What Just Happened to Global Credit?

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- **Some modest proposals**
- **Relief in Europe**
- **Time to lose "patience" in the US**
- **European risks lift**
- **China's bond buying**

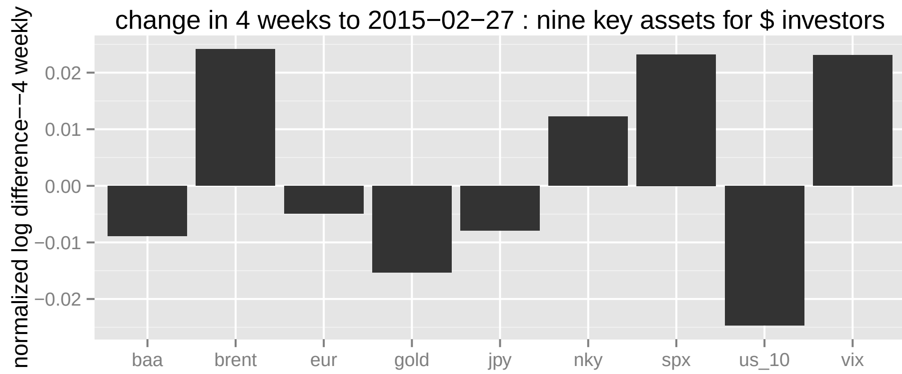
Two big events last month were a kind of resolution of Greece's demands for debt relief and a widening circle of negative interest rates in Europe. Linked by their effect on the debt mountain we now carry in the world economy, these are alternative forms of debt relief in case quantitative ease–ultimately a monetization of government debt on a vast scale–fails to ignite demand.

Not only do we not have any kind of experience base to know whether quantitative ease can work, but the policy itself is also shifting. We now we have Japan and soon Europe adopting these policies in large size, just as the Fed stops and begins to consider raising rates. A transition to quantitative ease outside the US might point reflation more directly where it is needed, as economies abroad keep lagging the US recovery. It might also offer a continuous reflationary impulse to the global system. But what if the policy fails? Then more radical measures may be needed.

In case of a relapse in global growth, stronger reflationary measures will be needed. Two possibilities were on trial out this month: debt write-off, as suggested by Greece, or deeply negative interest rates as practiced in Denmark, Switzerland and Sweden. For the first option, debt write-off, Greek politician called for writing off their voters' debt to foreigners, mainly. But Greeks will also be encouraged to stop servicing domestic debts as well, much of it to the public sector. Debt write-offs can indeed re-balance an over-indebted system, but done unilaterally and in stages they can also cause panic and disruption.

The other emergency option in the worst case may be moving policy interest rates to deeply negative values. For years this has been excluded on the basis that zero is an interest rate floor, mostly because investors would always have the option of holding cash instead. But is it impossible to levy a charge on increasingly electronic cash in a high-tech age? So far, several European nations whose currencies came under upward pressure have put in place negative interest rates with little visible difficulty. If rates go far enough below zero, assets and liabilities will fall, and the cost of new credit will look cheap enough to bring on a new equilibrium in global credit markets.

These are very big alternatives, reserved for the worst case scenario of a fall-back in world growth, which is not what we see right now. But these extreme alternatives just became one small step more viable this month.



Relief in Europe. Relief that Greece was not booted out of the euro zone bolstered markets last week. The Euro fell and European assets did very well, including a rally in some bonds to solidly negative yields that continue to perplex me. Over the month, Italian bonds were the biggest winners in my sample upon news of the Greek compromise.

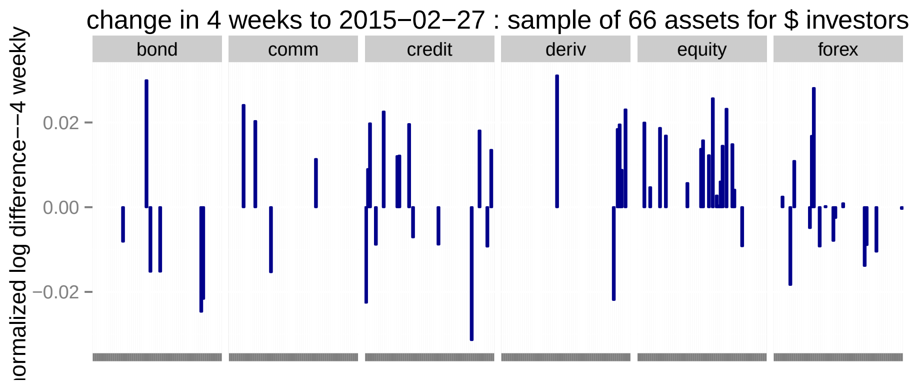
Additional relief at a near-cease fire in Ukraine was helpful for Europe, too. Worries about Russian sanctions were calmed as Putin's proxies and troops seem to have reached modest objectives and seemed ready to stop their recent offensive. Russian equities were the strongest performing asset in emerging markets.

