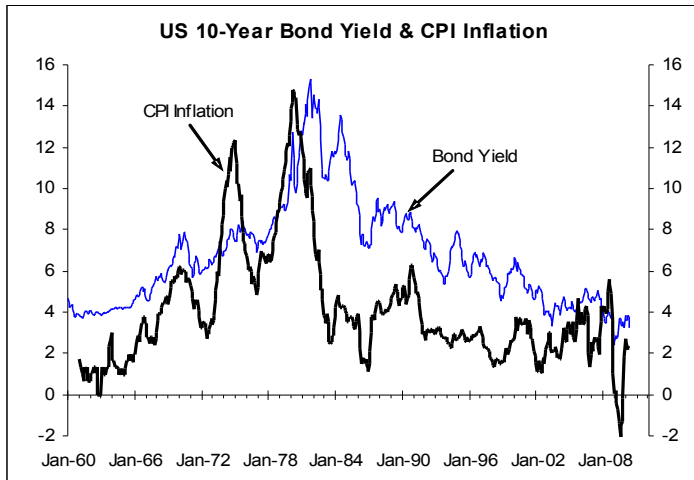


Inflation in NZ was initially allowed to rise in the second half of the 1960s when it averaged 4.3% versus 2.1% per annum in the first half of the decade. The 1972-75 Labour Government implemented policies, partly in response to the 1974 oil price shock, that pushed inflation to double digits, with it hitting 15.7% in 1975. Constrained by regulations, interest rates were not market-driven in the 1970s and as a result inflation ran well above the level of interest rates (see the chart). This was a fantastic environment for inflating away the cost of debt for the government and other borrowers. Too bad for savers!

In NZ's case it took five years of moderately pro-inflation policies to result in inflation rising from 2% to 5% and just under 3 years of highly pro-inflation policies for it to blossom from around 5% to 15%. This occurred in the context of a more inflation-friendly global environment in which pro-growth, “Keynesian” economic policies had been pursued by many countries. In the case of the US, inflation also moved substantially higher between the mid-1960s and late-1970s as a result of pro-growth, Keynesian style policies being pursued and a lack of vigilance or backbone at the Fed. Even with much freer markets in the US than was the case in NZ it wasn't until the end of the 1970s that longer-



term bond yields that reflect the cost of debt to the government increased to levels that reflected the much higher level of inflation (see the chart below).

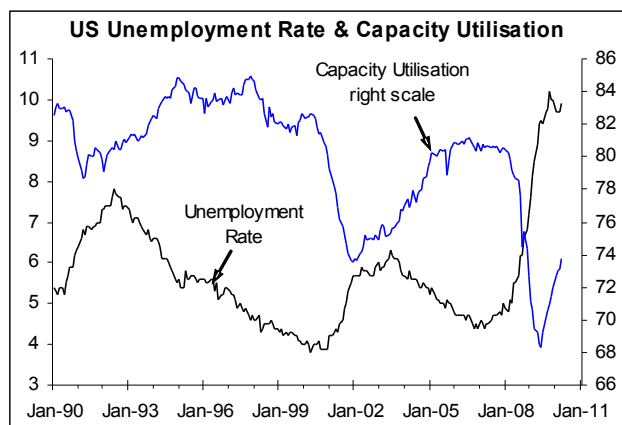
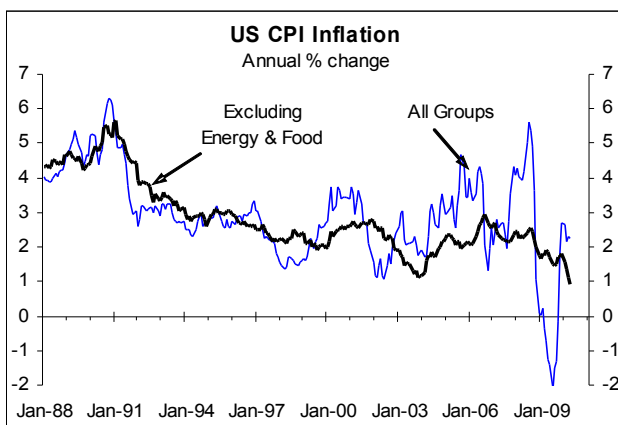


It took almost a decade of high inflation before countries like the US realised that higher inflation bought with it many more costs than benefits, while it took longer for NZ to learn the same lesson. Paul Volcker was appointed Fed Chairman in August 1979 and mounted an attack on inflation (http://en.wikipedia.org/wiki/Paul_Volcker). The aggressive interest rate hikes by the Fed played a part in driving up longer-term interest rates, with the higher interest rates ultimately solving the inflation problem, albeit that this took a recession to achieve the large reduction in US inflation in the early-1980s.

This experience ushered in an era of central bank independence/vigilance, with monetary policy focused on keeping inflation low. However, politicians face a very different environment and incentive structure now than was the case at the end of the 1970s when the focus was on solving an entrenched inflation problem. History has taught us that cunning politicians will, if it suits them, rewrite the rules of the game and that process is already underway in the US.

In the case of the Fed, just as is the case in NZ, politicians have the ultimate say over who runs monetary policy. In NZ the RBNZ Board is responsible for recommending a new governor to the Minister of Finance should the need arise, while the Minister of Finance has ultimate veto and the government also appoints the RBNZ Board. In the US the government appoints the Chairman and the President appoints the members of the Board. Obama has recently recommended three new appointments to the seven-member Board, which will add to four the total he has chosen. According to one commentator all three recent recommendations are “Keynesian economists ... known as regulators, technocrats, and inflationists”. (Source: <http://dailycapitalist.com/2010/04/28/obama-to-nominate-three-to-federal-reserve-board/>)

The slow trek to higher inflation is underway. However, with US core inflation currently at 1% (blue line, left chart) and the US having lots of spare capacity in both the labour market and the goods market (right chart), there is no imminent inflation threat. The immediate consequence is a constraint on the ability of the debt-burdened governments to wind up spending in election years. In the case of the Greeks, Spanish and Portuguese the immediate consequence is cutting government spending as part of the debt rescue package. It will be some time and possibly even 5-10 years before the inflationary consequences of the debt mountain become evident, but in the context of people that invest in “low risk” longer-term government debt over this period this big picture view is relevant.



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Recent history is often used as a basis for assessing future prospects. Research I undertook on international financial markets while working at the Bank of England in London in the mid-1980s revealed how much this was the case in the 1970s when financial markets didn't see the inflation threat coming and were slow to price higher inflation in to long-term interest rates. A cornerstone of recent history has been independent central banks focused primarily on keeping inflation low. The lessons from this recent history could prove to be a poor guide to investors and businesses over the next decade.

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