



Country Risk

“This somber fiscal outlook raises issues of (country) fiscal solvency, and could eventually trigger adverse market reactions. This must be avoided: market confidence in governments’ solvency is a key source of stability and a precondition for economic recovery. Therefore, there is an urgent need for governments to clarify their exit strategy to ensure that solvency is not at risk. The weaker state of public finances has dramatically raised the cost of inaction.”

IMF Staff Report June 6, 2009

Zero Sum Game

The markets have been focused on the brighter outlook for the private sector as a result of the global stimulus efforts. ***It is now occurring to us that it was a zero sum game.*** That is, while governments have been providing liquidity, direct fiscal spending, and monetary base growth to the private sector, there will be a commensurate slowdown in public sector spending as deficits grow.

The only way around this effect is if there is, in fact, a multiplier effect when governments put money into the private sector. That is, will a dollar spent result in a dollar plus in economic value and thus have a positive effect in tax receipts? **The only multiplier effect we respect is the creation of money through the multiplier effect of loans in the modern reserve system not a multiplier effect on the economy from deficit spending.**

The problem with the multiplier strategy is that *fiscal stimulus has a frictional cost and may not result in a net positive impact.* Neither capital, nor land, nor labor is created. The issue is further exacerbated by the projected slow growth trajectory coming out of the “great recession.” It will be slow to create jobs and thus jeopardizing a net positive revenue effect.

The IMF Report

We are struck by a particular report published by the International Monetary Fund staff back in June of 2009. The IMF Staff Position Paper “Fiscal Implications of the Global Economic and Financial Crisis” produced by “A Staff Team from the Fiscal Affairs Team.” 9 June 2009. With the recent concerns about the financial condition of Greece and others we think that the IMF’s staff researchers’ message was fortuitous and relevant going forward.

Some redacted excerpts:

“The global financial crisis is having major implications for the public finances of most countries. Fiscal revenues are declining through the operation of automatic stabilizers and because of lower asset and commodity prices. Direct fiscal support is being provided to the

financial sector, and many countries are undertaking discretionary fiscal stimulus. This is cushioning the global economy from the effects of the crisis. But it implies a fiscal deterioration that is particularly strong for advanced countries, where the increase in both government debt and contingent liabilities is unprecedented in scale and pervasiveness since the end of the Second World War.

They go on to say that...

“The fiscal balances of G-20 advanced countries are projected to weaken by 8 percentage points of GDP on average, and government debt is projected to rise by 20 percentage points of GDP in 2008–09, with most of the deterioration occurring in 2009. The fiscal balances of G-20 emerging market economies will deteriorate by 5 percentage points of GDP. For advanced economies, the increase in debt mostly reflects support to the financial sector, fiscal stimulus, and revenue losses caused by the crisis.”

The report was surprisingly ignored by the markets. The reforms suggested range from an exit plan from the stimulus programs to address the heavy health and pension liabilities of advanced industrial countries due to the aging population.

The following table shows the government debt as a ratio of GDP for key countries as a result of the stimulus efforts during the recession that resulted from excess in spending, risk taking by financial institutions, and social safety-nets.

Country	Government Debt					
	2006	2007	2008	2009	2010	2014
Argentina	76.5	67.9	57.7	50.4	50.6	48.5
Australia	9.6	8.9	8.9	11.3	13.9	16.6
Brazil	63.7	67.7	64.5	65.4	64.0	54.1
Canada	67.9	64.2	63.6	75.4	77.2	66.2
China	16.5	20.2	17.7	19.8	21.6	17.9
France	63.6	63.9	67.3	74.9	80.3	89.7
Germany	66.0	63.6	67.2	79.4	86.6	91.0
India	82.2	80.4	81.9	86.8	88.9	76.8
Indonesia	39.0	35.1	32.3	32.9	32.8	31.0
Italy	106.5	103.5	105.8	115.3	121.1	129.4
Japan	191.3	187.7	196.3	217.2	227.4	234.2
Korea	34.1	33.0	33.6	40.0	46.3	51.8
Mexico	38.3	38.2	43.3	46.9	49.3	44.0
Russia	9.1	7.3	5.8	6.9	7.0	7.4
Saudi Arabia	27.3	18.7	15.8	15.6	13.1	7.9
South Africa	33.0	28.5	27.3	29.1	30.8	29.9
Spain	39.6	36.2	39.4	51.8	59.2	69.2
Turkey 3/	46.1	39.4	39.5	47.2	50.4	53.7
United Kingdom	43.3	44.1	51.9	62.7	72.7	87.8
United States	61.9	63.1	70.5	87.0	97.5	106.7
G-20 countries	63.1	62.8	65.9	75.7	81.6	84.6
Advanced G-20 countries	78.3	77.6	83.4	97.7	106.4	114.1
Emerging market G-20 countries	37.6	37.8	36.4	38.7	39.9	35.0

Source: IMF, *World Economic Outlook*, April 2009.

The World Shifts Rapidly on Governments (at the wrong time)

The difficulty in creating revenues for countries can be attributed in part to the rapid shift in the balance of the three inputs to production-

- Land
- Labor, and
- Capital

Governments depend on the taxing of labors income while technology is rapidly shifting the mix more towards capital. The automation of labor or human capital is extraordinary. The “great recession may prove to have accelerated this process as the cost of labor such as ancillary employment benefits. The costs include healthcare, taxes, insurance and pensions.

Another input to production, land, is diminishing in its use since the decline of the agrarian age. Governments also rely on taxation of land.

SUMMARY

The conclusions that can be drawn are:

- The fiscal stress and consequences on countries will extend into and peak in 2014.
- The US debt to GDP is projected to peak at 106.7%. This will approximate the peak following the Great Depression and WWII.
- Large developed countries will not be immune to credit rating downgrades though the agencies will be reluctant to address the US debt problem.
- All developed or advanced countries are by-and-large in the same boat meaning that relative currency valuations may not be as large or violent as some market participants speculate.

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