

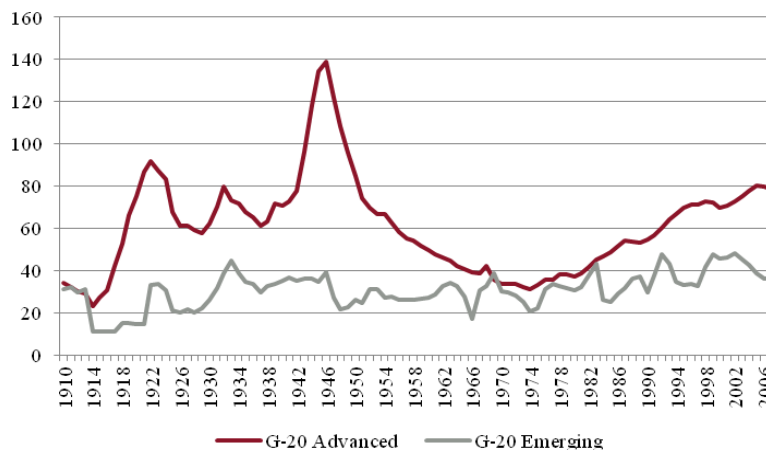
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Debt reduction through financial repression: the invisible tax

Public debt levels are currently higher than they have been at any time since World War II. Back then, however, debt ratios were reduced very quickly, without any advanced economy being forced to resort to debt restructuring. A comparison shows that we are now once again in an environment in which governments use similar mechanisms as in the past to contain excessive debt.

Sovereign debt crises like those we are witnessing at present are nothing new. However, at least in the advanced economies, only very few market participants actively remember how they can be managed. This is another reason why Greece is such an extraordinary case. Due in part to the economic crises of the past years, this subject has recently attracted again increasing attention (see Figure 1). The public debt ratio – i.e. debt as a percentage of gross domestic product – can be reduced in a number of ways: In the best case, through growth (assuming a steady increase in public revenues), privatisation programmes or fiscal austerity (even though, historically, there have been very few examples proving that austerity has ever worked as an isolated measure). At the other end of the spectrum, there is the option of a haircut of the kind we are seeing in Greece. Then there are a lot of mixed approaches combining growth on the one hand with a currency reform, hard restructuring, or default. Their make-up depends on the external environment in which a government operates. A particularly subtle mixed approach is so-called "financial repression". This term was first used in the 1970s (Shaw (1973), McKinnon (1973)).

Figure 1: Public debt in % of GDP (PPP GDP weighted)



Source: IMF

Financial repression is a special way of debt reduction. It is characterised by the combination of two policies (cf. Reinhart/Sbrancia (2011): The Liquidation of Government Debt):

1. Explicit or implicit influencing of interest rate levels for public sector borrowing (e.g. by capping interest rates, ...)
2. Creation and "maintenance" of demand for debt instruments (e.g. through regulations for banks/insurers, regulation of capital movements, unfavourable tax treatment of other asset classes, ...)

"Repression" may therefore take two forms: On the one hand, real interest rates are allowed to turn negative (when the market interest rate falls below the inflation rate, debt is reduced in real terms); on the other hand, investors are forced to buy and hold this asset class despite negative real interest rates (this way, the period of negative real interest rates may be artificially extended). This way of debt reduction – which is tantamount to a seemingly voluntary acceptance of a loss of purchasing power by the creditor – is open only to a sovereign power and is therefore a prerogative of governments. This is, by the way, one of many reasons why sovereign bonds issued by advanced economies still carry the lowest default risk.

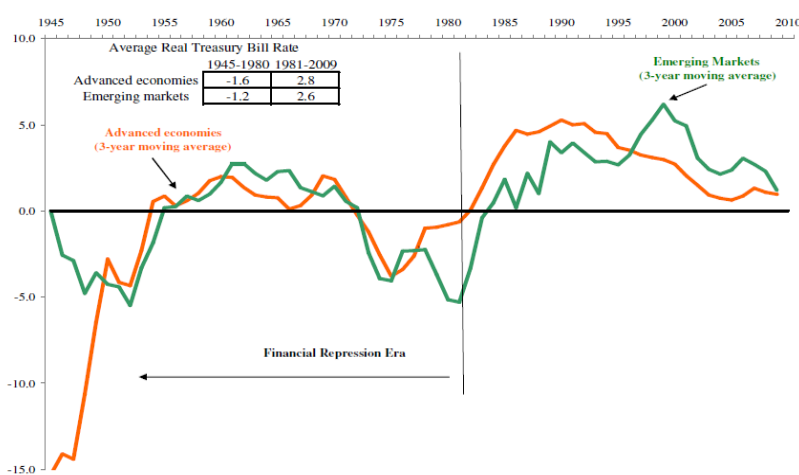
There are effectively no limits to what can be done: Well-known methods range from the imposition of increased liquidity requirements on the banking sector (this liquidity must of course be held in the form of sovereign bonds) to restrictions on capital movements or the creation of market entry barriers in the financial sector. In this stealthy transfer of resources, the focus is usually on the financial sector and its regulation. As the government has ways of controlling the financial sector (e.g. through nationalisation, the acquisition of stakes in companies, ...) this effect may be reinforced even further. The fact that regulation is inherently pro-cyclical also plays a role in this process that should not be underestimated.

