Quarterly Newsletter / Autumn 2011

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When we wrote the last quarterly newsletter, we were witnessing a standoff between President Obama's administration and the Republican-led Congress over raising the US debt ceiling. The three big credit rating agencies, Standard & Poor's, Moody's and Fitch signalled back in March that America was in danger of losing its cherished triple-A debt rating if agreement could not be reached or the spending cuts were not big enough. Investors moved out of the dollar, resulting in gold, the Swiss franc and Japanese yen all being pushed ever higher.

However, as often happens in American politics, the hatchet was buried at the last moment and a compromise was reached, allowing the debt ceiling to be raised by US$2.1 trillion whilst agreeing to reduce government spending that will result in a debt reduction of approximately US$2.5 trillion over the next ten years. This is not the last we have heard of it, and we can expect similar power struggles at budget time in the years to come. It was an unedifying spectacle to watch some politicians remaining totally intransigent and refusing to change their dogmatic views in any way, and in this we are referring, above all, to right-wing Tea Party proponents. Standard & Poor's must have thought so as well, apart from considering the cuts insufficient, and only a week after Congress had reached an agreement, it lowered America's credit rating by one notch from AAA to AA+. The American stock market went into a dive (the biggest daily fall since the Lehman Brothers debacle in 2008), triggering a chain reaction around the globe, but investors largely defied S&P's opinion by piling into US Treasuries, proving that American debt still is perceived to be a safe investment. Mind you, just a couple of days ago we learned that China had sold US$36 billion of US debt, but that was more than offset by Switzerland, Japan and the UK between them having invested some US$60 billion.

Commenting on the American debt ceiling debate, George Soros had the following to say: "The US situation is mainly theatre, but the eurozone is in a real crisis." Too true: Greek sovereign debt had already suffered a succession of downgrades by the credit rating agencies, reducing it to junk bond status as early as April, but at the time of writing this newsletter, more countries' sovereign debt has been put on "downward watch" (France) or actually downgraded (Italy and Spain). Moody's cut the credit rating of French banks SocGen and Credit Agricole, and Standard & Poor's followed suit by downgrading no less than 24 Italian banks! Not to be outdone, Fitch cut the rating of Swiss giant UBS. Alongside, we have witnessed the virtual collapse of Dexia, the Belgian-French financial institution, which had to be bailed out, mainly by taxpayers in Belgium, France and Luxembourg.

Proof positive, if it were needed, that the contagion from Greece and other weak member states at its periphery has already reached the very centre of the eurozone. The eurozone has got itself into an impossible position where it cannot allow its banks, who hold most of the toxic debt, to fail. A real banking crisis in Europe would have awful repercussions that would affect the whole world, so the contagion would by no means end at the borders of Europe. It is for that simple reason that President Obama and Treasury Secretary Geithner used strong language when urging the leaders of the eurozone member states to get their act together and sort out this mess.

It is worth remembering that it was a Franco-German axis that was the driving force behind the various treaties that ultimately led to the EU, so it is somewhat ironic that the two leaders of those countries now are at loggerheads on how to solve the current crisis. In a nutshell, the Germans want the holders of the dodgy bonds to take a haircut – and here we are talking about a severe crew cut rather than a gentle trim around the back and the ears – which Sarkozy opposes as it would cause havoc for the French banks. At the end of September, Angela Merkel managed to convince the Bundestag to vote for yet another rescue package by supporting the expanded €440 billion bailout fund called the European Financial Stability Facility (EFSF). The vote was 523 for, 85 against, and 3 abstained, and it was a perfect example of elected parliamentarians reaching a clear-cut decision whereas the general public undoubtedly would have voted against it.

€440 billion is nowhere near enough to solve the eurozone problem. Considerably more money is needed. The latest - and slightly mad - idea is for the European Central Bank (ECB) to improve the financial clout of the EFSF by lending it sufficient funds to increase the bailout fund to €2 trillion, the amount reckoned to be needed to recapitalise the banks, provide a backstop for Italy and Spain and contain a Greek default. Does the ECB have the necessary money to do this? Well, not in actual cash, you understand, and it already has over €500 billion exposure to the various PIIGS countries (Portugal, Ireland, Italy, Greece and Spain) and banks by holding some rather questionable debt. In theory, however, the ECB can write whatever cheques it wants, but this would lead to a whole new ball game. It would change the framework of the relationship between the ECB and the EFSF, and the ECB would no longer be free from political influence, quite apart from the fact that such an exercise would lead to fiscal integration of the eurozone member states. On the other hand – and this is the real political agenda of some eurozone leaders and officials - *if* the ECB could be 'persuaded' to push through this deal whilst still *not* subject to member states' parliamentary approvals having to be sought, it would avoid another lengthy delay and save blushes like the Slovakian parliament voting against paying its share to the bailout fund two weeks ago. Rather odd that the newest member state, itself a rather poor economy, should threaten the very fabric of the currency it was so keen to join.

We said this solution was a slightly mad idea, and here is the reason why: if the IOUs acquired by the ECB through lending to the EFSF, who in turn lend that money to eurozone countries and eurozone banks, were *not* to be honoured, who do you think would bail out the ECB? The answer, bizarrely, is the eurozone member states that have been bailed out themselves by the ECB.

