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MARKET COMMENTARY

Ashmore

The Emperor's new clothes

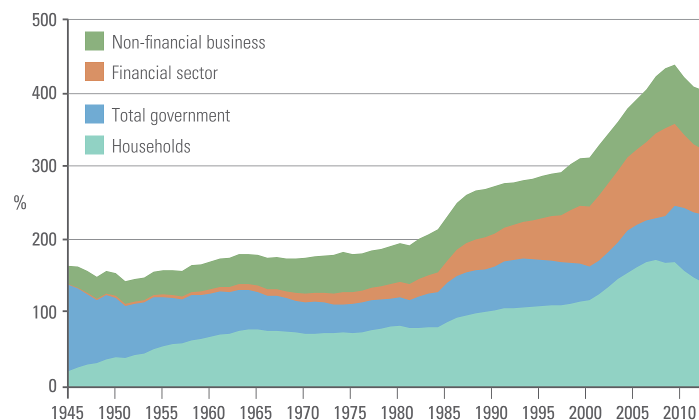
By Jan Dehn

This week's revision of US GDP numbers is widely expected to point to a larger US economy. A bigger economy implies better debt ratios, higher productivity, but also higher saving rates.

Still, the more interesting data release is arguably the advance estimate of Q2 GDP growth due out on Wednesday. Other data releases this quarter have pointed to a weaker Q2 print. Indeed, some Wall Street banks now say that US growth is tracking less than 1% growth in Q2. If confirmed, this would mark a further slowdown from the already measly growth rate of just 1.8% in Q1 (revised down from initial estimates of around 3.5%).

To us, it is less important whether the US economy is larger or smaller by 3% than understanding why the US economy is still not growing more than half a decade after the sub-prime crisis. We believe the reason for slow US growth is ultimately debt. Elephantine in size and glacial in motion, the US debt stock remains near unprecedented levels of more than 400% of GDP. This compares to less than 200% in 1981 when the current credit cycle began. Financial sector debt in particular expanded massively in response to financial liberalisation in the 1980s and 1990s. But the US debt stock excluding financials is also twice as high as in the early 1980s at more than 300% of GDP. Household debt comprises 142% of GDP, again nearly twice as high as in the early 1980s.

Fig 1: **US total debt by sector (% of GDP)**



Source: Federal Reserve.

There is surprisingly little discussion of the debt. Politicians ignore debt because they are powerless to reduce it. HIDC debt is still regarded by many as 'risk free', aided by regulation. Debt is also a taboo subject in polite financial circles. The market prefers to focus on high-frequency events, such as manufacturing cycles and QE sugar-highs although they have repeatedly failed to signal 'take-off velocity' in the US economy for the past five years.

We see two reasons why strategic investors should think deeper about the debt issue in the US and other HIDCs (Heavily Indebted Developed Countries).

First, it is difficult for the Fed and other HIDC central banks to raise interest rates without hurting growth as long as the debt stock is so large. The HIDCs need to find a way to reduce their debt before they can meaningfully raise rates.

Second, the potential growth rate in the US and other HIDCs could continue to wane if the large debt stock is not reduced in size. Investment rates remain very low. While this is often viewed as a sign that the economy could take off at any time it is just as likely that the economy's capital stock simply depreciates as investment decisions are continuously postponed.

The IMF Article IV report published on 26 July 2013 states that "despite the substantial legislated savings in the pipeline, US public finances remain on an unsustainable trajectory".[1] In particular, if real GDP growth, real interest rates, and primary balances return to historical averages – presumably they will if the US economy is recovering – US public sector debt will rise to 132% of GDP by 2018. If the key variables stay at last year's levels, US public sector debt rises to 117% by 2018.

Which of course raises a bigger question: How will HIDCs such as the US reduce their debt stocks? There are currently no major plans for deep fiscal adjustment in the US. Europe and Japan are both moving towards more fiscal profligacy. Weak coalitions in Europe and a divided US Congress mean that growth-enhancing structural reforms are extremely unlikely. This suggests that monetary and FX policy will play important roles in bringing down the stock of HIDC debt. This is particularly the case for the US, where such a large proportion of the debt is held abroad.

If the US chooses to financially repress, inflate, and devalue its way out of debt it would not be for the first time. The US government successfully reduced its overall debt ratio from 118% in 1945 to a low of just 38% of GDP by 1981 through a combination of financial repression in the 1950s and inflation in the 1970s. Looking at the US today, the country's overall debt problem is similar, only much bigger.

[1] United States 2013 Article IV Consultation, IMF Country Report No. 13/236, July 2013, International Monetary Fund.

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