

Soft Currency Economics Series

Facts and Fiction of Sovereign Debt Default

The S&P rating agency recently downgraded the outlook for US sovereign debt, which has sparked a firestorm among the politicians, economists and investors alike. In this continuing series on Soft Currency Economics, I would like to examine the facts and fiction behind sovereign debt default and the true meaning of the S&P downgrade.

When a sovereign nation's money supply is determined by the amount of hard assets that country holds, like gold or silver, the country's currency is called a hard currency. The country has to hold a certain amount of gold or silver and be ready to convert its currency into gold or silver upon request. Soft currency or fiat money is not backed by any tangible asset and therefore, the money supply of a soft currency is solely determined by the financial and economic policies of that government. A soft currency gets its value solely from its ability to extinguish tax liabilities of that country. There is no inherent limit on federal expenses and therefore on federal spending.

When the US government decides to spend fiat money, it adds to its banking reserve system and when it taxes or borrows (issues Treasury securities) it drains reserves from its banking system. These reserve operations are done solely to maintain the target Federal Funds rate. If the US government increased its banking reserves but failed to issue new securities, the interest rates would fall to zero. Let us take an example to better understand this concept. One may argue that you can always sell your US Dollars for other currencies or commodities like Gold, Silver, Oil, Grains, Stocks, etc. True, but at the end of that trading chain, somebody will be left holding the US Dollars and they will need a place to park those US Dollars to earn some return. If there were not enough Treasury bonds around, supply and demand dynamics would drive the investors to bid up the price of the Treasuries till the yield on them fell close to zero.

Now that we understand the mechanics of federal spending and the issuance of government securities, one can see that the spending is done before the issuance of securities and that spending is not curtailed by the government's ability to place its bonds. This leads to the next logical conclusion, which is that the government of a fiat currency (e.g. US, UK and Japan) can retire its domestic debt without financial constraint.

What about the level of interest rates on sovereign debt? Level of interest rates on sovereign debt compete with the expected rate of return on other assets denominated in that country's currency. Therefore, the interest rate on the 30yr US government bond is a statement on the expectation of risk adjusted return on other assets like stocks, which in turn is an expectation of long term economic growth. Case in point is Japan, where the debt/GDP ratio at 228% is much higher than the US, yet the 30 year interest rates are 2%. The Japanese GDP growth over the last 10 years has been close to 0. If a sovereign country's fiat debt was providing too high of a yield compared to other assets, investors

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would simply switch out of other assets into the debt, until the yield would equal the expected risk adjusted returns of other asset classes.

So what exactly is the S&P downgrade of the US debt outlook really saying? It is really a statement on the expected economic growth rate of the US economy and also a statement on the competitiveness of the US Dollar. While it is true that a sovereign government with fiat currency can print as much as it wants, it can have a detrimental effect on the value of its currency. Case in point again is the US Dollar's fall since August of 2010 when the Central bank embarked on its quantitative easing program. The price of commodities and value of currencies with strong economic growth has soared against the US Dollar. Therefore, the S&P downgrade is more a downgrade of the long term economic picture of the US economy and the value of the US Dollar. But, I do not put much faith in the analysis of the rating agencies and believe that this downgrade is about a year late and should really have been made last August and not now.

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