Which big country will default first?

- by Martin Hutchinson
- November 09, 2009

Of the world's six largest economies, three currently have budget and public debt positions that if allowed to fester will push those nations into bankruptcy (the seventh largest, Italy, also has a budget and debt position that is highly vulnerable, but its problems appear chronic rather than acute). Given the proclivities of modern politicians for delaying pain and avoiding problems, it is likely that festering is just what those positions will do. So which major country, the United States, Japan or Britain, will default first on its foreign debt?

The other three of the six top economies, Germany, China and France, appear to have fewer problems but are not out of the woods entirely. Germany has substantial public debt because of the costs involved in integrating the former East Germany, but those costs are now mostly past and the current government is highly disciplined – thus Germany is now the most stable major economy. France is less disciplined; its debt level is similar to that of Germany but its current budget deficit is much higher, at around 8% of Gross Domestic Product (GDP) in 2009, according to the Economist forecasting panel. However, its problems pale in comparison to those of the deficit-ridden trio. China has huge amounts of hidden debt in its banking system, which could well collapse, but its direct public debt is small, as is its budget deficit, so it is unlikely to enter formal default.

The worst budget balance of the three deficit countries is in Britain, where the forecast budget deficit for calendar 2009 is a staggering 14.5% of GDP. Furthermore, the Bank of England has been slightly more irresponsible in its financing mechanisms than even the Federal Reserve, leaving interest rates above zero but funding fully one third of public spending through direct money creation. Governor Mervyn King has a reputation in the world's chancelleries as a conservative man of economic understanding. He doesn't really deserve it, having been one of the 364 lunatic economists who signed a round-robin to Margaret Thatcher in 1981 denouncing her economic policies just as they were on the point of magnificently working, pulling Britain back from what seemed inevitable catastrophic decline. King's quiet manner may be more reassuring to skeptics than the arrogance of "Helicopter Ben" Bernanke, but the reality of his policies is little sounder and the economic situation facing him is distinctly worse.

Britain has two additional problems not shared by the United States and Japan. First, its economy is in distinctly worse shape. Growth was negative in the third quarter of 2009, unlike the modest positive growth in the U.S. and the sharp uptick in Japan. Moreover, whereas U.S. house prices are now at a reasonable level, in terms of incomes (albeit still perhaps 10% above their eventual bottom), Britain's house prices are still grossly inflated, possibly in London even double their appropriate level in terms of income. The financial services business in Britain is a larger part of the overall economy than in the U.S. and the absurd exemption from tax for foreigners has brought a huge disparity between the few foreigners at the top of the City of London and the unfortunate locals toiling for mere mortal rewards. A recent story that the housing market for London homes priced above $5 million British pounds was being reflated by Goldman Sachs bonuses indicates the problem, and suggests that the further deflation needed in U.K. housing will have a major and unpleasant economic effect.

A second British problem not shared by the U.S. is its excessive reliance on financial services. As detailed in previous columns, this sector has roughly doubled in the last 30 years as a share of both British and U.S. GDP. In addition, the sector's vulnerability to a restoration of a properly tight monetary policy has been enormously increased through its addiction to trading revenue. The U.S. has many other ways of making a living if its financial services sector shrinks and New York is only a modest part of the overall economy. Britain is horribly over-dependent on financial services, and the painful if salutary effects of London costs being pushed down to national levels by a lengthy recession are less likely to be counterbalanced by exuberant growth elsewhere.

The other question to be answered for all three countries is that of political will. If as is certainly the case in Britain, deficits at the current levels will lead to default (albeit not for some years since the country's public debt is still quite low), then to avoid default tough decisions must be taken. Britain is in poor shape in this respect. Its current prime minister, Gordon Brown, is largely responsible for the underlying budget problem, having overspent during the boom years, largely on added bureaucracy rather than on anything productive or value-creating. However, the opposition Conservatives, likely to take power next spring, are led by a center-leftist with a background in public relations and no discernable backbone or principles.

Britain has a history of such leaders, which it has managed to survive – the ineffable Harold Macmillan, in particular, who wanted to abolish the Stock Exchange and contemplated nationalizing the banks when they raised interest rates, was a man of outlook and temperament very similar to David Cameron's. Macmillan was notoriously prone to soft options that postponed economic problems, firing his entire Treasury team in pursuit of soft options in 1958 and leaving behind an appalling legacy of inflationary bubble on his retirement in 1963. If Cameron is truly like Macmillan, his government's response to economic and financial disaster will be one of wriggle rather than confrontation. With neither party providing solutions to an economic crisis, the British public is likely to discover that, unlike in the crisis of 1976, no solutions will be found. Default (doubtless disguised as with Argentina as "renegotiation") would in that case inevitably follow.

