HARGREAVEHALE

INVESTMENT BULLETIN

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Greek Tragedy

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Extract from an interview between Lee Kuan Yew, the long time head of Government of Singapore and the German newspaper Der Spiegel:

Der Spiegel: When you look to Western Europe, do you see a possible collapse of society as a result of Globalisation?

Lee Kuan Yew: No, but I see ten bitter years ahead. In the end, the Europeans, whether they like it or not, will realise that the cosy world they created after the second world war has come to an end .....the old system has gone in the blink of an eye when two to three billion people joined in the race, one billion in China, one billion in India, and over half a billion in Eastern Europe and the former Soviet Union.

This does sound a bit apocalyptic. However apocalyptic is from the Greek word meaning: "a disclosure of something hidden from mankind in an era dominated by falsehood and misconception". This seems apt, from the Latin aptus.

Is Lee Kuan Yew hinting perhaps that we Europeans might have to start living within our means? What a terrible thought. Particularly to those of us used to the last two decades when ever lower priced manufacturing imports from the Far East abolished, in Gordon Brown's words "boom and bust". And when the "golden rule" of fiscal deficits was comprehensively rubbished, and fiscal incontinence reigned, obscuring the need to rein in consumer debt by the traditional method of raising interest rates.

Whoever occupies the Chancellors residence after the election will have a demolition job of some magnitude on their hands. Pre election the fight has seemed to centre around cutting an additional £6 billion to the additional £10 billion already planned by "attacking waste". £6 billion is a joke figure. You are probably going to require cuts of over £40billion a year by 2014 to get to grips with the deficit in any meaningful way. This is a big sum, equivalent to half the cost of the basic state pension, or twice the cost of the police or three quarters of the defence budget. As Gordon said to Nick recently on television: "Get real"

Talking about "getting real" the estimates of spending cuts required are based on some optimistic estimates of GDP growth going forward averaging 3.5%.

The reality is probably hikes in the big taxes such as VAT which raises about £80 billion, National Insurance, which raises £90 billion, or income tax which raises around £150 billion. Something fairly dramatic is going to have to happen, probably raising the rate of VAT or extending VAT to all areas where it is currently zero rated or a combination. Putting the VAT rate up to 20% and eliminating zero rating, for example could raise £30 billion. Combined with freezing benefits and tax credits, cutting funding to the Scots and the Welsh, cutting public sector pay or deferring public sector pensionable age and you could make a serious dent in the deficit.

Could it be done in the UK without rocks in the street, Greek style, and deaths in the streets, Greek style? Probably but much less easy in the context of a double

dip recession caused by the baleful influence of the global banking sector of the Greek tragedy now unfolding. The myth of Sisyphus condemned to an eternity of rolling a boulder up a hill and then watching it roll back again, springs to mind. For Sisyphus read the new Chancellor of the Exchequer.

During the course of the financial crisis, the massive imbalances accumulated by the private sector via the trading losses of the integrated banks and their counterparties in obscure derivative contracts, were by necessity shunted onto the balance sheets of Governments. Hence the Sovereign risk crisis now confronting markets exacerbated by the huge build up in consumer debt over decades which has weakened the ability of populations to withstand higher taxation.

The big, very big bet now is: Do Western Governments have the strength to live with the consequences of cutting back their fiscal deficits in the face of populations well capable of rioting and killing innocent bystanders in the process. Or will they decide to resort to the printing presses as the only way out.

The ECB and the IMF have finally launched a 110 billion Euro rescue package for Greece which will impose "severe" austerity on the Greek population. The public sector will no longer receive fourteen monthly payments for twelve months work every year, and the dozen odd registered millionaires in Greece may be joined by others as the tax authorities "get real". The package was designed to take care of the Greek Government's financing needs for at least two years. But unfortunately, the markets dismissed this emergency funding as being largely irrelevant. This was not just because of a growing perception that the Greek Government could well fall, but the beginnings of an acknowledgement of the scale of the problem. Since the package was announced the yield on Greek three year bonds rose from 11% to 17%. A little more sinister was the fact that yields on similar dated Spanish and Portuguese Government bonds rose by a full percentage point just this week.

This is important because the mark to market rules suggest that a lot of banks are going to make rightdowns on their sovereign debt, Greek and peripheral and they might find it difficult to fund their day to day operations if liquidity dries up. The problem is that European banks at present do not have huge buffers of capital as a result of the credit crunch and the lending debacle.

To get an idea of the scale of the problem, a leading securities house has made some guestimates of UK bank exposure. In particular, Euro "at risk" loans in relation to balance sheets. For example Barclays is indicated to have Euro loans of 99 billion, Euro risk bonds of 11 billion which compares with shareholders equity of Euro 47 billion. RBS is indicated to have EU risk loans of 92 billion compared with shareholders equity of Euro 70 billion. Lloyds is indicated to have Euro risk bonds of 24 billion and shareholders equity of 43 billion. In sharp contrast, both HSBC and Standard Chartered are indicated as having very limited direct exposure. But, may be it is a bit too early to get excited by the investment prospects of some of the UK banks.

