

Low Rates Will Create Bad Habits In Germany Eventually

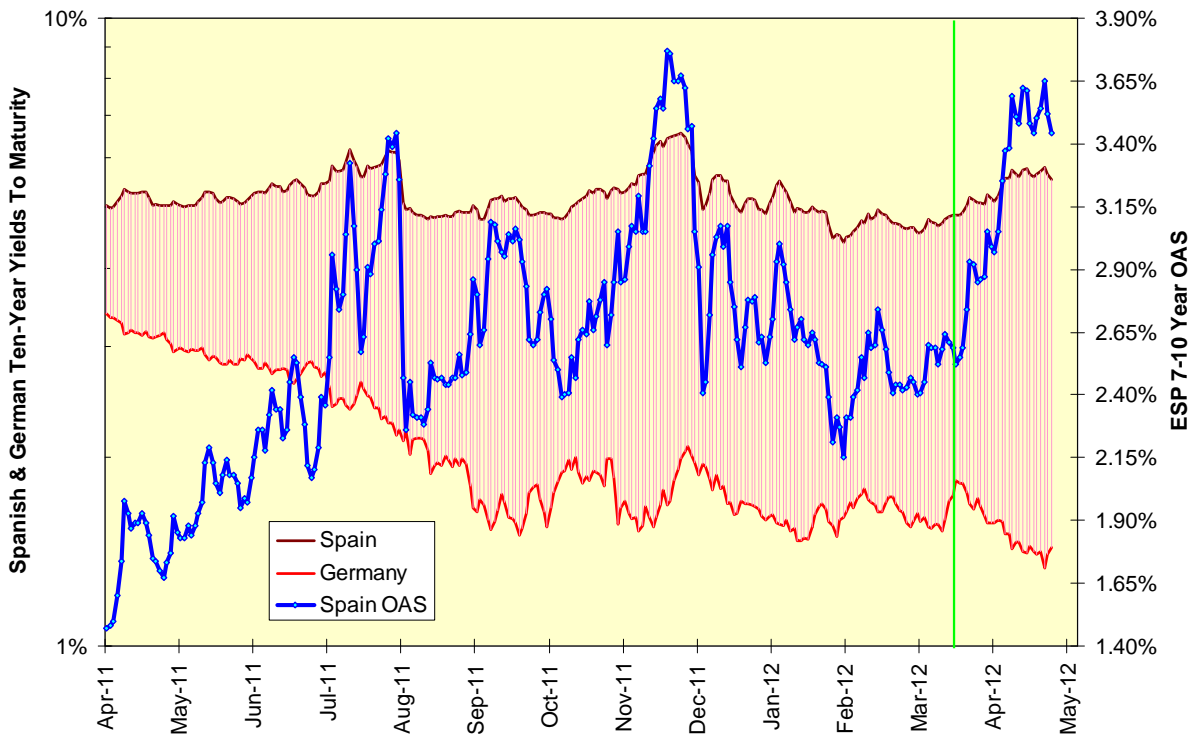
Money For Nothing Should Be A Nein On The Rhine

We economists are funny people; practicing the Dismal Science can do that to you after a while. I have stood aside while others have cracked their knuckles and tut-tutted over rising bond yields in countries such as Spain and Italy and have quoted these countries' bond spreads to Germany. Well, as Frank Sinatra sang, "That's life, and as funny as it may seem, some people get their kicks, stompin' on your dreams."

