The Boston Consulting Group

Collateral Damage

Stop Kicking the Can Down the Road

The Price of Not Addressing the Root Causes of the Crisis

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THE RECENT TURBULENCE in global financial markets came as a surprise to those who believed that the intervention of governments over the last three years had saved the day. Within the course of a single week, stock markets declined by trillions of dollars. Since the signing of the debt deal on August 2, the S&P 500 has lost all its gains for the year; the Dow Jones index has lost roughly 10 percent. In Europe, the mood is similarly sour: the Euro Stoxx 50 Index is down by 17 percent from its February high, and the Italian market has fallen by almost 24 percent. The German DAX has lost 15 percent.

The uncertainty caused by the downgrading of U.S. government debt by Standard & Poor's from AAA to AA+ added to the financial tensions—and led to further declines on stock markets around the world—although this change should not have come as a surprise to anybody. The reality is that U.S. government debt had not fulfilled the AAA standard for some time. The deficit is significant, and the Congressional Budget Office expects the U.S. government to add a total of $8.5 trillion over the next ten years to its already high debt burden.[1] This is too much for an economy that is barely growing and goes some way toward vindicating Harvard professor Niall Ferguson's somewhat colorful view, argued last year in the *Financial Times,* that "U.S. government debt is a safe haven the way Pearl Harbor was a safe haven in 1941."[2]

We have seen in the past that stock markets can act as a leading indicator for the real economy. Does this mean we are at the brink of a global double-dip recession? If so, how is that possible? It seemed that the recovery was well on its way and that the politicians had (finally) dealt with their problems, both in the U.S. (debt ceiling) and in Europe ("final" package for Greece). Wasn't it time to enjoy the holidays at last!

Unfortunately, this was only wishful thinking. A deeper look at the facts reveals that governments have been indecisive and playing for time—kicking the can down the road, rather than addressing the root causes of the crisis. The problems of the world economy have grown since 2008, and we see a significant risk that lying ahead of us is a new recession with deeper implications than the one we just left behind. Throughout 2008 and 2009, we argued that the recession would be long and deep—and that subsequent economic growth in most developed economies would be anemic (at best). We did see better growth in the less-leveraged Asian economies—and thus the emergence of a two-speed world. We see little reason to change this lukewarm view of many of the world's economies.

In contrast to just three years ago, when the original crisis hit, there are five features of today's global economic landscape that constrain the scope of any potential response.

- When the crisis hit in 2008, interest rates were generally high enough around the world to allow for the stimulating (or at least the alleviating) response of significant reductions in the cost of borrowing. This is clearly no longer possible given the extraordinarily low interest rates prevailing in most developed markets.

- In 2008, the quantum of government debt in many economies was significantly below danger levels. Three years of attempting to stimulate the economy, quantitative easing, and the need to cover burgeoning entitlement payments at a time of economic stagnation have combined to increase the sovereign-debt mountain.

- An unencumbered Asia (particularly China) and other rapidly developing markets barely dipped, and were seen by many as the drivers of the next wave of growth. China now has uncertainties of its own: a stubborn property bubble and inflation have prompted its government to rein in the economy. We never thought that Asian economies were large enough and decoupled enough from the West to pull the train. This remains the case.

- The prospect of consumers riding to our rescue is no better than it was in 2008. The intervening years have not treated many of them well: indebtedness remains high in many markets; confidence remains stubbornly low—particularly in austerity economies; home prices are either stagnating or falling in developed economies; and employment prospects are not encouraging.

- Banks in many countries have not repaired their balance sheets. Yet if another shock hits, it is uncertain that some governments have enough ammunition left in the economic arsenal to bail them out again.

It is the U.S., the euro zone, and the high sovereign-debt levels that readers of our previous papers will know worry us most.

The U.S.: Worse Than Expected and No End in Sight

The recession in the U.S. in 2008 and 2009 was the deepest since the Second World War and, as recent data show, it was much worse than previously understood. The Bureau of Economic Analysis revised the 2009 growth data for the U.S. from –2.6 percent to –3.5 percent. The U.S. has still not managed to return to its precrisis level of GDP, and unemployment remains high while new job creation continues to disappoint. Real GDP per capita is at the same level as in the second quarter of 2005. The real estate market continues to be weak and to undermine both confidence and mobility—with around a quarter of U.S. families trapped in negative equity. At the same time, the U.S. government is running a deficit of 9 percent of GDP as a result of applying a fiscal stimulus equivalent to 7 percent of GDP in order to avoid an even deeper slump.[3] The Federal Reserve lowered interest rates to an historic low in December 2008 and has kept them there. Including the quantitative

easing programs, the Fed has more than tripled its balance sheet since 2008. The muted reaction to the Fed's announcement that it would maintain very low interest levels until 2013 underscores how concerned it is about the economic prospects (and how few tools the Fed has left in its locker).

The U.S. is in the middle of a balance sheet recession that shows alarming similarities to Japan's situation in the 1990s.[4] Both recessions were the result of the bursting of debt-financed asset-price bubbles, resulting in massive private-sector deleveraging. Asset prices in the U.S. follow exactly the pattern observed in Japan after the bubble burst. Monetary-policy intervention did not reach the real economy in either country and has proven to be an ineffective tool.