An altogether different proposal envisages the creation of a "new-style eurobond", which is different from the existing Eurobonds that we have known for nearly fifty years – they allow bonds to be issued in a currency that is different to the currency of the issuing country. The proposal is that these "new-style eurobonds" will be issued by a newly created eurozone debt agency. Not a very good idea either, I am afraid. Whilst the eurozone *as a whole* looks respectable in terms of credit rating (IMF figures reckon the whole eurozone debt amounts to 88% of GDP, compared to 98% in the US and 83% in the UK), but pooling the individual sovereign debts would remove the difference in yields between the member states' bonds, punishing the most creditworthy countries with higher interest rates whilst lowering them for fiscally weaker countries. Furthermore, not only would the existing EU treaties and some national constitutions need to be amended and a new debt agency created (just think of the many months all that would take!) but it effectively would render useless the EU's central powers to dictate terms to economically errant member states (like the PIIGS!). In essence, however, in case of defaults the end game would still be the same: the wealthier nations like Germany would pick up the tab.

The crunch comes this weekend at the Brussels summit, but hearing only today that Frau Merkel and Monsieur Sarkozy have already agreed to yet another meeting to be held immediately after this summit, we think it highly unlikely that proper progress will be achieved in Brussels. It yet again proves that the politically driven idea of the EU's Economic and Monetary Union was never properly thought through. Only now do we hear politicians begrudgingly accept that the single currency necessitates a fiscal and economic regime governing taxation and expenditure across the eurozone, but it is truly too late to change tack with the euro crisis in full swing.

It is obvious that Greece is in no position to honour its debts, nor will it be in the foreseeable future, and it is questionable whether further delays for the inevitable to happen are helpful. Greece *will* default; it just depends when and to what extent. Indeed, it might be in Greece's interest to abandon the euro experiment and revert to the drachma.

Greece has got the EU and its common currency, the euro, into serious trouble, but the EU itself has a lot to answer for, too. That may sound quite weird, but it is very close to the truth.

Before joining the eurozone, Greece experienced interest rates that were much higher than virtually anywhere else in Europe. For example, the Greeks used to pay roughly 10% more for their borrowing than the Germans did. Consumer credit like credit cards or mortgages was virtually unknown in Greece.

To the Greeks, becoming part of the eurozone and thus replacing the drachma with the euro promised a bright new world with cheaper credit and, more importantly, their borrowing effectively underwritten by the other eurozone countries, in particular Germany. However, there was a slight problem. To join the eurozone, a country needed to demonstrate that its budget deficit was less than 3% of GDP, and there were a number of other requirements under the heading "convergence". For example, inflation should not exceed 1.5% of the average three *best* performing member states. Without going into other requirements or benchmarks, these two alone were way outside Greece's capability. During the 20 years before joining the euro, Greek inflation mostly ran in double digits, and the budget deficit was massive.

State-run financial skulduggery is nothing new, but the Greeks took it to an altogether different level. In order to curb inflation, they slashed duty on alcohol, tobacco and petrol, and utility prices were frozen. To massage GDP figures, a lot of public spending was moved off the books, including expenditure in defence and state pensions! They quickly learned other tricks, such as securitizing *future* earnings like airport landing fees, road toll income and, believe it or not, even future EU handouts! In his recent book dealing with the crisis, the author Michael Lewis quotes a senior IMF official as declaring: "How in hell is it possible for a member to the euro area to say the deficit was 3% of GDP when it was really 15%?"

To make matters worse, this racket continued for years, and things got ever more exotic. In 2002, Goldman Sachs, undoubtedly against payment of a hefty fee, arranged for a loan-cum-currency swap which enabled Greece to hide its true debt to the tune of US$1 billion. Of course, this quasi loan will have to be repaid, and the German magazine Spiegel reckons that the related bonds will mature between 2012 and 2017, which will further exacerbate Greece's problems.

We said earlier on that the EU had a lot to answer for in getting Greece into trouble, and you may well ask what we meant with that statement. Well, it is almost unbelievable that there were no proper checks in situ that would have exposed Greece's financial hocus-pocus at the time it joined the eurozone. One could point the finger at the European Central Bank who, instead of scrutinizing the quality and veracity of potential eurozone entrants, was at that time squabbling over which country should be given a seat on its Executive Board. Transparency and accuracy have never been strong points of the EU, highlighted by the fact that the Court of Auditors have refused to sign off the EU accounts for the *last 16 consecutive years!*

The last few months have seen incredible volatility in financial markets. We already have touched on many of them, but stock market indices tell their own story. In the three months from July to September, Japan proved to be the least affected, recording a negative 11.4% in the Nikkei Dow. The American Dow Jones was down 12.1% and the S&P 500 down 14.3%. The Eurostoxx 50 was down 23.3%, not really surprising given the debilitating loss of confidence, and the BRIC index fared even worse, down 26.3%. The UK market's performance was relatively benign with a negative 13.7%.

Some calm has returned to equity markets, and most indices have recovered around 10% in the last three weeks. Clearly, the lack of certainty about the situation in Europe worries the whole world, not just investors, and the threat of a return into a double-dip recession is very real.

Let us hope that, just for once, someone at the Brussels summit shows some guts and real leadership. If that does not happen, it will be interesting to learn what Merkel and Sarkozy decide on after the weekend.

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