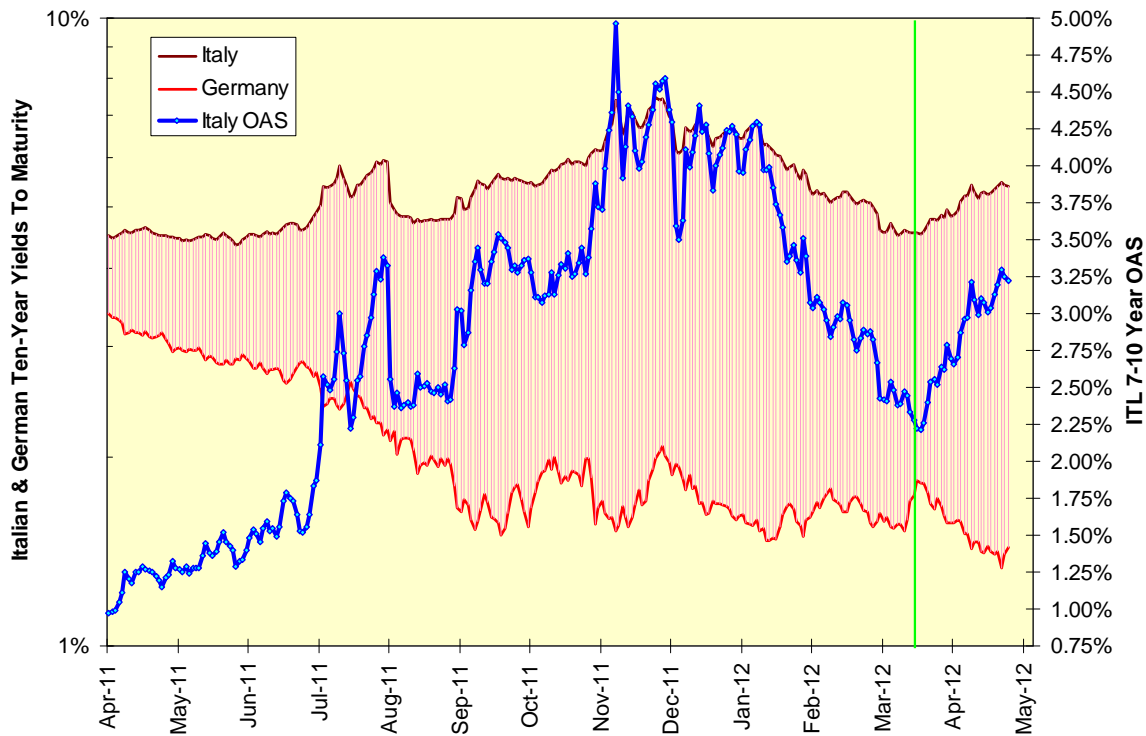
Me? I decided to ask the simple question whether German yields were falling faster than their Spanish and Italian counterparts' yields were rising. The simple fact I am discussing the topic should be your first and only clue as to the answer: German 7-10 year yields have declined at a daily loglinear rate of 1.01% since they reached a local maximum on March 20, 2012. Spanish and Italian 7-10 year yields have increased at 0.61% and 0.67%, respectively. This is equivalent to saying the panic to flee into German bonds exceeds the panic to get out of Spanish and Italian bonds.

I have plotted these yields below along with the 7-10 year option-adjusted spread between the Spanish and Italian bonds and what is purported to be a high-quality European index. Please note how Spain is worse off than Italy in the OAS department; whether they give out prizes for "less bad" I know not.

German Yields Falling More Quickly Than Spanish Yields Rising



German Yields Falling More Quickly Than Italian Yields Rising



On one level this may seem to be a statistical plaything. I disagree. If we have learned anything over the past quarter-century, a dubious proposition, it is every credit bubble begins as an interest rate bubble. It reminds me of a long-ago conversation I had with a self-made billionaire wherein he confessed to having done some stupid things when he first got to that level, "Because I could." The Greek and Irish austerity programs of today are the direct result of their debt binge resulting from their ability to borrow at a narrow spread to German rates.

How can Japan afford its 200%+ debt/GDP ratio (and please do not tell me because the Japanese lend to themselves)? How can the U.S. finance its expanding debt/GDP ratio at a net interest/GDP ratio near decade-ago levels? The answer seems to be, in all cases, a low debt service cost does not lead to lower debt levels; it leads to an expansion of underlying debt in a perverse twist on Say's Law that supply creates its own demand. Think of how the Clinton surpluses turned into the Bush deficits and the Bush deficits, enabled by an increasingly profligate Federal Reserve, turned into the Obama deficits.

I think this process will happen in Germany if low rates persist. Everyone likes to pretend they are virtuous until the freebies are passed about; then we find out how few aesthetes really exist. Just as absolute power corrupts absolutely, free money destroys prudence.