In a 2002 speech, "Deflation: Making Sure 'It' Doesn't Happen Here," Ben Bernanke argued that the lost decade in Japan was a result of interventions by the government and central bank that were too late and too few. The focus of his speech was broader, addressing the question of how to avoid the prolonged period of low growth (a decade or more) that can follow the bursting of a bubble along with the ensuing "deleveraging" process. Bernanke said that "the Fed would take whatever means necessary to prevent significant deflation in the United States and, moreover, that the U.S. central bank, in cooperation with other parts of the government as needed, has sufficient policy instruments to ensure that any deflation that might occur would be both mild and brief."[5] He clearly believed that this policy mix would be able to stop the deleveraging process and get the economy back on a growth trajectory. Three years into the crisis, after stimulus programs of historically unprecedented dimensions and after the application of the broadest range of monetary-policy measures, we have to acknowledge that the similarities with Japan's lost decade, combined with the continued weakness of the U.S., give some cause to believe that "it" *can* happen there.

In some important respects, of course, the U.S. is in a better position than Japan was: the U.S. population is still growing (partly owing to immigration); the dependency ratio is more favorable; and, constrained as they may be, U.S. consumers are still spending a bit. But in other important respects, the U.S. position is even worse: Japan benefited from high domestic savings (invested in domestic bonds) and from buoyant economies elsewhere in the world that were willing to suck in large quantities of Japanese exports. Moreover, in the U.S., consumers are trying to pay down their often crippling levels of debt, so there is pressure on fragile consumer spending.

If the private sector is deleveraging, a country has two routes to resolving the consequences: the government can increase its borrowing or the country can expand net exports. In Japan, the result of the burst bubble is still apparent today. Government debt increased from 68 percent of GDP in 1990 to more than 200 percent today. What for? As Martin Wolf put it, "Despite a loss in wealth of three times GDP and a shift of 20 percent of GDP in the financial balance of the corporate sector, from deficits into surpluses, Japan did not suffer a depression. This was a triumph. The explanation was the big fiscal deficits."[6]

The implication for the U.S. should be clear. However, the U.S. still runs a trade deficit and has agreed to a debt deal that requires massive public savings in the

coming years—although the U.S. budgeting convention of recognizing the value of cuts as the cumulative value of ten years of savings means that the savings required over the next 12 months are substantially less (and correspondingly do less to reduce debt). Furthermore, the U.S. relies on foreign capital, which will be less inclined to finance continued huge deficits. Richard Koo summarizes the dilemma nicely: "When someone saves money or pays down debt in a national economy, GDP will shrink unless someone else steps in to borrow and spend those saved or repaid funds.… In a balance sheet recession, demand for funds can remain far less than the supply even with interest rates at zero because there are so few borrowers.…If left unchecked, this gap will throw the economy into a deflationary spiral as the economy loses demand equivalent to the saved but unborrowed funds each year. And this is exactly what happened during the Great Depression, the last great balance sheet recession, where U.S. GDP was cut in half in just four years."[7] To avoid this, the U.S. has two possible options: improve the trade balance or let the government borrow the excess savings until the private sector is healthy enough to borrow. Neither is likely to happen anytime soon. We will return later to what the U.S. may need to do.

Europe: North Versus South

In Europe, too, bad news continues to outweigh good news. With the exception of Germany—which is benefiting from increased demand from the emerging markets, mainly China, and which continues to enjoy favorable trade with most of Europe (where even the weak periphery can use the strong euro to buy German goods that would otherwise not be affordable)—Europe struggles to get on its feet. Slow growth, high government deficits, and unemployment dominate the news. Worst hit are Spain, Ireland, Portugal, and Greece. Italy is increasingly coming into the firing line as its aging workforce, unfavorable demographics, poor productivity, and high debt open it up to attack. Austerity programs will be a drag on growth for many years to come, accompanied by social unrest.

The second bailout for Greece has not calmed the markets. Instead, the markets continue to put pressure on Italy and Spain. Manuel Barroso, the president of the European Commission, fueled the panic by demanding a bigger rescue facility. The European Central Bank (ECB) had to step in. It resumed purchasing government bonds of the countries in trouble, in spite of continued opposition from some members, notably the German Bundesbank.

At the same time, apparently "safe" countries like France are also under pressure. The International Monetary Fund (IMF) reminded France to take action to cut its deficit, which it predicts to be 5.8 percent of GDP—higher than the euro zone average. The IMF also warned that without further austerity measures, President Nicolas Sarkozy's government would miss its key target of cutting the deficit to the euro zone ceiling of 3 percent of GDP by 2013. With anemic growth of 0.8 percent, a growing trade deficit, and lost competitiveness, France runs the risk of being the next country after Italy to face increased interest rates. Moreover, French banks face a possible downgrade because of their material exposure to the European periphery. We saw the first warning sign on August 8, when French credit default swap (CDS) spreads widened significantly; they are now almost three times those of the U.S.[8]

If worse came to worst and Spain had to apply for emergency funds and France lost its AAA rating, the lending capacity of the European Financial Stability Facility would be significantly reduced. The original amount of €440 billion would come down to €166 billion, according to Credit Suisse's calculations.[9] This would clearly render the stability fund essentially worthless. All the pressure would then be on Germany—which would not be able to alleviate this financial burden, even if it wanted to—which is another question.

