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BANK

# ECONOMIC SITUATION AND STRATEGY

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## Can you really pay down long-term debt with short-term debt?

Discussions about the future of the euro area frequently involve a line of reasoning that seems to defy the fundamental principles of economics as well as common sense. Still, both politicians and journalists keep bringing up the argument that austerity measures of recent years have hampered GDP growth in many euro area countries resulting in debt levels higher than they need to be. This logic not only questions the veracity of the Maastricht criteria but even the basic tenets of austerity policies. This leads to the conclusion that restrictive fiscal policy should be stopped to boost growth, which may then be used to pay down debt.

At first glance that may make some sense but a less restrictive fiscal policy is merely a euphemism for more debt, as it takes new borrowing to make fiscal policy meaningfully more expansive. This suggests taking on more short-term debt to pay down long-term debt. Looking at it that way, it sounds more like pulling yourself out of a swamp by your own boot straps.

However, is this really absurd or is there some method to the madness? Whenever such questions may not be answered immediately one should look at the empirical data. If the logic were sound, countries with particularly stringent austerity policies or especially accelerated debt reduction relative to their GDPs should have since seen such strong growth declines that their debt levels have risen as a result. However, we find it hard to find an example for such circumstance. On the contrary: Countries that excelled in reducing current budget deficits and overall debt relative to GDP growth actually showed stronger GDP growth thereafter. Even on a long-term horizon there is no country to be found that turned increased short-term debt into such vigorous and sustainable growth that it could pay down its long-term debt through this effect.

If you paid good attention in undergraduate economics classes, you should realize that this cannot work even in theory. The argument is confusing basic concepts. For instance, it uses the term “growth” casually while actually meaning cyclical effects and production potential utilization. Of course, production potential utilization tends to increase on higher short-term borrowing. This may actually boost business activity for a few quarters with correspondingly higher tax revenue that can be used to pay down long-term debt. However, this is only sustainable if production potential utilization continues to grow and that is impossible by the very nature of the theory. It would be far more realistic and preferable if not the utilization rose but production potential itself. Only in that scenario could one academically correctly speak of sustainable growth.

This is the crux of the matter: Growth in the sense of steadily rising production potential is not really attainable through higher borrowing. Just to be perfectly clear about this: It is possible to leverage economic utilization but not production potential growth. Production potential will grow sustainably if an economy has good infrastructure, a great educational system, an efficient legal system, a functional capital market, sound demographics with high employment levels, and a stable political environment. Government debt is not even part of the equation which should put an end to the fairy tale of paying down long-term debt with short-term debt.

Those who cannot let dead horses lie will then bring up the multiplier theory. The multiplier in question is by how many percentage points economic value creation will rise per percent of increase in government spending. If this multiplier, for instance, stood at two and the increase in government spending was financed with new borrowing, such debt could in the long term be repaid from higher tax revenue (assuming a tax rate of 50%). However, since the economically relevant tax rate is below 50%, the multiplier must be correspondingly higher than two for the bootstrap-out-of-the-swamp theory to hold water.

You may have guessed this is where the argument breaks down: Real multipliers are never that high. One simply cannot build a debt-fueled economic perpetual motion machine. Empirical studies going back to the 19th century show that these multipliers typically range between 0.6 and 1.0. Even in the best case scenario the multiplier still falls short of two assuming that the government makes only the most “rewarding” investments. Mathematics thus precludes the feasibility of paying down long-term debt with short-term debt.

A cynical mind may conclude that the proponents of this idea already know this. It is conspicuous that the anti-austerity champions often also call for community debt liability thinking that if the perpetual motion machine does not work after all somebody else can pay for it. Italian Prime Minister Guiseppe Conte is probably the most prominent proponent of anti-austerity policy combined with community debt liability. Mr. Conte recently demanded common EU risk liability in parliament. And he wants that without any strings attached in terms of reform processes or progress. Such demands make sense in economic politicking as they have a high probability of quickly winning a lot of votes. Often because voters cannot really calculate the long-term effects and community liability would hedge the bet if the policy does not work out. It comes as no surprise that mostly (but not exclusively) populist parties have been very successful in gaining votes with such stratagems.

In this light it is important to understand what basic agreements on the subject of community liability Angela Merkel and Emmanuel Macron have reached at their Meseburg meeting. Some of the agreements are rather controversial including making the European Stability Mechanism into EU law stripping national parliaments of their rights to participate in the decision-making process. They also agreed on making deposit guarantees for bank balances a community endeavor and to give the euro area its own budget.

