

# Monthly INSIGHTS

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## Is Austerity the Solution to the Global Debt Crisis?

*"I contend that for a nation to try to tax itself into prosperity is like a man standing in a bucket and trying to lift himself up by the handle." - Winston Churchill*

### Summary

- The global debt crisis is the result of years of accumulated debt and inefficiencies.
- The solution will require a credible deficit-reduction plan, including government spending reductions, modest tax adjustments, and currency devaluation.
- Eurozone politics complicate the situation and make the path toward resolution less predictable and more volatile.
- We advocate regular rebalancing toward a neutral market-risk position to take advantage of the volatility.
- The European debt crisis has created investment opportunities by reducing the value of all international equities, despite their diverse revenue sources.
- The outcome — either a weaker European economy or greater European Central Bank (ECB) action — will likely cause continued downward pressure on the euro.

### Recent Volatility and European Insolvency

How many times do we see the same story line replayed with just a slightly different twist? In Ernest Hemmingway's *The Sun Also Rises*, Bill Gorton asks his friend Mike Campbell about his financial difficulties: "How did you go bankrupt?" Mike concisely responds, "Two ways. Gradually and then suddenly." In the latest production, Greece plays the part of Mike Campbell, this time as a spendthrift nation with a huge public sector and not-so-competitive labor costs. According to Harvard professor of economics Kenneth Rogoff, "Greece has been in default roughly one out of every two years since it first gained independence in the nineteenth century." As a result, prior to the formation of the European Monetary Union (EMU), Greece was paying upwards of 15% on its borrowings, reflecting its propensity to default.

When Greece joined the EMU, its monetary situation improved dramatically, yet its fiscal discipline worsened. The formation of the EMU and the fiscal requirements of membership created an implication that the group financially guaranteed its members, allowing countries like Greece to borrow at lower interest rates. This type of very affordable growth can result in a gradual but dramatic shift in fiscal policy. While Greece has not defaulted since joining the



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EMU in the late '90s, by the end of 2009 its debt had swollen to near 130% of GDP.

It should be noted that in this period of prosperity, the more conservative EMU nations benefited from a rise in exports to the profligate members. German and French banks helped finance Greece's growth, and today, Greece accounts for 157% and 125% of the equity at German and French banks, respectively. Unsurprisingly, while EMU member nations were benefiting from Greece's growth, there were rarely complaints about the rising debt burdens.

Eventually, though, the accumulation of debt among the eurozone nations reached a point of no return. In response to the subprime crisis of 2007-2008 and the associated recession, global governments were forced to transfer private debt onto public balance sheets. When combined with the lower tax receipts of the economic downturn, what had been a slow-motion train wreck was quickly accelerated. Governments with less fiscal discipline found their spending budgets dramatically misaligned with revenues, resulting in faster rising debt levels. Already headed in the wrong direction, Greece's officials were limited in their ability to stop the train.

The eurozone debt crisis is probably not what the architects who designed the EMU had imagined. Theoretically, a currency union offers economic advantages due to increased trade and mobility associated with neighboring countries operating under a common currency. Since the formation of the EMU, there has arguably been a lift in eurozone GDP, but it is hard to identify how much of this is from increased trade and how much is from the propensity of nations to finance economic growth at discounted borrowing costs. Despite the good intentions, the lack of uniform fiscal discipline may be the EMU's Achilles' heel.

