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Morgan Stanley Australia Limited+ **Gerard Minack**
Gerard.Minack@morganstanley.com
+61 2 9770 1529

Morgan Stanley & Co. Incorporated **Jason Todd, CFA**
Jason.E.Todd@morganstanley.com
+1 (1)212 761 7991

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Downunder Daily

Default or Inflate or…

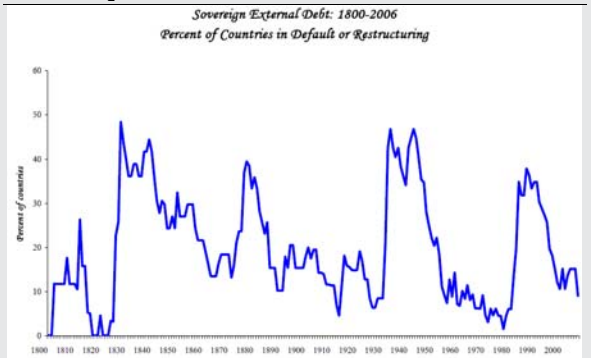
So many countries with so much debt: Crisis seems very likely at some stage. As we've noted before, the options seem to be severe belt-tightening (threatening renewed developed-world recession), bail-out, or default, overt or covert. Last Friday we looked at what belt-tightening requires. Bail-out is possible for an individual country, but not really feasible this time given the breadth of the problem. Who could bail out the G-20? So here we look at the third option.

We've taken three messages from Reinhart & Rogoff's *This Time Is Different: Eight Centuries of Financial Folly*. First, debt levels now are very high by historical standards. Second, sovereign default is, on a long view, quite common. The past few years have seen a lull, but there have been lulls before (Exhibit 1). Third, this time will probably *not* be different.

Sovereign borrowers can default overtly or covertly. Covert is currency debasement: literal debasement in the case of commodity-based money; by inflation with fiat money. (There used to be a third option: 'creditor reconstructions'. Absolute monarchs had a history of executing creditors, which was one reason why it was not unusual for sovereign debt to trade at an interest rate *premium* to private debt.) History shows that inflation tends to rise in times of sovereign stress (Exhibit 2). This is one reason why my colleague, Joachim Fels, says that sovereign risk boils down to inflation risk (see *Five Themes for 2010*, 6 January 2010).

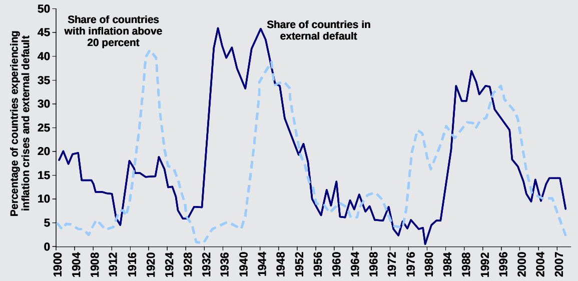
As we've noted before, inflation doesn't solve a debt problem, *unanticipated* inflation does. Think of it this way: If a borrower's debt is tied to inflation (along the lines of TIPS), then it's not possible to inflate away the debt. From a macro view, a sovereign can inflate away the debt if the average interest rate on the debt falls below the growth in nominal GDP. (It doesn't matter whether it's volume growth or inflation driving GDP.) This is how the public-sector deleveraging after World War II was accomplished. Exhibit 3 shows that the average interest rate on public debt in the US was below the nominal GDP growth rate.

Exhibit 1
Sovereign Crises Come In Waves



Note: Sample based on countries (out of a sample of 66) that were independent in the specified year.
Source: Carmen Reinhart & Kenneth Rogoff, *This Time Is Different;* Morgan Stanley Research

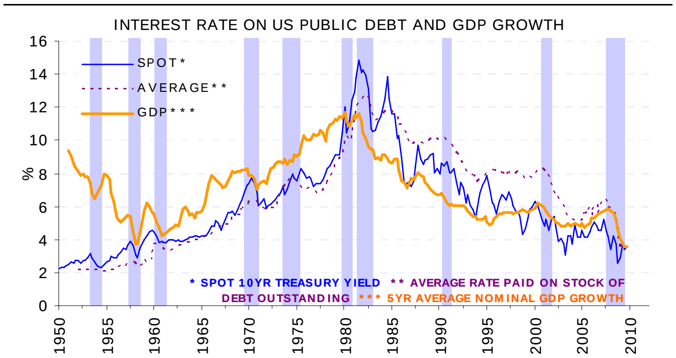
Exhibit 2
To Default, or to Inflate?