The United States is in somewhat better shape than Britain. Its deficit is somewhat lower, at 11.9% of GDP in calendar 2009, although its debt level is higher if you include the direct debt of Fannie Mae and Freddie Mac, as you should. It also has lower overall levels of public spending, although spending is rising rapidly. Furthermore, it has a much more diverse economy and a healthier real estate market, so that further likely downturns in California and Manhattan real estate and the financial services sector can be easily overcome.

U.S. pundits like to whine about the impending deficits in social security and health-care, but the former is easily overcome by adjusting the retirement age while the latter could be greatly mitigated by simple cost-containment measures, such as limiting trial lawyer depredations, making the state pay for the "emergency room" mandate to treat the indigent and allowing interstate competition for health insurance. All those changes would be politically difficult, but they are clearly visible and involve no damaging cuts in vital services, unlike the changes that would probably be necessary in Britain.

The other U.S. advantage is political: it has an alternative to overspending. Last Tuesday's election results were a useful shot across the bows of the overspending consensus that had developed in both the Bush and Obama administrations (as well as among the ineffable barons of Congress) since 2007. Whereas voter concern about spiraling deficits and public spending has no satisfactory outlet in Britain, it can now express itself clearly in the U.S., producing either a sharp change of policy by the current administration and Congress or a change of administration in 2012. Since the likelihood of a reversal of policy towards sound budgetary management is greater in the U.S. than in Britain, the probability of eventual default is less.

Japan has already had its change of government, throwing out the faction of the Liberal Democrat Party (LDP) that regarded politics as the art of creating pointless infrastructure. Unfortunately, the Japanese electorate, faced in August with a no-good-choices problem similar to that of U.S. voters last year and British voters next spring, replaced a long-serving overspending government with another committed to a different set of spending priorities rather than to ending the spending itself. The Democratic Party of Japan (DPJ) has cut back sharply on the infrastructure "stimulus" but is showing signs of replacing it with social spending. It is also committed to economically dozy policies such as reversing postal privatization, organized with such great political effort by Junichiro Koizumi in 2005.

Japan does however have a couple of advantages that may enable it to avoid default. First, its public debt carries very low interest rates, mostly below 2% per annum, and is owned almost entirely by its own citizens. What's more, state-owned entities such as the now un-privatized Postal Bank lend vast amounts of money to the government, acting as conduits to the less efficient bits of the public sector in the same way as do China's state-owned banks. This is appallingly bad for the efficiency of the economy and for living standards, but it postpones default and makes it less likely.

Second, it's not inevitable that the LDP's wasteful infrastructure spending will simply be replaced by wasteful social spending. Finance minister Hirohisa Fujii is reputed to be a budgetary hard-liner. Further, at least part of the DPJ's spending will take the form of handouts to families with children. Those may increase domestic consumption compared to exports and thereby balance the Japanese economy better, increasing its growth potential marginally. Nevertheless, since Japan's public debt is currently around 200% of GDP, Japan is much closer to the default precipice than either the U.S. or Britain. Thus, while the better structure of Japan's economy and its debt make Japan's probability of default lower than Britain's, it's likely that if both countries defaulted, Japan would do so first.

We have not experienced a debt default by a major economy since the 1930s. That three such defaults are currently conceivable indicates both the severity of the current downturn and the wrong-headedness of the policies taken to address it. If it happens, a major sovereign debt default of this kind will cause the seizure of global capital markets, prolonging downturn for a decade or more.

We'd all better hope the urge for fiscal responsibility hits London, Washington and Tokyo pretty damn soon.

The Bears Lair is a weekly column that is intended to appear each Monday, an appropriately gloomy day of the week. Its rationale is that, in the long '90s boom, the proportion of "sell" recommendations put out by Wall Street houses declined from 9 percent of all research reports to 1 percent and has only modestly rebounded since. Accordingly, investors have an excess of positive information and very little negative information. The column thus takes the ursine view of life and the market, in the hope that it may be usefully different from what investors see elsewhere.

Martin Hutchinson is the author of "Great Conservatives" (Academica Press, 2005). Details can be found on the Web site www.greatconservatives.com