The debt crisis in Europe is far from being solved and looks set to be a drag on growth for many years.

The financial and economic crisis is amplified by the structural limitations of the single-currency area in Europe. As critics of the euro have long argued, the euro zone is not an optimal currency area: it lacks sufficient practical labor-market mobility, coordinated economic policies, and fiscal transfers. In the current crisis, the currency union limits the ability of governments to react (no devaluation of the currency if a country is uncompetitive and no ability to resort to interest rate changes to address an overheating economy, as happened to Ireland), thus amplifying the problem. A case in point is the ways in which Spain contrasts with the U.K.: a lower government-debt-to-GDP ratio and a lower private household-debt-to-GDP ratio, but a higher nonfinancial sector-debt-to-GDP ratio. Overall, the total debt loads are similar, and both countries experienced a significant real-estate bubble. Yet the interest rates on government debt and the price for credit insurance are much lower in the U.K. than in Spain. As of August, Spain's CDS spreads had risen to more than 400 basis points—compared with less than 80 basis points in the U.K. The interest that the Spanish government has to pay on ten-year government bonds has risen to over 6 percent—twice as much as the U.K. has to pay. Consequently, the Spanish government needs to run a primary surplus in its budget of 2.4 percent of GDP in order to stabilize its debt load, while the U.K. can still run an additional deficit of 1.8 percent of GDP.[10] How is that possible? Financial markets price in the limited political levers of Spain compared with those of the U.K.: the U.K. could devalue its own currency, it could pursue an inflationary policy, and it can print its own money.[11]

The euro zone will be able to survive only with much closer economic cooperation, fiscal transfers, and at least a partial "socialization" of government debts in the form of a euro bond. In addition, higher inflation rates are needed to support the adjustment process between countries to restore competitiveness. It is much easier to lower salaries by raising them by less than the inflation rate than by outright cuts.

We are skeptical that the creditor countries, notably Germany, but also the Netherlands, Finland, and Austria, will be prepared to go in this direction. It is therefore reasonable to assume continued political and economic turbulence in Europe.

Not much has changed in the last three years. Governments have tried to fight too much debt with more debt and have hoped to be rescued by the emerging economies. They kicked the can down the road and did not address the root causes of the crisis: global imbalances and unsustainable debt loads.

Global Imbalances

It is widely agreed that global trade imbalances, notably between China and the U.S. (and, to a lesser degree, Europe) and between Germany and some countries in the euro zone (such as Spain, Portugal, and Greece) have contributed to the crisis. This is because current-account deficits can be financed only by increased indebtedness—and increased indebtedness needs to be paid for, so interest burdens serve to increase the required levels of primary current-account surpluses. In spite of the recession, the deficit countries have not managed to improve their trade position. Germany and China still enjoy significant trade surpluses of more than 5 percent of GDP, while the deficit countries run deficits of between –3.2 percent (U.S.) and –4.5 percent (Spain) of GDP. Asian economies, notably China, are responsible for the fact that "water continues to flow uphill"—emerging markets export capital (the Institute of International Finance estimates $395 billion in 2011) instead of absorbing savings. Without a rebalancing, it will not be possible for highly indebted countries to reduce their debt levels.

Unfortunately, rebalancing requires the deficit countries to become competitive. In the case of the U.S., the industrial base of only 13 percent of GDP (compared with more than 20 percent of GDP in Japan and Germany) means that only some sectors, such as technology and aerospace, are strong enough to compete in global markets. Domestic products cannot substitute for many of the goods imported into the U.S. A recent BCG study argues that we might see a return of manufacturing to the U.S., but this will require investments and improvements to national education standards—and so will take time to make a real difference.[12]

The same holds true for some European countries. Greece and Portugal are competitive in few areas. In Spain, it is estimated that unit labor costs would have to be reduced by 30 percent in order for the country to become competitive with Germany. In former times, these countries would have devalued their currencies to manage the required adjustment, but in a single-currency environment, they must increase productivity significantly and reduce salaries. Such adjustments take time and require several years of austerity. This is unlikely to be achieved, given already very high unemployment in these countries—in Spain, 46 percent of the population under the age of 25 is without a job, creating the potential for social unrest and political turmoil.

Too Much Debt

Politicians and central banks do not acknowledge (at least publicly) that a decade-long trend has come to an end: the huge leveraging up of the Western economies has run its course. In the run-up to the crisis, the debt load of governments, nonfinancial companies, and private households rose to unprecedented levels. Between 2000 and 2007, U.S. debt grew from $18 trillion (183 percent of GDP) to $32 trillion (225 percent of GDP), while in Europe, debt grew from €14 trillion to €20 trillion (227 percent of GDP). Since the start of the financial crisis, overall debt loads have continued to rise, mainly driven by governments and central banks trying to postpone the inevitable. In the U.S., the total debt grew by a further $4 trillion (to 246 percent of GDP), and in Europe by €5 trillion (to 269 percent of GDP). Fighting a debt crisis with even more debt is not a viable remedy, as we described in *The Debt Monster.*[13]

In theory, there are four ways to reduce the debt load: grow out of debt, save and pay back ("deleveraging"), write off and restructure the debt, or inflate it away.

