Greece No Lehman, But Global Strife Brews

Last week's panicked trading on world financial markets was eerily reminiscent of the post-Lehman chaos of September 2008. Equity markets plummeted (partly induced by system failure), debt markets froze, inter-bank lending rates skyrocketed and everyone wanted to be at the short end of the curve. Remember when US Treasury bills traded at prices that reflected negative yields?

On Friday last week Australian Government bonds were trading at prices that suggested the next move in rates would be down. That's not because people actually thought rates will be cut (it's not out of the question if the economy turns south) but simply because panicked investors were seeking the safe haven of Government bonds and the shortest duration possible.

No doubt the contagion risks are similar. The question is not whether Greece can or cannot pay its debts (without dramatic cuts to government spending, it looks nigh on impossible), but which country is next. With Spain, Portugal and Ireland in the firing line, it's no wonder banks are reluctant to lend to each other.

When banks stop lending to each other, they also stop lending to customers. We might need another reminder in a decade but for now the events of 2008/9 are fresh in our minds. Dramatic credit contractions can have devastating impacts on the real economy.

This time around, governments and central banks would be running low on ammunition with which to fight another credit crisis. Interest rates are at or near zero (1% in the EU, zero in the US) and governments can hardly rack up even bigger deficits in the current environment, given that is the cause of the problem to begin with. Hence the massive support package announced by Europe's leaders last night. They cannot let this spiral out of control.

There are, however, three important factors that seem forgotten amongst last week's equity market collapse. Firstly, the banking system is much better capitalised than it was. A McKinsey report from January this year showed that, thanks to massive recapitalisation efforts, the global banking system 'had deleveraged to the point at which capital levels were at or above the average levels of the 15 years preceding the crisis'. That gives them less reason to worry about each other and more reason to lend.

Secondly, many listed businesses have themselves raised substantial amounts of capital and bolstered their balance sheets, thus reducing their dependence on the banks.

Finally, US consumers, long the global growth engine, have substantially cut back on debt as a way of financing consumption. In short, the world's dependence on debt is not what it was when Lehman collapsed. If credit dries up again, I expect the impact on the real economy will be proportionally less. Short-term, this too will pass.

Long-term, this Greek crisis is simply a precursor to the problems the world faces. The Europeans, being European, took their time. But, not surprisingly for students of human nature or politics, they've taken the easy option and kicked the can down the road. For more than a

decade, Western consumers borrowed too much money, ably assisted by financial institutions creating financial products they themselves didn't understand. When the consumers couldn't pay and the banks were about to collapse, governments bailed them out. Remember the calls for 'a global stimulus package'?

Well, it worked in as far as we're not looking down the barrel of another Great Depression. Amongst the chaos last week, statisticians announced that the US economy generated an astonishing 290,000 jobs in April.

But the original problem – too much debt – hasn't gone away. It has just been transferred to government balance sheets. Now, one of those governments can't meet its obligations. So what do we do? We just transfer the problem onto bigger balance sheets. In this case, they're the ones owned by the European Union (EU) and the International Monetary Fund.

The buck, however, stops here. Europe and the US are not too big to fail, but they are too big to bail. It is going to hurt but eventually, eventually, the Western world needs to reduce the overall leverage in the system.

The McKinsey report referred to earlier is an insightful analysis of 45 prior episodes of deleveraging, 32 of which followed financial crises (there have been no financial crises in history that have not been followed by a period of deleveraging). The authors identify four ways in which economies can successfully deleverage and no, pass the parcel is not one of them.

The relatively painless option is to grow your way out of debt. Historically, this has been associated with wars (the US during the Second World War) or oil booms (Egypt in the late seventies and Nigeria between 2001 and 2005). Neither of these conditions exist in the US or Europe today (while the US could currently be described as 'at war', expenditure as a percentage of GDP is a fraction of its WWII levels).

The short and painful approach is simply to default on your obligations. Neither the US nor the EU (we might as well view it as one now that the implicit monetary support has become explicit) will default in a traditional sense. Argentina (2002) and Russia (1998) both went down this path in recent times but neither had the luxury of being able to borrow in their own currency. As long as you can print your own money with which to repay debt, you'll never need to default.

That leaves two options: inflation and 'belt tightening'. The latter has been the most common tonic to a bout of indebtedness (16 of the 32 post-crisis deleveraging episodes). This means cutting back on government spending in order to bring spiralling foreign debt balances under control and the result, in all cases, was a substantial reduction in economic growth.

Portugal and Spain, petrified by the Greek experience, have already announced substantial new austerity measures. Both the UK and the US will lose investors' patience if they don't soon show a credible plan for bringing their deficits under control.

The fiscal largesse saved us from a Great Depression, but unwinding the associated deficits is going to result in anaemic economic growth for the next few years at best. Potentially, it could be a drag on economic growth for a decade.

Inflation might seem like a far more palatable solution and, for creditors, there's no doubt it is.

Perhaps best described as 'default by stealth', inflation erodes the value of debts and, if you're the supposed recipient of those debts, the value of your assets. It also reduces the value of all other assets in an economy, creates substantial frictional costs and destroys a country's ability to borrow in its own currency again.

It might be the most palatable option for a leveraged electorate, but for investors inflation is a disaster. These two solutions – inflation and belt tightening – or a combination of both will, most likely, be the path chosen by or forced upon the West's leaders. Whichever way it goes, it's a process that will be painful for investors. The Western world needs to reduce the overall leverage in the system.

Finally, lest you think these adjustments have nothing to do with us and our China-fuelled economy, the Greek crisis provides one more important lesson. When countries run massive deficits, they need to get the money from elsewhere.

The only countries that can lend it are those running surpluses. So it was no surprise when the Germans turned up as one of the most substantial Greek bondholders, and stood to lose the most if Greece defaulted on its debts.

The Chinese are probably quite content about the US$2 trillion they've run up in foreign reserves, mostly US treasuries. The austere, hard-working, big-saving Chinese are not to be blamed for US profligacy, they would argue. But they've ended up owning trillions of dollars 'worth' of assets that pay them zero interest and run a very serious risk of being inflated away. It's like selling drugs to a junkie on the promise of an IOU – you have to wonder who's taking advantage of who.

It's in everyone's interests to unwind global trade imbalances and begin the process of Western deleveraging sooner rather than later. I doubt there's the political wherewithal just yet, but a couple more crises might just do the trick.