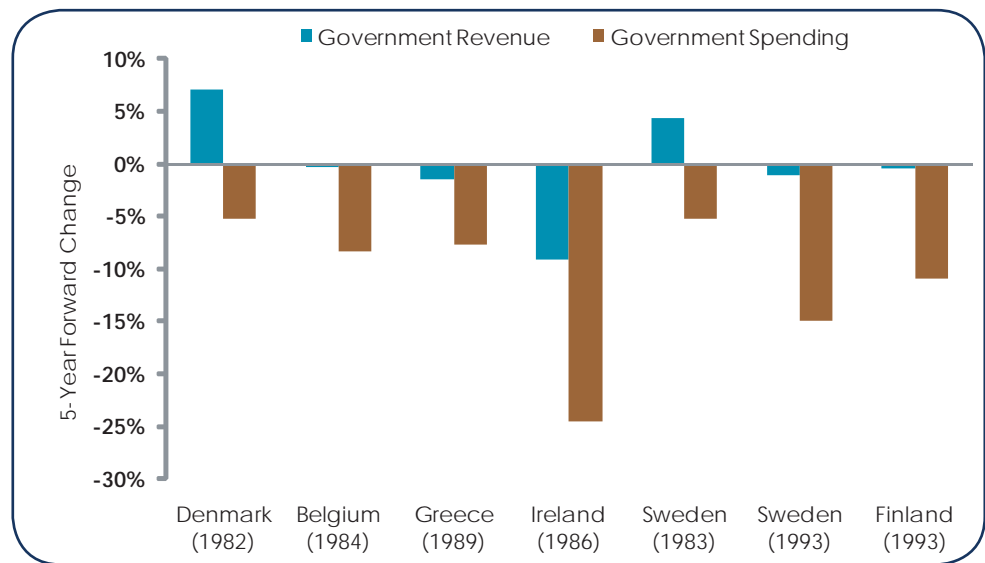
### **Can the Solution be This Simple: Raise Taxes?**

At the root of the debt dilemma is an imbalance between long-term income and spending levels. There are only two ways to remedy this situation: increase income or reduce spending. In this situation, no one wants to modify their spending habits; rather, we would prefer our income increase. Likewise, a government's natural reaction is to prioritize increased taxes over more difficult measures such as reductions of government spending programs.

However, when tax rates are increased, the result is often a corresponding decrease in economic activity and taxable income that partially offsets the increase in revenue from the rate hike. Due to the associated impact on economic activity, tax increases can weigh on government finances if carried to disproportionate levels. Thus, Winston Churchill's man-in-the-bucket analogy.

A historical survey of debt crises shows that, often, the more effective responses focus on gradually reducing government spending rather than increasing taxes. The past 30 years have seen seven observed cases in which fiscal deficits were reduced by 10% or more while economic growth remained positive. A common factor in each situation was a policy focus on productivity improvement and

5 Year Forward Change in Government Spending and Revenue



Source: BCA Research

reduced government spending. The maintenance or lack of a tax rate increase provided protection to the economic participants, and the elimination of inefficient government spending provided the needed relief from budget shortfalls. Conveniently, just like the private sector, the public sector typically accrues spending excesses during strong economic cycles, thus providing opportunity for less painful budget reductions.

An example of a successful reduction in government spending is demonstrated by Britain’s 1921 Committee on National Expenditure, an independent commission dubbed the “Geddes Axe” in reference to its leader, Sir Eric Geddes. The committee was tasked with providing workable recommendations for the reduction of Britain’s deficit and debt balance following World War I. The committee conducted a thorough review of departmental budgets and comparisons between pre-war and current spending and continually asked the questions of how far new demands explained the difference and whether there was remediable waste. They used benchmarking relative to private industry as a way to identify expenditure inefficiencies and possibilities for outsourcing government functions.

On the whole, recent austerity measures enacted by European governments are moving in the right direction. The majority of the initiatives focus on reducing expenses of lower or sometimes unnecessary costs. In particular, Greece’s austerity program requires the closure of hundreds of poorly performing government programs within the next three years, a measure not dissimilar to Geddes’ plan. Greece’s strategy also includes an increase in the average public-sector retirement age from 53 to the more common

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level of 67. This greatly reduces the obligation owed to younger retirees and improves the health of the retirement plan for older employees. Still, some sanctions will have an even greater impact on the economy, such as the nearly 15% reduction of government salaries. It will be important to monitor the economic impact of each nation's plans and the result on top-line government revenue (taxes) figures in order to determine whether these measures truly succeeded.