Throughout the month investors also adjusted to the idea that a US recovery was increasingly likely to pull along a global recovery. Oil rose, as did the S&P index and US bond yields. Even more telling was a recovery in copper, often the most accurate tell-tale of a global industrial recovery.

Time to lose "patience" in the US. Choppy data continues to point to weaker GDP through the first quarter of 2015. Consumer spending has paused, health care spending as roughly estimated by the BEA could advance more slowly, and car buying may have plateaued. Furthermore, inventory build-up and imports could ebb off, confusing the picture. Supply chain issues may be particularly obscured, by the slowdown and lockout at the ports of Los Angeles and Long Beach. Overall I expect slower output gains than final consumer demand, which should be bolstered by hiring and incipient wage gains, as for example, at the ports. An element of doubt about the recovery might suggest to the Fed the wisdom of waiting past mid-year to raise rates.

Financial factors argue otherwise. A large quantitative easing programs in Japan and about to start in Europe should replacing the one ending in the US. Both partner countries have seen sharply lower long term interest rates. One could say this reflects global deflation and the folly of an early US rate hike. Alternatively, these offshore policies could hold US long-term rates lower than otherwise, capping crucial US mortgage rates. Looking at it this way, there is now little cost to the process of beginning to normalize US overnight rates.

Furthermore, operational problems in moving up US overnight rates argue for getting with it sooner than later. Excess fed funds still swamp bank balance sheets. Lifting fed funds while massive excess reserves prevail has never been done before, and despite extensive testing of a scheme to absorb market funds at positive rates through reverse repurchase agreements, it is not proven that any rate over zero can be maintained while excess reserves remain in the multi-trillion dollar range. It might be possible, if the Fed can persuade markets that it has unlimited room for reverse repos if needed, but must be an uncertain thing until proven by experience. Far better to get on with it ahead with it when there is no overwhelming market pressure to do so, and no panic in case of a brief accident.



European risks lift. As fast as it seemed to slip into a spiral of failure, Europe snapped back last month. A new cease-fire seems to be holding in Ukraine, and the threat of a military bully next door may diminish once Russia achieves its main objectives. And growth seems to be turning back up, ever so slowly. Most importantly, the potential ejection of Greece from the euro zone has been averted.

One feature of the Greek debate was the absence of a community of discourse: the new Syriza government seemed unaware of some elements of its problem and so proceeded to argue by slogans rather than negotiate in a business-like manner. Fundamental in this confusion is the question of why so many Greeks are so indebted. Of course, one reason is that Greeks seek a European standard of living that may not be in line with local productivity. That search has led over the decades to a rising cost of doing business in Greece compared with anywhere else in Europe, until imports meet the higher consumption demanded, financed with debt.

So claims that dismissal of old debts will solve Greece's problems may be a dangerous misdiagnosis. The problem rather is ongoing excessive costs that require support with credit–from the public sector and then from foreigners. Clearly running an extreme form of austerity will bring a painful balance at an untenable price level, but that is politically unenforceable over time. So, the answer is an urgent reduction in costs, wages, and constraints on business. A shock liberalization or round of wage and costs cuts could replace the devaluation that for decades has been the Greek way of getting out of the overvaluation position to which as a society it has been chronically prone.

Arriving with a debt-reduction plan, Greek official found their counterparts rightly alarmed. Without any change in Greek costs, and having lost access to market financing, the idea that reducing claims of other European nations ahead of demanding new credit from them seemed absurd. Also dangerous, since several other countries have a lesser form of the same problem. If granted, Greek terms would embed an ongoing transfer to demanding Greek voters from richer countries without democratic approval in the granting countries. And it would be certainly followed by other similar demands. That could be good for global credit growth for a time but it could very well put the Eurozone on a course for inevitable break-up.