The result is in any case a kind of invisible tax on financial assets or a tax on the financial sector's (monopoly) profits. Crucially, inflation need not even be high. Repression is effected by forcing nominal interest rates below the rate of inflation. Certain mechanisms (see example above) may be used to prolong such a situation artificially over extended periods of time. While a rise in inflation would help, it is in fact not even necessary for the mechanism to work.

Reinhart/Sbrancia showed that from the end of World War II to well into the 1980s, this form of deleveraging has not been confined to emerging markets but was also used extensively by advanced economies (see Figure 2). In the UK, for example, real one-year interest rates were negative roughly half of the time during that period.

Figure 2: Real returns on short-term government debt

average ex-post real interest rates on T-Bills (1945-2009, 3-year moving average)



Source: Reinhart/Sbrancia (2011)

Mild deleveraging – potential adverse effects

Even if in the past this approach proved to be the most tolerable and mildest way of reducing public debt levels, its potential negative impacts should not be overlooked. The possibility of influencing the banking sector, especially by capping lending rates (when lending to the government) or interest paid on household savings, may impair the banking sector's most important role – the efficient allocation of capital. The result would be distorted capital costs, which in turn would create false incentives for market participants and would put the private sector at a disadvantage. This may well be one of the explanations why, in an environment of negative interest rates, stocks have historically tended to underperform. If this also applies in the future, stocks will work as hedges in the current environment only to a limited extent.

Nor may we assume that the mechanism will work today with similar effectiveness and smoothness as it did in the post-war period, as a number of critical parameters are absent or different.

- Most importantly, private sector debt levels are now much higher in the advanced economies than they were 50 years ago. This means that resources are transferred today between two highly indebted sectors, which causes the private sector's assets to shrink. This might exacerbate the private sector's deleveraging problem even further.
- The importance of sovereign bonds in the operations of the banking and financial sector has increased substantially.
- In the advanced economies, the demographic trend also differs significantly from that of the post-war period ("baby boom"). The demographic dividend is far from the levels it used to be: At a time of projected population growth, deleveraging is much more tolerable than in a stagnating population.
- Growth, inflation and the economic incentives that existed in the post-war era are likewise not comparable with the current situation.

Alternative portfolio strategies

The implications for investments are anything but clear. If one believes in the scenario described above, managers of portfolios investing in sovereign bonds only have three options:

1. Accepting the fact that at a given risk level real portfolio performance is necessarily lower
2. Accepting the need to move to more risky asset classes if one wants to earn the same real return
3. Looking for or more aggressively adding other asset categories with - hopefully - low correlation to re-optimize the portfolio's risk-return profile

All these ideas become obsolete, however, once risk aversion rebounds again significantly, which is why sovereign bonds will have to form a fundamental part of any balanced portfolio even in the future.

Conclusion: "Financial repression" is not a disaster scenario, but, as we believe, a very realistic (since for the government very convenient) way of slowly reducing the mountain of debt that has been accumulated. One must not overlook, however, that this may keep certain market mechanisms from working smoothly for extended periods of time, which may have an adverse effect in particular on private sector activity. Nor is there any assurance that these methods will be similarly successful as they were in the past. Nonetheless, any knee-jerk reactions of regarding sovereign bonds, therefore, as a necessarily unattractive asset class should be firmly kept in check, if only in view of the need for diversification.

Nikolaus Görg, CEFA, Bank Gutmann Aktiengesellschaft

Sources:

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For further details please contact:

Friedrich Strasser

Member of the Board and Partner

Bank Gutmann Aktiengesellschaft

Phone: +43-1-502 20-216, friedrich.strasser@gutmann.at

www.gutmann.at

Renate Skoff, The Skills Group

Phone: +43-1-505 26 25, skoff@skills.at

www.skills.at

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Phone: +43-1-502 20-0, www.gutmannfonds.at

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