All this is not news. Readers of our Collateral Damage series know that we urged early on for aggressive measures.[14] William White, chairman of the OECD Economic and Development Review Committee, asked last year for "a plan B to curb the debt headwinds."[15] White described why inflation could be the only solution but that it would be difficult to achieve a "controlled" inflation. He even saw a certain risk of hyperinflation if the inflationary route were taken. We tend to share his view: once started, inflation is hard to control—rather like trying to control the flow of ketchup after shaking the bottle.[16]

Before we address a potential way forward, it is worth reminding ourselves that the level of uncertainty facing business remains high. Under such circumstances, management teams might do well to consider the actions being undertaken by some of their well-prepared peers. (See the sidebar "What Businesses Need to Do Now.")

WHAT BUSINESSES NEED TO DO NOW

Nearly a year ago, we interviewed executives at companies that had dealt successfully with the downturn of 2009. They shared their approaches to managing through the recession—and, more important, to permanently improving their competitive position. All these winners in the crisis had set similar priorities.

- *Innovation.* Without exception, the managers we interviewed emphasized how innovation would play a decisive role in enabling them to exploit the opportunities arising over the next few years, particularly with less savvy competitors cutting back. As one of them observed, "The crisis is a catalyst for change in the technological environment. Things that we only gave half a thought to in the past are suddenly being addressed very quickly." Many innovations are geared to optimizing processes and reducing nonpersonnel costs. Fundamental issues are also being broached: "Without innovating," said one manager, "it won't be possible to prosper over the next few years." One characteristic shared by all the companies surveyed is that none reduced spending on research and development. On the contrary, some even increased it sharply because, as another executive emphasized, "The capital market is looking longer term—at least for now." The winners are making the most of the opportunities arising from modified investor perspectives.

- *Production Strategy.* A large number of companies with international production networks reviewed their location policy. Many managers told us about protectionist-related obstacles that they had not made public for fear of putting their company at a disadvantage.

- *Regional Mix.* The potential winners in the coming years are

WHAT BUSINESSES NEED TO DO NOW (CONTINUED)

taking their cue from the growth markets of tomorrow, with some relocating entire activities to those regions. One company has divided up its entire business portfolio: highly innovative operations that will continue to have an attractive market in industrialized countries for the foreseeable future are remaining in Europe and the U.S. All other activities, primarily those for which more growth is expected in emerging economies, are being relocated in full and managed from within those markets.

- *Pricing Policy.* Even relatively successful companies were affected by the downturn. Most had to make concessions in terms of prices, in part to help out long-standing customers. Returning to former price levels and improving the ability to respond quickly and intelligently to pricing challenges are consequently at the top of the agenda. In addition, some companies prepared for an unforeseen lift in inflation—for example, by including an inflation clause in their contracts.

- *Investment Strategy.* Companies with strong balance sheets preempted competitors by making aggressive investments in new capacity. In doing so, they not only secured new clients for the additional supply early on—notably in the fast-growing Asian markets—but also rendered similar investments by competitors less attractive. Such actions can help achieve a significant gain in defendable market share.

- *M&A.* All the executives we surveyed had a "wish list" of companies to be considered for acquisition. These lists were constantly updated and the very latest information collected about the companies concerned. Today, many of these executives regret not taking action at the height of the crisis—despite their companies' solid financial positions, they all shied away from the perceived risk given the turmoil in the capital market. In the summer of 2011, the people we spoke with tended to be skeptical as to whether the time was ripe for attractive acquisitions, given the current level of stock market valuations. All said that they expect more consolidation in their industries over the coming years.

- *Lobbying.* When asked whether the influence of policymakers was increasing, the executives we interviewed replied in the affirmative. Yet most have not yet derived any concrete measures from this new reality. Many are still looking for the right way to get closer to political decision-making processes. One company had already resolved to relocate its U.S. headquarters to Washington, D.C.

The winners have been doing more than simply following the positive signals and translating the opportunities of the postcrisis era into competitive advantage. They are also preparing for the possibility that there could be another downturn in the coming months—and are readying themselves accordingly. Three measures

WHAT BUSINESSES NEED TO DO NOW (CONTINUED)

are at the forefront of (preventive) crisis management:

- *Early-Warning Systems.* Many companies set up new reporting structures during the crisis to enable them to react quickly. They observed changes in the marketplace and analyzed the development of key performance indicators, such as new orders and (especially) cash flows. Although most companies are no longer functioning in acute-crisis mode, many have retained these early-warning systems with the intention of refining and anchoring them in the organization. More than in previous years, different scenarios are being incorporated into business plans and investment decisions.

- *Weatherproofing.* The crisis revealed the places in the company where there were weaknesses that could be addressed after stabilization had been achieved. Some managers are using the positive backdrop to discontinue operations that have not proved crisis resistant, thus ensuring that these activities do not weaken the entire enterprise.

- *Increasing the Agility of the Company.* Winning companies prepare themselves for greater volatility and shorter cycles. This implies a constant focus on strong balance sheets, stable cash flows, and lower breakeven points. This is a precondition to "riding the waves." As one executive put it, "We all need to be good surfers from now on."