Source: Carmen Reinhart & Kenneth Rogoff, *This Time Is Different;* Morgan Stanley Research

The key question now is: Can governments get the nominal growth rate above the average interest rate? We're not persuaded that targeting higher inflation will do the trick. In part that's for obvious reasons: it would require a wholesale abrogation of many of the institutional arrangements put in place over the past few decades – such as independent central banks, inflation targets – and the hard-won gains achieved through the disinflation period starting from the early 1980s.

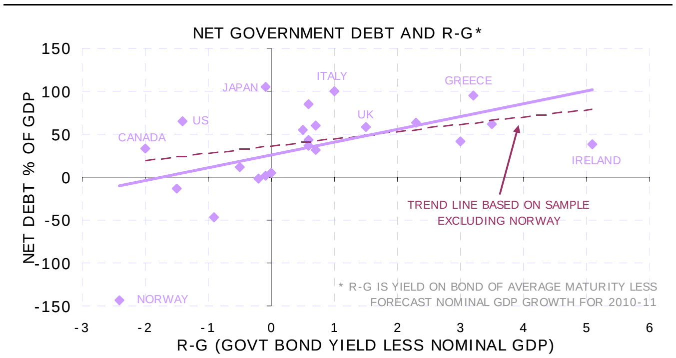
Exhibit 3
How to De-lever: Lift Growth but Not Rates



Source: Federal Reserve, Treasury, DataStream; Morgan Stanley Research

In part we're skeptical because markets are seemingly awake to the risk. Exhibit 4 shows a scatter plot of countries' net government debt and the current gap between the bond rate and (forecast) nominal GDP growth. Most countries with high debt are already paying interest rates above expected nominal GDP growth. And markets demand a higher premium as debt increases.

Exhibit 4
Can Markets Be Fooled?

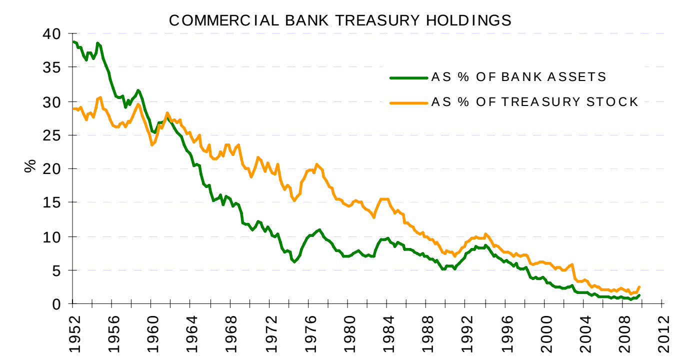


Source: *The Economist*, Morgan Stanley Research

Exhibit 3 also shows that in the US there is a clear link between nominal GDP growth and the bond yield (and, with a lag, the average actual rate paid on the stock of public debt). As an additional complication, Dick Berner notes that in the US nearly half of budget outlays are now effectively indexed to inflation. See *We Can't Inflate Our Way Out*, 19 February.

Interest rates *were* below nominal growth rates in the years after World War II, which was also when the public sector accomplished most of its deleveraging. This was largely due to financial regulation. The Federal Reserve, which was not at that stage independent, acted to cap long-end rates at 2½%. This arrangement ended with the Treasury accord of 1951.

Exhibit 4
An Offer They Won't Be Able to Refuse?



Source: Federal Reserve; Morgan Stanley Research

Here's our key point: If the way to covertly default is to pay an interest rate below the nominal growth rate, we think it's possible that policy makers will aim to lower the interest rate rather than lift the inflation rate. In a sense, central banks buying government debt are already a small step down that path. A medium-term approach, however, could be to compel private financial institutions to purchase government debt. Such holdings were often mandated (as prudential measures) prior to the deregulation of financial systems in the 1980s.

In the US, for example, commercial bank holdings of Treasury paper have fallen significantly, both as a percentage of bank assets and as a percentage of the stock of Treasuries on issue. Commercial banks now have a balance sheet of around US$8 trillion. Requiring them to hold 20% of their assets in Treasuries would imply demand for over $1.5 trillion of Treasury paper. All else equal, this would obviously squeeze the provision of credit elsewhere in the system, unless regulators allowed banks to increase their leverage (which would be justified on the basis that so much of their asset base is in 'safe assets'). We are not recommending this. But it seems to us that high sovereign debt may be resolved not by a deliberate shift to higher inflation, but by re-regulation that compels buyers to accept uneconomic yields.

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Morgan Stanley

The Americas
1585 Broadway
New York, NY 10036-8293
United States
Tel: +1 (1) 212 761 4000

Europe
20 Bank Street, Canary Wharf
London E14 4AD
United Kingdom
Tel: +44 (0) 20 7 425 8000

Japan
4-20-3 Ebisu, Shibuya-ku
Tokyo 150-6008
Japan
Tel: +81 (0) 3 5424 5000

Asia/Pacific
1 Austin Road West
Kowloon
Hong Kong
Tel: +852 2848 5200