In addition, there is substantial interbank and sovereign debt exposure and this is what is troubling markets at present. Greece owes a total of $236 billion, of which $45 billion is owed to Germany, $75 billion to France and $15 billion is owed to

the UK. Italy has debt of $1.2 trillion and of that it owes France $511 billion or nearly 20 per cent of French Gross Domestic product. Nearly one third of Portugal's debt is held by Spain and both countries credit ratings have been dropping. The result of this is that the cost of insuring bank debt has been rising all week. The cost of insuring Royal Bank of Scotland debt rose by 38 bps last week and yields have been rising in the corporate credit sector. The German man/woman in the street was quoted as saying: "Rescuing Greece is like a rat's tail. It will come round to hit us, our money will be worth nothing, there will be a big inflation and who will help us then".

There is a strong possibility he /she will be proved right. This is because if the Greek rescue does not work out as planned the contagion effects could be serious and the money available to finance the next bailout might not be there. Markets are already talking about the European Central Bank preparing for a one year loan facility of 600 billion Euros at one per cent to help out more than 1000 banks in their short term funding requirements.

No wonder that European Governments via the ECB and The International Monetary Fund have been keen to come to Greece's aid. And even after the recent 110billion loan there is still money in the kitty. Who paid up for the 110 billion Euroloan? 15 European nations provided a total of 80 billion, amongst them France providing 17 billion, Germany 22 billion and the US via the IMF providing something like 20 billion. The UK provided about 6 billion, by coincidence about the same sum relating to efficiency savings which the major political parties were squabbling over in the recent election. The IMF has probably a further 500 billion of immediate lending ability but there could come a point when the monetisation of these loans becomes a necessity.

The ECB has to date refused to consider the idea of quantitative easing. This means printing money and using that money to buy Sovereign Debt directly. Instead of forcing populations into austerity by raising taxes in order to pay back debt you devalue the debt by creating inflation. You do destroy savings in the process and you do create social disorder but it is an easier choice for democracies to make.

This might well happen sooner than expected. At a news conference this week the Governor of the European Central Bank Jean Claude Trichet when asked about quantitative easing, said: "We did not discuss this option", preferring to stake his credibility on the ability of countries on the periphery of Europe like Ireland, Spain, Portugal and Italy to maintain the necessary budget discipline at the core of the European Currency Union. Such denials are like red meat to famished tigers when it comes to foreign exchange markets. "We did not discuss this option" is translated as: "We did but we don't want to countenance such an option until it is too late."

Because of the size of the problem facing the European Union, the betting is that to save populations from rioting and to save banks from the consequences of their loans and to prevent the seizing up of credit markets, some note printing will be introduced either via the European Central bank or less directly via the IMF and the expansion of special drawing rights.

Once the markets got a sniff of this then the Euro would fall, exporters would thrive and some of the large European stocks selling into global markets, many of which are trading already on single figure price earings ratios would look very attractive. Seriously insane punters convinced that the choice of monetising debts had been made could even consider banks in Portugal or Greece, with some currently trading at or near long term lows. Too dangerous to touch them now, but come monetisation, the opportunity might present itself to very high risk speculators.

At the same time, monetising Euro debts would be very helpful for the UK authorities. Granted Sterling would be less competitive against the Euro, its most important export market, but the task of funding the UK'S fiscal deficit via gilt issuance and a revived quantitative easing programme would be made much less onerous. The Bank of England could rediscover its highly successful programme of buying Government bonds, with limited foreign exchange risk against the Euro.

As things now stand, financial contagion, far from being prevented as a result of the recent 110 billion Euro funding package appears actually in danger of spreading. This is because the package is dependent on deficit reduction measures actually being successful in Greece and the ferocity of the rioting has put this in doubt. The market now also appears to be turning its attention to Portugal and Ireland. These two countries have to refinance around 20 billion Euros of debt in the next three months and it is the case that that in macro terms both Italy and Spain are also vulnerable. Italy needs to deal with 125 billion Euros of bond redemptions between now and the beginning of August and Spain is facing 49 billion Euros of redemptions in the same time period.

In order to prevent the further spread of contagion, the Greek army and police, who have recently received pay increases, will have to be more effectively mobilised to prevent the deaths of any more innocent bystanders. Closer relationships between the European Central banks will have to be forged with the US Federal Reserve. It is estimated that US prime money funds provide funding of $83 billion to Spanish and Italian banks and this liquidity source might have to be replaced by the re-establishment of $ swap lines by the Fed.

In addition, you probably need some sort of EU Central Bank guarantee for all sovereign debt currently in the market, possibly the establishment of a new entity with a mandate to buy sovereign debt and fund it at the ECB. Failing all that of course you need to monetise the debt. This would upset the Germans it is true but they could always go out and buy gold instead which is probably what they will do anyway.

Meanwhile the crisis in Europe has provided the UK gilt market with something of a breathing space. It was helpful to us that everybody and his dog was short of Sterling and the conventional UK Gilt market well before the Euro crisis broke. The UK has the advantage of controlling its own currency, and of a much longer average gilt maturity profile (14 years), no big redemptions looming in the foreseeable future and a much smaller proportion of its gilts being held by foreigners (estimated less than 20% compared with up to 70% in some smaller European countries). It also faces the possibility of serious political leadership for the first time in a generation and reform of some of the Greek practices which

have been eroding the efficiency of the political and administrative establishment in the UK. It is sad that a very successful politician such as Luan Yew, a man whose long term strategic vision built Singapore into a highly successful country, should regard the UK and Europe as places where only bitterness will reign in the future.

George Finlay May 2010

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