Fixed Income

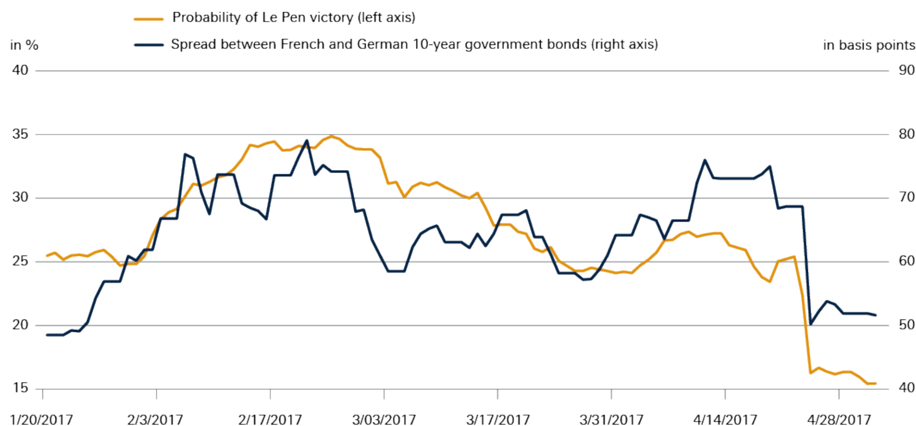
Of Frexit, sovereign defaults and other boogeymen

In bond markets, there is always a tendency to overreact. To avoid knee-jerk reactions, investors should think more carefully about why and when to worry.

On Sunday, April 23rd, socially liberal Emmanuel Macron convincingly won the first round of the French presidential elections. It is still too early to altogether write off Marine Le Pen, his far-right opponent in the run-off. In recent days, Macron's inexperience has been beginning to show. Perhaps, he is also exhausted. In any case, Macron has already committed several faux-pas, notably when visiting his home town Amiens last week. As my European colleagues have argued, however, there are few signs as yet in the data that would suggest much of an opening for Le Pen.

Bond and political betting markets have come to similar conclusions. Throughout the long campaign, spreads between French and German government bonds have moved in tandem with the likelihood of Le Pen winning, as measured by the odds in electronic betting markets.

Likelihood of Le Pen victory & spread France vs. Germany



Sources: Oddchecker, Bloomberg Finance L.P., Deutsche Asset Management Investment GmbH, as of 5/2/17

Since Friday, April 21st, Le Pen's odds of winning have receded, according to betting markets. So, too, have spreads of French 10-year government bonds over German ones. And so too, have the spreads of government bonds from other Eurozone countries, such as Spain and Italy, perceived to be vulnerable if France gets into trouble.

In terms of tactical investor positioning, these market reactions are completely understandable. Perhaps surprisingly, they also make sense from a longer-term perspective. Even during the worst of the Frexit fears, France was seen as one of the credit-worthier borrowers. When trading Eurozone sovereign bonds there are

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Expectations in a nutshell

- Markets have been fretting about Frexit. However, there are factors beyond the survival of the common currency to consider, when you look at Eurozone government bonds.
- For the government in question, sovereign default is never an easy option.
- Just because you dislike someone's politics does not necessarily make them harmful to your bond-market wealth.

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factors to consider beyond how likely the survival of the common currency area as a whole appears to be at any given point in time.

For example, the outlook for a highly indebted country like Greece is likely to be much worse than that of another highly indebted country like Italy. Even if they had exactly the same debt load, it seems likely Greece would have a much tougher time fending for itself. At least, that's what their respective histories suggest.

That old Greek tragedy

In the days of the Drachma, Greece already had the same weak institutions that have hampered the efforts of various recent governments to enact reforms ever since. Most importantly, Greece has always had a patchy track record when it comes to collecting taxes. Following the oil shocks of the 1970s, successive governments failed to tame inflation. Social spending and public sector employment rose quickly in misguided attempts to boost the economy.

All this was debt-financed; most of the bonds were held by Greek banks, which were mostly controlled by the Greek government. The interest rates on those bonds, as well as on bank deposits on loans, were mostly set administratively, according to a complex set of rules and regulations. The predictable result was a long period of economic malaise with the Drachma continuously declining in value. In Greece, 1970s style stagflation lasted until the early 1990s. The economic pain, in turn, reinforced public pressures for governments to spend even more. It was only the prospect of membership to the European Monetary Union (EMU) that finally allowed Greece to break this vicious cycle, as a weighty, 650-page report by the Bank of Greece and The Brookings Institution, a Washington think tank, noted in 2001.[1]

In Greece, the initial result of EMU membership was a boom in the early 2000s, thanks to falling interest rates. Unfortunately, Greece subsequently squandered the opportunity to get its public finances in order or to continue liberalizing its product and labor markets. It also failed to pursue further reforms to its public sector, starting with building a functioning tax system and making its welfare state affordable. From a bond-market perspective, Greece has been a basket case for more than four decades. EMU membership temporarily plastered over its structural weaknesses – making them all the more glaring when they moved back into the market spotlight during the crisis.

A short Italian journey

Contrast this with Italy, which was doing pretty well throughout the 2nd half of the 20th century. Public-sector debt was a challenge, to be sure, but a manageable one as long as the private sector remained pretty healthy. Much of Italian government debt was held directly and indirectly, by private households, and steadily inflated away. Italy was by no means perfect, but from the perspective of

[1] Ralph C. Bryant, Nicholas C. Garganas, George S. Tavlas (editors), Greece's Economic Performance and Prospects, Bank of Greece and The Brookings Institution, 2001

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foreign bond holders owing dollar-denominated Italian bonds, say, it all worked pretty well.