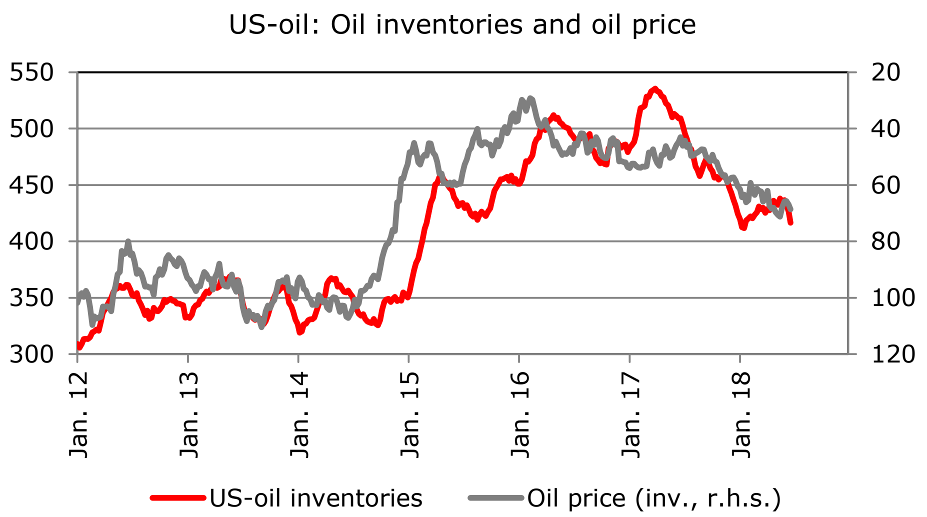
All of these are steps toward community liability. But it is only a community liability that would allow the proponents of paying down debt with debt to win elections and try out their theory in praxis. If it does not work out – and there is no chance it might – voters can pass on the bill to community liability. The German government should take heed of this dangerous incentive and come to appropriate conclusions.

## Weekly outlook for July 2-6, 2018

| | Jan | Feb | Mar | Apr | May | June | Release |
|---|---|---|---|---|---|---|---|
| DE: PMI, manufacturing, final | 61.1 | 60.6 | 58.2 | 58.1 | 56.9 | 55.9 | July 2 |
| DE: PMI services, final | 57.3 | 55.3 | 53.9 | 53.0 | 52.1 | 53.9 | July 4 |
| DE: Incoming orders, m/m | -3.5% | -0.2% | -1.1% | -2.5% | 0.5% | | July 5 |
| DE: Incoming orders, y/y | 8.7% | 3.1% | 3.0% | 0.0% | 1.1% | | July 5 |
| DE: Industrial production, m/m | 0.1% | -1.7% | 1.7% | -1.0% | 0.5% | | July 6 |
| DE: Industrial production, y/y | 5.9% | 2.1% | 3.9% | 2.0% | 1.6% | | July 6 |
| EU-19: Unemployment rate, adjusted | 8.7% | 8.6% | 8.6% | 8.5% | 8.5% | | July 2 |
| EU-19: PMI manufacturing, final | 59.6 | 58.6 | 56.6 | 56.2 | 55.5 | 55.0 | July 2 |
| EU-19: Producer prices m/m | 0.4% | 0.1% | 0.1% | 0.0% | 0.4% | | July 3 |
| EU-19: Producer prices y/y | 1.6% | 1.7% | 2.1% | 2.0% | 2.7% | | July 3 |
| EU-19: Retail sales, m/m | -0.4% | 0.3% | 0.4% | 0.1% | 0.2% | | July 3 |
| EU-19: PMI services, final | 58.0 | 56.2 | 54.9 | 54.7 | 53.9 | 55.0 | July 4 |

*MMWB estimates in red*

## **Chart of the Week:** OPEC and non-OPEC countries agree on higher production volume




Oil prices have advanced some 20 percent since the beginning of the year due to high demand in the wake of a long, cold winter in the northern hemisphere and a booming global economy. Global oil supply, however, did not keep pace as OPEC and non-OPEC countries complied with their production limits set in November 2016. US oil fracking even at record high level could not close the demand gap. Last weekend, the OPEC and non-OPEC states agreed to raise their production volume by about one million barrels per day not least triggered by President Donald Trump's tweets complaining about artificially inflated oil prices. This increase and ever growing US oil production should bring oil prices down. However, President Trump has also called on all countries to stop importing oil from Iran by the beginning of November at the latest. With a daily production volume of around 3.8 million barrels, Iran is one of the highest producing OPEC members after Saudi Arabia and Iraq. Recently, the country has been exporting some 2.4 million barrels primarily to India, China, South Korea, Japan, and Europe. The oil embargo creates a new supply gap that will be hard to close in the short term, which means that oil prices will probably remain at a high level for the time being.

