Finance 101 for Idiots. How To Fund a Cash Flow Insolvent Business Forever.

Imagine you wanted to issue bonds but no one would buy them from you. Now wouldn’t it be clever if you bought them yourself, but now you didn’t have the money to buy them, at least not until you issued the bonds. There is a way.

There is certainly no way you could do this in USD or GBP or any (barely) credible currency, but you could do it if the bonds were denominated in gift vouchers issued by you. Remember that if no third party will buy your bonds, you can only buy and pay for the bonds you issued with something else you issued. If, you did this in scale, however, at some point, you’d have more gift vouchers than inventory stock. At that point, the gift vouchers purchasing power must come under severe doubt.

How do you pay down a debt that is 7 times your nominal GDP? Well, first you have to reorganize it. But you have to do it without calling it a reorganization lest the cost of rolling the debt becomes too high. You have to reorganize it first by monetizing it. In a private enterprise in trouble, the first thing to do is to file a plan of reorganization, in consultation with the creditors, stop all interest payments on existing debt, reorganize the business, and reorganize the debt. No such orderly process exists for countries. The crucial step that has no analog for countries is the business reorganization. That’s where factor prices are realigned with productivity, lots of job descriptions get rewritten, lots of benefits get cancelled and lots of people take to the streets. You

can’t sell off a division of a country, although airport services, or banking supervision, might be good places to start.

Assuming that, after long discussions with unions, interest groups, political parties, serious men in suits from the IMF, and yes, even creditors, a business reorganization is agreed, there remains the reorganization of debt.

Interest expense needs to be cut. This can take the form of charging the interest on depleted notionals, or suppressing interest rates. One is a clear default, the other can be structured to avoid default. So far in the brand of capitalism that has evolved to reward success and forgive failure, suppressing interest rates is the preferred solution.

Ideally, most, if not all the debt is refinanced at these lower interest rates. As most of the debt will be purchased by a connected party, a local bank, the central bank, some hapless state or federal pension plan the effect on the banking system will be an inflated balance sheet which eventually invites inflation. Before the bulk of the debt is refinanced, interest rates will be suppressed at all cost. Once the bulk of the debt is refinanced, the balance sheet inflation will very likely result in inflation and rising interest rates. To keep interest rates low, the issuer’s opcos would have to maintain its purchasing of the associate’s debt. This seems clever, except that it will ultimately crowd out any external lender and place potentially catastrophic downward pressure on the currency.

This is the plan, by the way, for the US, UK, Japan and Europe. Some emerging market countries have already executed this trick decades ago, so everybody has a go.

Europe has been discussed ad nauseum so I shall not devote any serious analysis to it, just some naïve observations.

If you have a chain of restaurants and they have differing profitability, either the underperforming ones are ‘reformed’ or shut down. Or, the profitable shops must subsidize the unprofitable shops. If in aggregate

the whole is unprofitable then the prospect of the profitable subsidizing the unprofitable is simply not sustainable.

If the unprofitable ones seek credit lines to continue their operations, lenders will likely say no, or demand a huge premium. Left on their own, no one will lend them money. Everyone is happy to lend to the profitable ones of course but the returns will be understandably low.

The weak shops may of course call upon the group or holdco to help them finance themselves. One would expect the strong shops to protest or block such a funding strategy since it is clear where the cash flow to service the debt will come from. Now if the holdco was ultimately forced to assume the funding responsibility, the cost of its funding would certainly not be as low as that for a strong shop. Lenders would take into account the profitability of the weak and the strong in aggregate in pricing the debt.

If in aggregate the whole was unprofitable, then its cost of funds must rise impacting its ability to pay down the existing debt of the group as a whole.

This brings us back to the initial problem and its less than perfect solution of print-to-pay.

Shops may decide to spin-off and leave the group. The shops with the highest motivation to leave must be the strong, not the weak, since the weak have the most to gain and the strong, while there may be synergies to being in the group, will have to support the weak.

A sum of parts analysis would advise disaggregation of the shops.