### **What Role Does Currency and Monetary Policy Play?**

Other factors common to past successful fiscal cutbacks are currency devaluation and stimulative monetary policy. In each of the seven examples above, currency devaluation provided a temporary lift to exports and an offset to tight fiscal policy. When advising troubled nations, the International Monetary Fund has repeatedly prescribed a combination of tight fiscal policy, loose monetary policy, and/or currency devaluation.

Implementing such policies in a currency block is new territory for economists. Currency and monetary policies are not under Greece's control but are instead implemented by the European Central Bank (ECB) for the mutual benefit of all member nations. What is beneficial for Greece is often perceived not to be in Germany or France's best interests. As a result, the process towards resolution has been highly political. More dramatic monetary policy will be implemented only when it becomes apparent that economic weakness in the troubled nations impairs the stronger nations. While progress is being made, without more monetary aid the European economy will remain weaker than normal and more susceptible to further financial shocks.

### **Investment Strategy: Focus on Opportunities Created by the European Debt Crisis**

The developed-market debt issue will likely take years to resolve, restraining economic growth and investment returns. Due to the inherent political complications, government response to the crisis will likely remain more reactive than proactive, leaving the global economy vulnerable to further disruptions and volatility. We believe that this volatility, in the context of a longer-term investment strategy, can lead to opportunity.

The hesitancy to respond quickly to Greece's difficulties pulled the impending debt problems forward in time, and caused a severe reaction in equity and debt markets. Such market reactions are often a good opportunity for investors to rebalance portfolios back to their desired allocations at attractive prices. Specifically, equities on the whole have declined materially versus more stable fixed income assets, and international equities, particularly those of European companies, have reached attractive valuations of less than 10x trend earnings.

Since such declines are often accompanied by distortions in relative valuations between assets, they can result in advantageous entry points for longer-term investments. Emerging-market equities have declined in sympathy with the current problems, but do not face the same sovereign debt or private debt dilemmas. Unlike past financial

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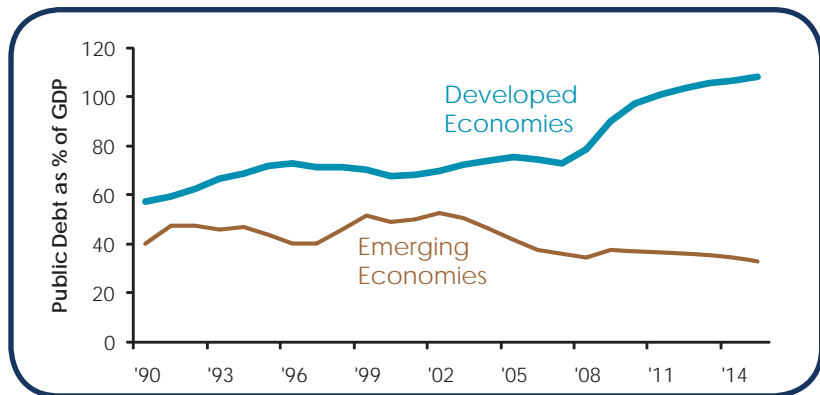
crises, emerging economies appear in much better shape than their developed counterparts; the adjacent chart shows the divergence in sovereign debt balances in developed and emerging economies.

Lastly, we believe the European debt crisis either will cause below-average European growth or will trigger a meaningful ECB reaction. Either result will likely lead to continued

pressure on the euro. Additionally, we expect policy makers will favor a weakening euro as a way to stimulate economic growth, similar to a more traditional currency devaluation. In recognition of this outcome, we continue to recommend that investors position portfolios to defend against a declining euro.

Although recent austerity measures and concerns about a weakened European economy have caused downside volatility in the financial markets, it is premature to call for the end of the developed world's debt cycle. Nevertheless, excess debt and complicated European politics will likely cause continued volatility, creating opportunities for nimble investors to outperform in an otherwise low-return environment. As a result, we continue to believe it will be important for investors to more actively identify and act on valuation opportunities as they emerge.

### Public Debt : Developed vs. Emerging Economies



Source: Strategas, IMF

Data as of 5/31/2010