## Market data overview

| Stock marktes | As of<br>29.06.2018<br>11:46 | Change versus<br>22.06.2018<br>-1 week | 26.05.2018<br>-1 month | 28.03.2018<br>-3 months | 29.12.2018<br>YTD |
|---|---|---|---|---|---|
| Dow Jones | 24216 | -1,0% | -2,2% | 1,5% | -2,0% |
| S&P 500 | 2716 | -1,2% | -0,2% | 4,0% | 1,6% |
| Nasdaq | 7445 | -3,5% | 0,2% | 6,2% | 7,8% |
| DAX | 12341 | -1,4% | -4,6% | 3,1% | -4,5% |
| MDAX | 25909 | -1,3% | -3,0% | 1,6% | -1,1% |
| TecDAX | 2699 | -3,6% | -4,4% | 5,6% | 6,7% |
| EuroStoxx 50 | 3412 | 0,2% | -3,0% | 2,9% | -2,6% |
| Stoxx 50 | 3053 | 0,6% | -2,1% | 4,1% | -3,9% |
| SMI (Swiss Market Index) | 8577 | 1,4% | -2,1% | -0,7% | -8,6% |
| Nikkei 225 | 22305 | -1,7% | -0,7% | 4,6% | -2,0% |
| Brasilien BOVESPA | 71767 | 2,4% | -9,0% | -14,4% | -6,1% |
| Russland RTS | 1144 | 3,0% | -2,2% | -8,1% | -0,9% |
| Indien BSE 30 | 35374 | -0,2% | 1,3% | 6,6% | 3,9% |
| China Shanghai Composite | 2848 | -1,0% | -9,3% | -10,1% | -13,9% |
| MSCI Welt (in €) | 2080 | -2,1% | -1,2% | 7,5% | 1,8% |
| MSCI Emerging Markets (in €) | 1047 | -4,0% | -7,7% | -6,1% | -6,9% |
| **Bond markets** | | | | | |
| Bund-Future | 163,14 | 99 | 212 | 391 | 146 |
| Bobl-Future | 131,99 | -21 | -6 | 86 | 38 |
| Schatz-Future | 112,05 | -6 | -3 | 8 | 8 |
| 3 Monats Euribor | -0,32 | 0 | 0 | 1 | 1 |
| 3M Euribor Future, Dec 2017 | -0,29 | -1 | -2 | 1 | 0 |
| 3 Monats $ Libor | 2,34 | 0 | 2 | 3 | 64 |
| Fed Funds Future, Dec 2017 | 2,16 | -3 | 3 | 9 | 0 |
| 10 year US Treasuries | 2,85 | -4 | -8 | 7 | 44 |
| 10 year Bunds | 0,33 | -1 | -8 | -17 | -10 |
| 10 year JGB | 0,03 | 0 | -1 | 1 | -2 |
| 10 year Swiss Government | -0,05 | -2 | -5 | -2 | 8 |
| US Treas 10Y Performance | 565,74 | 0,8% | 0,9% | 0,2% | -2,7% |
| Bund 10Y Performance | 617,88 | 0,1% | 0,8% | 1,8% | 1,7% |
| REX Performance Index | 485,49 | 0,1% | 0,6% | 1,0% | 1,0% |
| US mortgage rate | 0,00 | 0 | 0 | 0 | 0 |
| IBOXX AA, € | 0,77 | 2 | 0 | -1 | 9 |
| IBOXX BBB, € | 1,62 | 9 | 7 | 23 | 39 |
| ML US High Yield | 6,52 | 9 | -3 | -9 | 37 |
| JPM EMBI+, Index | 784 | -0,1% | -1,9% | -3,8% | -6,2% |
| Convertible Bonds, Exane 25 | 7331 | -0,5% | -1,3% | 0,7% | -0,9% |
| **Commodities** | | | | | |
| CRB Spot Index | 438,33 | -1,3% | -1,4% | 0,4% | 1,4% |
| MG Base Metal Index | 342,76 | -0,8% | -3,3% | 0,7% | -4,5% |
| Crude oil Brent | 78,58 | 6,6% | 2,8% | 11,9% | 18,0% |
| Gold | 1250,84 | -1,4% | -4,1% | -6,9% | -4,0% |
| Silver | 16,19 | -0,8% | -2,2% | -2,2% | -4,8% |
| Aluminium | 2186,50 | 0,3% | -3,0% | 8,3% | -3,1% |
| Copper | 6693,50 | -1,4% | -2,5% | 1,3% | -7,1% |
| Iron ore | 64,81 | -0,2% | -2,2% | -7,9% | -9,1% |
| Freight rates Baltic Dry Index | 1329 | -1,3% | 23,4% | 19,0% | -2,7% |
| **Currencies** | | | | | |
| EUR/ USD | 1,1644 | 0,9% | -0,3% | -5,9% | -2,9% |
| EUR/ GBP | 0,8854 | 1,1% | 1,1% | 1,0% | -0,3% |
| EUR/ JPY | 128,84 | 1,0% | 0,9% | -1,7% | -4,6% |
| EUR/ CHF | 1,1572 | 0,7% | -0,2% | -1,6% | -1,1% |
| USD/ CNY | 6,6160 | 1,8% | 3,5% | 5,3% | 1,7% |
| USD/ JPY | 110,26 | 0,2% | 0,8% | 4,7% | -2,2% |
| USD/ GBP | 0,76 | 0,8% | 1,3% | 7,6% | 2,9% |

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