Alternatively, not getting the debt reduction and further credit transfers, Syriza negotiators might have opted to pull out of the Euro and devalue. At a stroke 20 years of creeping overvaluation could be eliminated and Greece could grow again. I assumed this was the most likely case, but it seems to have meant more risk than Syriza's leaders or their electorate were willing to take. The euro is a stronger community than I thought. Greece dropping out of the Euro would have been contractionary to global credit because the shock of higher Euro debt would squeeze un-hedged debtors. Debt write offs would follow and new credit could take time to emerge.

In fact, neither of these two more disruptive alternatives came out in the end. Instead we had late night talks and a vague compromise in which Greece agreed to limited demand boosting measures, and kept some cost cutting ones. The new government seems to think, possibly taking Piketty as a guide, that the key is new wealth taxes. While fashionable, that is not going to help bring in the private investment that could help boost productivity and cut costs at the fixed exchange rate. But at least we will not have either of the two other deeply disruptive outcomes that have been avoided. On balance, and coming ahead of the coming big ECB bond-buying program, the solution of the Greek crisis is credit positive for Europe.

United States

ACTIVITY	CREDIT	POLITICS
Payrolls continue rising: ECI wages up	Yellen suggests early end to "patience"	
Walmart raises its minimum wage	JPMorgan to charge large depositors	
Jan car sales 16.7m rate	Wave of long US corporate bond issues	
Drillers cut back	Companies cut oil investment plans	Obama suggests tax on offshore corporate cash
LA/Long Beach disruptions continue	S&P downgrades Puerto Rico	Weapons for Ukraine suggested
Slow 4q investment and high imports	Student and car loan delinquencies rise	

Europe

ACTIVITY	CREDIT	POLITICS
E-coin up		France avoids EU fine with its reform plan
Stong Italian car sales	Some bank outflows return to Greek banks	Modest French reforms at great political cost
Strong German IQ GDP	Swedish, Danish negative rates	Greeks agree to adjustment and loan
Solid IGMetall wage contract in Germany	Italian mutual bank structure to change	Greek collateral no longer good at ECB
		ELA credit replaces regular loans. E60b=>68b
		Greek default risk rises

China

ACTIVITY	CREDIT	POLITICS
	Surge in trust lending	
	First housing junk bond sold since Kaisa failed	
	Reserve requirement cut	New Year Holiday
Stabilizing manuf survey	FT questions Hanergy Solar's funding	Widening corruption inquiry in the military
Tech protectionism steps taken	Capital outflows continue	
No sign of a bottom in steel prices		

China's bond buying. China's slow-motion slide into recession continued, but quietly because so many were visiting family over the long New Year's holiday. A striking collapse in domestic freight shipments was ominous, however. With at least a controlled pause in apartment building underway, basic materials including steel continue to fall in price. Overall, GDP in China seems to be tracking closer to 6% than to 7% growth, based on independently reported components. Despite every risk in this credit-heavy system, a disruptive credit event has not yet emerged to trigger a recession as we know it. Still, the central banks was concerned, and cut rates again once business resumed after the holiday.

China's ties to the rest of the world were long limited to trade in goods. A swelling trade surplus led to enormous reserve accumulations, which posed important investment choices. That pair of linkages still dominates China's links to the rest of the world, but, in addition, the great credit cycle in China has begun to pull in credit from abroad and could see sudden outflows, too.