Italy's stagnation only really started under the EMU. When thinking the unthinkable, namely what would happen to a particular country if the Eurozone went under, it surely is appropriate to differentiate between a country like Greece and a country like Italy.

The French connection

Which brings me back to France. To be sure, the plans unveiled by Le Pen and her team are worrying. The core idea is creating a new currency and redenominating the bulk of French public sector debt, if need be. The new Franc would supposedly be "closely" linked to the euro, eventually allowing for devaluations in an "orderly" way.

The direct and indirect effects of such re-Franc-ization would most probably have dramatic negative consequences for the whole Eurozone and its financial sector. It seems unlikely that the scenario would play out quite along those lines. Le Pen would face tremendous political and constitutional hurdles to deliver on her Frexit promises. Most French voters are in favor of staying within both the Eurozone and the European Union. If Le Pen somehow won, she would have strong incentives to tone down her rhetoric further and take all things euro-related slowly indeed as the newly elected president. But if she somehow convinced French voters to leave the common currency, her Eurozone partners would have strong incentives to try to limit the fall-out.

There is little doubt, moreover, that following an orderly exit, a country like France would have a decent chance to maintain or fairly quickly regain credibility in bond markets. Going back over the last 200 years, France has had a pretty good track record in avoiding sovereign default, much better, say, than Austria or Germany. Leaving aside the decision in 1934 not to repay the external debts incurred during World War I, you arguably have to go back all the way to 1812 and the Napoleonic Wars to find a clear-cut case of French sovereign default.

Sovereign default is never an easy option

The reason for this is simple and of broader significance: for a government of any sort, defaulting on external financial debt is not an easy option. It carries tremendous economic and political risks, because at least in the short term, it makes raising new funding impossible. In the French context, it is by no means a stretch to see the problem of public finances as a root cause of the French revolution of 1789, as Thomas Sargent, a 2011 recipient of the Nobel memorial prize in economics once argued.[2] (The deterioration in public finances during the waning years of the old regime, in turn, was caused by a series of financially disastrous wars, mostly with Britain.)

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[2] Thomas J. Sargent , and François R. Velde , "Macroeconomic Features of the French Revolution," Journal of Political Economy 103, no. 3, 1995, pp. 474-518

Governments do not like to default. They do it if there is no other option, because they are chronically unable to raise necessary funding. That, in turn, depends on their ability to raise taxes. And when it comes to taxation, the French are second to none.

“The art of taxation consists in so plucking the goose as to obtain the largest possible amount of feathers with the smallest possible amount of hissing.” That quote is variously ascribed to either Jean-Baptiste Colbert, the finance minister under the Sun King Louis XIV, or Louis XIV’s chief minister and Colbert’s boss, Cardinal Jules Mazarin. Either way, the French state has had more than 350 years of experience when it comes to “plucking the goose.” Whoever moves into the Élysée Palace will inherit that apparatus.

Following years of quantitative easing by the European Central Bank, no member country is likely to be able to extract itself from the Eurozone without doing much damage to itself and its partners. France, however, would probably be in a better position than most in pulling off such a hazardous feat. The reason is that unlike many of its partners, it has the sort of institutions that should keep the French state solvent. This is not necessarily a good thing from the perspective of French tax payers. But it is exactly the sort of thing you tend to appreciate as a bond investor when looking at, say, a country in emerging markets whose currency peg is under attack. Markets tend to look more closely at the institutions of emerging markets than they do when assessing advanced economies. This is probably based on a misguided view of seeing advanced economies as altogether different from emerging markets.[3]

A lesson from emerging markets

This takes me back to my initial source of inspiration for writing this post. By coincidence, Bloomberg ran an interesting story a few days ahead of the first round of the French presidential elections.[4] It compared how emerging-market sovereign bonds have done in recent years, depending on how democratic the issuing country was. Two eye-catching examples mentioned were the diverging fortunes between Venezuela and El Salvador. Throughout all its recent travails, Venezuela has reliably made good on its payments to foreign bondholders. In democratic El Salvador, by contrast, political squabbling and brinkmanship recently caused the government to default on a relatively small payment to a local pension fund, leaving foreign bondholders to fret about the implications.

These are not isolated examples. For the past few years, there seems to have been a link between democratic rule and bond-market underperformance, according to Bloomberg. This link disappears, the further you look back. Lately, however, the article[5] concludes that “Dictatorships are on a hot streak in the bond market.”The statement is provocative, to be sure. But it is also a helpful reminder applicable in developed democracies as much as in autocratic emerging markets: Just because you dislike

[3]Carmen M. Reinhart and Kenneth S. Rogoff, Financial and Sovereign Debt Crises: Some Lessons Learned and Those Forgotten, Journal of Banking and Financial Economics 2, no. 4, 2015, pp. 5–17
[4]Ben Bartenstein, The Bond Market Prefers Dictators to Democracies, Bloomberg, 4/20/17
[5]Ben Bartenstein, The Bond Market Prefers Dictators to Democracies, Bloomberg, 4/20/17

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The European Central Bank (ECB) is the central bank for the Eurozone.

European Union (EU)

The European Union (EU) is a political and economic union of 28 member states located primarily in Europe.

Eurozone

The Eurozone is formed of 19 European Union member states that have adopted the euro as their common currency and sole legal tender.

Eurozone

The Eurozone is formed of 19 European Union member states that have adopted the euro as their common currency and sole legal tender.

Frexit

Frexit describes plans to lead France out of the European Union and the Eurozone.

Quantitative easing (QE)

Quantitative easing (QE) is an unconventional monetary-policy tool, in which a central bank conducts broad-based asset purchases.

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