The Financial-Repression Solution

There is a "softer" version of the inflation solution called "financial repression," which refers to the approach taken by the U.S. and the U.K. to lowering their debt burdens after World War II.[17] Legislation forced investors to invest in lower-yielding government bonds ("risk-free assets"). With the nominal growth rate of the economy higher than the interest rate on the government debt, the debt-to-GDP ratio came down significantly, on average by 3 to 4 percent of GDP per year. Recent regulation of banks and insurance companies—Basel III and Solvency II—goes in the same direction. Banks and insurers do not need to provide equity for their holdings in government debt, be it German or Greek. This provides a very strong incentive to invest in government debt.

But could financial repression work today? To assess this, we assume that a sustainable total debt level for economies is 180 percent of GDP. This is based on the criteria defined in the Maastricht Treaty, which set a debt target of 60 percent and a deficit target of 3 percent of GDP per year for governments. Both targets followed an economic logic: in an environment of 5 percent interest rates and 3 percent GDP growth, a 60 percent debt-to-GDP ratio is sustainable (as 5 percent interest incurred on 60 percent equals a 3 percent interest burden incurred on total GDP). Higher debt ratios are sustainable only if either the interest rate is lower (as in past years) or the growth rate of the economy is higher.

Applying the same logic to private households and nonfinancial companies seems reasonable. It is not necessary for the debt load to be equally distributed among all three sectors, because a more highly indebted government could use funds (taxes) from a less leveraged private sector. Still, breaking the 60 percent threshold is a strong sign of a potential buildup of imbalances that could lead to economic difficulties in the future. Indeed, as the experience of recent years shows, countries like Spain and Ireland are under significant economic pressure in spite of relatively low government debt—because they suffer from relatively high private-debt burdens.

Assuming 180 percent of GDP to be the sustainable debt level for countries, Exhibit 1 shows a simulated financial-repression solution on the basis of three scenarios in which nominal GDP growth exceeds the interest rate of the economy.[18] The greater the difference, the faster the relative deleveraging. Even in the relatively optimistic scenario of a 3 percentage point difference between nominal growth and nominal interest rates, it would take between 4 years (in Germany) and 28 years (in Ireland) to return the debt load to sustainable levels. This scenario is quite optimistic because it assumes that the total debt burden only grows by its interest rate (that is, this scenario does not include additional debt to fund stimulus programs or to cover other expenses, such as the increased costs of demographic aging). If we assume that 2 percent additional debt is taken on every year, then the period of financial repression needs to be much longer, or the

EXHIBIT 1 | How Long Financial Repression Needs to Last

	Debt/GDP (%): Government debt	Debt, nonfinancial companies	Debt, households	Total	Number of years to breakeven (Nominal interest rate – Nominal GDP growth): –1 percentage point	–3 percentage points	–5 percentage points	2009 interest – GDP growth[1]
U.S.	84	77	96	257	38	13	8	1.1%
Japan	194	95	62	351	70	24	14	0.3%
Germany	73	65	63	202	12	4	2	0.1%
France	78	86	54	218	20	7	4	2.2%
U.K.	72	85	99	256	37	12	8	–0.6%
Italy	116	77	42	236	28	10	6	2.3%
Spain	53	135	86	275	44	15	9	3.2%
Greece	127	58	52	237	29	10	6	6.4%
Portugal	76	139	97	312	58	19	12	5.3%
Ireland	66	207	121	393	82	28	17	7.2%

Sources: OECD; BCG analysis.
Note: It is assumed that government debt accounts for one-third of total debt and that a sustainable total debt level for economies is 180 percent. An interest rate of 4.5 percent for countries was kept constant. Years were rounded to the nearest whole number. Scenarios are based on 2009 debt data.
[1]Interest = total Interest/total debt (2009); GDP growth is from 2009 to 2010.

scale of the repression much bigger. In the exhibit, a scenario of 3 percent repression would equal the –1 percentage point column (3 percent to bring down the existing debt load and 2 percent to neutralize the effect of additional debt) on timing. Sticking to the time frame of the –3 percentage points column would require a 5 percent repression.

In today's low-growth environment, a 3 percent excess growth rate over the interest rate would require nominal interest rates across all sectors of the economy to be 1.5 percent, on average, for those economies that are expected to grow in 2011; for all others, nominal interest rates would have to be negative. In 2009, only the U.K. managed to achieve a nominal growth rate above the interest rate, mostly thanks to higher inflation, with real economic growth remaining sluggish. In 2011, it looks like Germany and the U.K. are again in this position, while virtually all the other major Western countries are still struggling with a positive interest rate-to-growth gap.

But how could financial repression be achieved?

- *Low Interest Rates.* The Federal Reserve, like the ECB, aggressively lowered interest rates following the financial market crisis of 2008, leaving interest rates at record low levels—notwithstanding small steps taken by the ECB to increase rates. The key precondition to achieving low interest rates is creditor trust—trust in the central bank's ability and willingness to fight inflation and trust in the debtor's ability and willingness to pay its debts. Until now, the central banks have been successful in taming expectations of inflation. And for countries such as the U.S. and Germany, the market assumes no credit risk. On the other hand, creditors are more skeptical about the prospects for countries like Spain, Italy, and France, and are asking for higher interest rates to cover the perceived higher risk of not being paid back in full (default). This risk-based increase in interest rates in itself serves to increase the risk of default because the debtor economies then need to run a bigger primary surplus—which, in turn, requires austerity measures that lead to lower growth. It seems highly probable that countries like the U.S., the U.K., Germany, and the Netherlands will be able to hold their interest rates low. For the other countries in the euro zone, we see a significant risk that it will not be possible to lower interest rates enough for financial repression to work, unless the ECB starts to buy these countries' bonds—in effect, monetizing government debt. This would increase the probability of significant inflation.