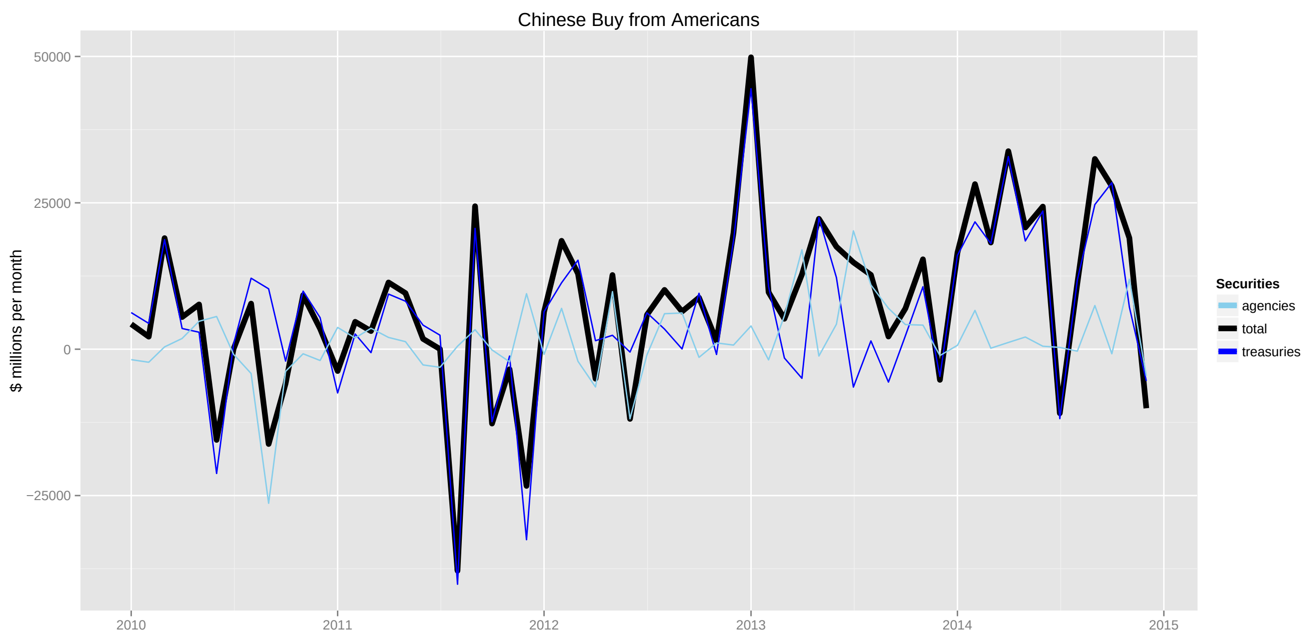
Modest capital outflows have in fact emerged, at least partly reflecting expected higher interest rates and better returns in US markets. A deliberate push down on the renminbi late last year changed the attractiveness of high-yielding investments in the rising renminbi to two-sided risk. My rough estimate puts underlying capital outflows at $125b per quarter during the last half of 2014.

An estimate of this kind is a residual of the rest of the balance of payments. To start with, reserves have been falling fast, partly because of dollar-valuation losses on the big share of enormous reserves that are held in euros. Book-value losses could have been $75b a quarter and may peak in the current quarter as the euro's decline has accelerated. Underlying flows into reserves showed a smaller outflow, at about $0-25b a quarter.

Comparison with a swelling trade surplus raises the reasonable question: where did all of China's trade surplus go? As a manufacturing country that imports raw materials, falling commodity prices have been an enormous boon for China. China's trade surplus surged to nearly $150b a quarter at the turn of the year from $60b for several years. Disregarding other items, that swing roughly corresponds to the swing from substantial capital inflows to the more recent outflows.

At the same time, Chinese investments in US bonds surged last year. US Treasury data shows a step up in the pace of Chinese buying of US treasury and agency directly from US traders (not counting additional trades in London or elsewhere offshore) from about $25b a quarter to $75b during most of 2015.The most likely explanation is that while the euro was widely expected to weaken, China's reserve managers seem to have moved decisively into dollar investments and out of Euros. Alternatively private capital outflows are finding their way into US treasuries and agencies.

As the Fed was easing off on its buying of government bonds, Chinese investors kept buying, increasing the scarcity of US bonds to the rest of the global investing public. This was the indirect result of lower global commodity prices, Chinese reserve managers' growing aversion to predicted losses in euro investments, their taste for the safest available securities, and the new private outflows into dollars. One result may have been to keep US risk-free yields under somewhat more downward pressure than fully justified by the economic outlook.



For me, the main process in global markets is the transition from US to offshore quantitative ease. US rates could be rising soon, as soon as some near-term economic noise passes. But as we mentioned at the beginning, if a shifting but persistent policy of quantitative ease fails to bring global economic lift off and positive inflation, alternatives are waiting. Not all are good for investors.

For now, we remain optimistic that global deflation is mostly just the product of falling oil prices, which seem to have stabilized. Negative interest rates in the safer parts of the eurozone will normalize as Greek euro-exit risk fades, and as the ECB avoids deeper negative rates because recovery is beginning. Lastly, we assume that creeping debt rejection as a social policy in parts of Southern Europe will gain little traction once it becomes clear that both creditors and debtors will be local. In that case, write-offs are suddenly less appealing as an electoral program, even to the Greek electorate.

If we make our way safely through those minefields, the lingering presence of which still argues for easily triggered market panics, investors will still have to price the transition from US to offshore quantitative ease. In particular, the assumption of a very long wait before US rates begin to be hiked could be very wrong.