- *Higher Economic Growth.* The best solution would be higher real growth of the economy. Unfortunately, the empirical evidence gives little hope. According to studies by Carmen Reinhard and Kenneth Rogoff, the growth rate of economies after the bursting of a financial bubble tends to be lower for several years because of the necessary deleveraging. Their work demonstrates that a government debt load of more than 90 percent of GDP typically leads to a drop in real economic growth of 1 percentage point. Most countries in the West now have government debt loads of more than 90 percent. This problem is amplified by imminent demographic change. It is axiomatic that economic growth is driven by growth in the size of the workforce combined

with increases in productivity. In Europe, the workforce is already shrinking, while in the U.S., the growth rate is forecast to be lower than in the past. Combine this with the fact that productivity growth has been constant for some time in most developed economies (the so-called technological frontier) and the probability of achieving sizable real economic growth in the next ten years is low.

- *Higher Inflation.* It becomes obvious that successful financial repression requires tangible inflation. The greater the gap between interest rates and growth, the faster the financial repression. Let's look at the math. Assume that an economy takes on 2 percent of new debt in addition to its interest payments, that the nominal interest rate is 3 percent, and that real economic growth is 1 percent. In order to achieve a 5 percent financial repression, the rate of inflation would need to be 9 percent.[19]

- *Capital Controls/Government Intervention.* Our examples demonstrate that it requires more than traditional methods to reduce existing debt burdens. This is only imaginable when governments also intervene significantly in financial markets, including banning cross-border capital flows and imposing strict regulation on how savings have to be invested.

Politicians are trying to solve the problem of too much debt by playing for time. This will fail. Financial repression would have to be significant and requires close political coordination. In addition, it does not address the pressing issues of global imbalances and the adjustments required within the euro zone. The longer this play for time continues, the higher the risk of significant disruptions and social tensions. As discussed in earlier articles, we believe that the failure to act significantly increases the risk of increased protectionism and an unconstrained financial and economic crisis, which could lead to a drop back into recession. Given the empty coffers of governments and their recent heavy use of monetary instruments, there is not much left to stimulate the economy once more.

When Will We See a Plan B?

We believe that it would be preferable to stop the vicious circle of too much debt leading to more debt by executing a program of structured workouts and write-offs. Creditors would need to accept that they have lost a sizable portion of their money. The longer the day of reckoning is postponed, the more money will be lost. The effect of compound interest is not well understood in either economics or politics. At a 5 percent interest rate, the amount of outstanding debt doubles every 15 years. The problem gets even worse when the cost of aging societies is included. As a paper from the Bank for International Settlements shows, maintaining the level of payouts implicit in current entitlement programs means that government debt in the West will explode over the next 30 years.[20] If we apply solid accounting standards, it is clear that such debts cannot be sustained.

Politicians shy away from telling the public the bald truth. This is understandable, since the prospect of reduced pensions, negative returns on savings, and outright default would not be popular. For this reason, we believe that governments and

central banks are most likely to resort (eventually) to a policy of aggressive financial repression: that is, high inflation.

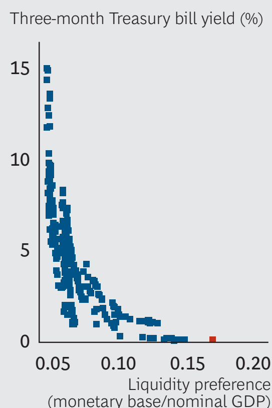
The preconditions for high inflation are there. Exhibit 2 shows the thin tightrope on which the Federal Reserve is currently walking. Rewinding its expansive monetary policy may well prove much more difficult than expected. Given the intervention of the Fed since 2008, the potential for inflation in the U.S. is extremely high.

The left-hand graph in the exhibit shows the relationship between the short-term risk-free interest rate (three-month Treasury bill yield) and the propensity of the public to hold cash, measured by the monetary base divided by GDP.[21] If interest rates are high, people tend to hold low cash reserves, preferring to invest in interest-bearing assets. On the other hand, in a low-interest environment, the public is willing to hold much more cash. For example, most of the clients we talk to have a significant short-term cash position because of the combination of low interest rates and insecurity in financial markets. The red square in the exhibit marks the current position: the ratio of monetary base to GDP is at an all-time high.

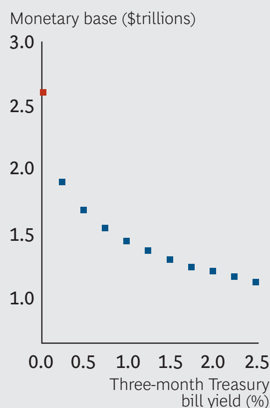
The center graph shows scenarios in which the monetary base and interest rates are noninflationary. In order to create no inflation, any increase in interest rates—for example, due to investors being insecure about future inflation and/or the ability and willingness of the U.S. to serve its debt—needs to be accompanied by a

Exhibit 2 | Monetary Overhang in the U.S.

The lower the short-tem interest rate, the more money people are willing to hold



Noninflation curve shows noninflationary combinations of interest rate and monetary base[1]



What happens if interest rates increase?

Monetary base	Interest rate (%)	Price level (%)
–$700 billion	0.25	40
–$920 billion	0.5	55
–$1.3 trillion	1.5	88
–$1.5 trillion	2.5	143
–$1.6 trillion	4.7[1]	182

An interest rate increase has to be matched by a contracting monetary base; otherwise, inflation is the result

Current situation

Sources: Federal Reserve Board; Bureau of Economic Analysis; Hussman Fund; Federal Reserve Bank of Dallas, Working Paper No. 34.
[1]Average for 1950 to 2011.

reduction in the monetary base. This means that the Fed would have to reduce its balance sheet by the appropriate amount by selling assets that it bought during the crisis.

To provide an indication of the required size of these asset sales, the right-hand part of the exhibit shows potential combinations of interest rates and the required shrinking of the Fed's balance sheet—or the implied inflationary potential if the monetary base is not reduced. In the case of an increase in interest rates to 1.5 percent (not high given the long-term average of 4.7 percent), the Fed would need to sell $1.3 trillion to the market. If it did not sell these assets, the price level in the U.S. would need to increase by 88 percent—a sizable inflation.[22]

Stop Kicking the Can Down the Road

It is obvious that time and doing nothing cannot solve the problem—it just grows bigger. With every new softening of the economy, the pressure on central banks to intervene one more time will increase. Every rise in interest rates driven by creditor worries of default—like for some countries in the euro zone—will lead to pressure on the central banks to intervene. The longer we postpone the necessary write-off of debt, the more volatility we will see and the more intervention by governments. The final outcome, the devaluation of debt, can be postponed but is unlikely to be avoided.

Politicians will be loath to acknowledge that default and restructuring are inevitable. So they will continue kicking the can. Businesses need to be prepared for an environment characterized by the following:

- Overall low growth of the economy for most of the largest developed economies.
- Much higher volatility, leading to an increased risk of more recessions.
- Constant intervention by governments in an effort to "fix" things.
- Increased tensions between countries, including protectionism.
- Broader social unrest.
- Significant inflation.

All this leads us to believe that many of the "new realities" we described in the spring of 2009 still represent likely outcomes.[23] (See the sidebar "The Global Economic Order: Major Change, Major Challenge.")

How long can this go on? We don't know. But it will be very hard to stabilize economies and organize a soft landing. Financial markets will start to realize that governments and central banks are running out of ammunition. Either the politicians need to organize a systematic debt restructuring for the Western world and/or generate inflation fast, or we run the risk of the situation spinning out of control. In which case, there will be no place to hide.

THE GLOBAL ECONOMIC ORDER
Major Change, Major Challenge

During the boom times, governments all around the world pushed back the boundaries of the state, with deregulation, privatization, and free-trade policies being the order of the day in a world where virtually every country appeared to be prospering. Many developed countries were content to export jobs to lower-wage countries in the name of lower costs and lower inflation at home because jobs, typically in the service sector, were still being created. But times have changed. Over the next few years, we expect to see the following trends:

- Lower growth rates.
- A rebalancing of international trade.
- Increased economic protectionism (trade protectionism, new financial protectionism, and labor protectionism—that is, restrictions on economic migration).
- Reindustrialization and self-sufficiency.

Government: New Activism

We expect governments to pursue policies of economic protectionism. But we also expect them to be active in other ways—reregulating businesses (particularly in the financial sector), experimenting with fiscal and monetary policy, and intervening in and taking ownership of private enterprises.

Industry Structures: Fundamental Changes

Recessions typically see an acceleration in the reshaping of industries. This time will be no different: ineffective business models will not survive the tougher climate, mature industries will face increasing pressure to consolidate, cross-border M&A will become tougher to pull off, and different companies will emerge as leaders of their industries—partly driven by the increase in innovation that is a feature of recessionary times.

Companies: Lower Profit Levels, More Regulation

Companies have enjoyed many years of rapidly improving quarterly earnings. This will change as underlying economic growth slows, leverage is reduced, and companies shy away from risk in favor of financial prudence. Over the last two years, many companies have maintained strong bottom-line performance—more through rigorous cost control and less through strong sales growth. This has helped many companies build up cash reserves. A number of companies have also prospered by increasing their focus on rapidly developing economies.

Investors: Preferences and the Appetite for Risk Will Change

Over the past few years, we have witnessed significant changes in investor behavior. Not content with market returns, investors have sought enhanced returns, turning to private equity, hedge funds, leverage, and financial engineering. The financial crisis and significant losses on instruments mistakenly thought to be low risk will change investor preferences and their appetite for risk.

THE GLOBAL ECONOMIC ORDER (CONTINUED)

Major Change, Major Challenge

- The crisis will have a lasting impact on investors.
- Stock yields may beat bond yields once again.
- The market will reward solidly financed companies.
- Sovereign wealth funds will be repositioned.

Banking: An Industry Transformed

The financial crisis has redefined what financial institutions must do to compete and win. This will prove to be as transformative as it is destructive, precipitating changes that are more fundamental than actions driven solely by self-preservation—such as the scramble for funding and hurried efforts to cut costs.

- The national-champion model will reemerge.
- The financial sector's share of total profits will come down.

Individuals: Shaped by the Economic Whirlwind

Consumers drove the boom. And they will determine—through their changing habits and behavior—many of the new realities. In the U.S., consumer spending accounts for 70 percent of GDP. Given that the U.S. generates such a large share of global GDP, approximately 16 percent of the word's GDP is driven directly by U.S. consumers. In the past, these consumers could spend their way out of a recession. But not now. We see a number of developments:

- Consumers will become more conservative.
- Consumers will become more value conscious.
- Consumers will extend their working lifetimes.
- The retirement generation will get squeezed.
- Traditional employers will be more attractive.

Society: Increased Political and Social Tensions

It is reasonable to assume that we will see a broad change in social mood. The period of economic expansion, easy credit, and reduced global tensions since the end of the Cold War created an atmosphere of optimism and confidence. The abrupt economic slowdown, along with the return of protectionism and other forms of economic nationalism, will have a clear impact on the political agenda, resulting in the following:

- Social unrest.
- Political instability.
- Fundamental doubts about the free-market economy.
- International tensions.

Notes

1. Congressional Budget Office, *Budget and Economic Outlook: Fiscal Years 2011 to 2021,* 2011.

2. "A Greek Crisis Is Coming to America," *Financial Times,* February 10, 2010.

3. For details, see Alan S. Blinder and Mark Zandi, "How the Great Recession Was Brought to an End," July 27, 2010, www.economy.com/mark-zandi/documents/End-of-Great-Recession.pdf.

4. Richard C. Koo, "U.S. Economy in Balance Sheet Recession: What the U.S. Can Learn from Japan's Experience in 1990–2005," 2010, www.house.gov/apps/list/hearing/financialsvcs_dem/richardc.koo.pdf.

5. "Deflation: Making Sure 'It' Doesn't Happen Here," Remarks by Governor Ben S. Bernanke, 2002, http://www.federalreserve.gov/boarddocs/speeches/2002/20021121/default.htm.

6. "Japan's Lessons for a World of Balance-Sheet Deflation," *Financial Times,* February 17, 2009.

7. Koo, "U.S. Economy in Balance Sheet Recession, www.house.gov/apps/list/hearing/financialsvcs_dem/richardc.koo.pdf.

8. Credit default swaps (CDS) are a form of insurance against default. The CDS spread is the premium paid by the buyer, in basis points. A CDS spread of 100 means that default insurance for $1 million costs $10,000 per year.

9. Credit Suisse, "EFSF Users' Manual," October 28, 2010, http://doc.research-and-analytics.csfb.com/docView?language=ENG&format=PDF&document_id=864777231&source_id=em&serialid=lvOl4KUj6Cfc1%2FSy6r3Jfg7LYyVHmPBa04cnuV1h9GY%3D.

10. The primary surplus is the budget balance before interest payments.

11. See Paul De Grauwe, "A Fragile Eurozone in Search of a Better Governance," CESifo Working Paper Series No. 3456, http://ssrn.com/abstract=1851324.

12. Hal Sirkin and Michael Zinser, "Made in the U.S.A., Again," June 2011, https://www.bcgperspectives.com/content/commentary/manufacturing_supply_chain_management_made_in_the_usa_again/.

13. Daniel Stelter, Dirk Schilder, and Katrin van Dyken, *The Debt Monster,* BCG Focus, May 2011, https://www.bcgperspectives.com/content/articles/management_two_speed_economy_growth_debt_monster/#chapter1.

14. See http://www.bcg.com/expertise_impact/capabilities/management_in_a_two_speed_economy/collateral_damage.aspx.

15. "We Need a Plan B to Curb the Debt Headwinds," *Financial Times,* March 2, 2010.

16. See Ulrich Pidun, Daniel Stelter, and Katrin van Dyken, *Why Companies Should Prepare for Inflation,* BCG Focus, November 2010, and Ulrich Pidun and Daniel Stelter, *Making Your Company Inflation Ready,* BCG Focus, March 2011.

17. Carmen M. Reinhart and M. Belen Sbrancia, "The Liquidation of Government Debt," NBER Working Paper 16893, www.imf.org/external/np/seminars/eng/2011/res2/pdf/crbs.pdf.

18. The scenarios use 2009 OECD data, because 2010 data are not yet available; however, debt levels increased further in 2010.

19. A 3 percent interest rate plus 2 percent new debt minus 1 percent real growth minus 9 percent inflation leads to 5 percent financial repression.

20. Stephen Cecchetti, Madhusudan Mohanty, and Fabrizio Zampolli, "The Future of Public Debt: Prospects and Implications," BIS Working Paper 300, March 2010, http://www.bis.org/publ/work300.htm.

21. The monetary base is the total amount of a currency that is either circulated in the hands of the public or is held in commercial bank deposits held in the central bank's reserves.

22. This is based on empirical findings described in "Sixteen Cents: Pushing the Unstable Limits of Monetary Policy," Hussman Funds, January 24, 2011, http://www.hussman.net/wmc/wmc110124.htm.

23. *Collateral Damage, Part 5: Confronting the New Realities of a World in Crisis,* BCG White Paper, March 2009, www.bcg.com/documents/file15451.pdf.

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