

# Winter in Europe, spring in the U.S. and autumn in China

10 February 2012

By Lars Stouge

 JYSKE GLOBAL  
ASSET MANAGEMENT

## JGAM seminar in New York

On 27 January, JGAM hosted a seminar in New York, presenting and discussing together with business partners the outlook for 2012. The seminar was attended by almost 100 clients and prospects. In this Editors' Corner Report I summarize my presentation at the seminar.

## This time is no different

It should come as no surprise to us that the subprime crisis back in 2007/2008 is now followed by a sovereign debt crisis with an offset in Europe. Reinhart & Rogoff (2009) documents in their book, "This time is different", that historically sovereign debt crisis almost always follow banking crisis. The mechanism is the following: Private sector borrowing inflates housing and stock prices beyond their long-run sustainable levels and makes banks seem more stable and profitable than they really are. When the banking lead asset price bubble bursts, debt burdens become a challenge for the private sector. Ultimately the public sector has to bail-out private agents in order to contain a recession. The outcome is that governments are left with the debt problem.

## "One Market, One Money"

The sovereign debt problem in Europe is worsened by the fact that the euro is a one-size-fits-all-currency not suitable for the eurozone members. Europe was never an optimal currency area and the architects behind the euro knew this. Back in 1990 the EU Commission published its "marketing report" on the euro. The report carried the title "One Market, One Money" and it claimed that the euro would be "a positive-sum game" for Europe. The arguments were that the single currency would create microeconomic efficiency, macroeconomic stability and convergence between countries and regions. However, the EU Commission knew that there were challenges, especially with respect to convergence. Here is what the Commission wrote back in 1990: "*Italy and Spain have some adjustments to make... Greece and Portugal have larger adjustments to make*". Two decades down the road these countries are still struggling because the euro only made things worse.

## Europe was never an optimal currency area

The fundamental problem for the eurozone is that accumulated loss of competitiveness since the introduction of the euro in 2000 has created significant internal imbalances. Unit labor costs in countries like Greece, Italy, Spain and Portugal have increased to a level 30% to 40% above Germany's, and there is no "quick fix" left in the form of compensating currency devaluations – a single currency is a single currency. The EU Commission made a miscalculation back in 1990 when it "placed the wagon in front of the horse" expecting things to converge and normalize. On the contrary, the horse only got further behind and now we face a "runaway" wagon with unsustainable high unemployment levels in Southern Europe and Greece on the edge of default.

## Lender of last resort

It is almost as if the founding fathers of the euro had anticipated the crisis, expecting it to move members on to a monetary and fiscal union. Today we are lacking the fiscal part. Also, the European Central Bank (ECB) has been restricted, not being allowed to act as lender of last resort and bail out governments. When governments in a monetary union issue debt they do it in a "foreign" currency as they cannot control the printing of money. Therefore, the argument goes, the ECB should be lender of last resort and guarantee that cash will always be available to pay back loans. Opponents, like Germany and the ECB, argue that printing euro's to bail out governments would create inflation and moral hazard problems.

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My argument is that we should not worry about inflation in the present economic environment of low growth and even recession. In a financial crisis the money base (the balance sheet of the ECB and banks) and the money stock (money in circulation among consumers and investors) disconnect. The money never goes to work but stay on balance sheets in the financial sector who is hoarding capital to meet strict new capital requirements. Furthermore, until the ECB introduced its Long-Term Refinancing Operation (LTRO) in December, it had been nowhere near the U.S. Federal Reserve (Fed) and the Bank of England (BoE) with respect to Quantitative Easing (QE).

However, moral hazard is a real problem. The problem is that if the ECB guarantees that cash will always be available to pay out sovereign bond holders, it may lead governments to issue too much debt and become insolvent. Ideally, the solution is to impose rules that constrain governments in issuing too much debt. Furthermore, ideally functions should be segregated; (1) the ECB's lender-of-last-resort function should only be used when governments have a *liquidity* problem, and (2) the *solvency* problem should be left with another institute. This is what Germany is demanding should be written into a new EU treaty, realizing that the European Financial Stability Facility (EFSF) and the European Stability Mechanism (ESM) are poor substitutes for a true fiscal union.

## Austerity alone will not work

Tightening the screws on fiscal deviants may feel good but it will not work. At the EU summit 8-9 December 2011, Merkel and Sarkozy agreed on a "stability and growth union" or rather, as Martin Wolf puts it in Financial Times, 14 December: *"An instability and stagnation union... The single currency will come to stand for wage falls, debt deflation and prolonged economic slumps. Can this stand, however big the costs of a break-up?"*

In January S&P downgraded Italy to triple B plus with the following comments: *"We have not changed our political risk score for Italy. We believe that the weakening policy environment at European level is to a certain degree offset by a strong domestic Italian capacity."* Therefore, it came as no surprise that the new Italian prime minister, Mario Monti, made it clear to Berlin that he wants a return on his effort. *"There has to be a visible improvement somewhere else"*, he said with a clear message to Angela Merkel, the German chancellor. But Merkel is tough and keeps demanding committed budget discipline. On 1 March a new EU treaty is to be ratified, including not only the old 3% and 60% rules on budget and government debt limits to GDP, but a new 0.5% limit on the "structural deficit" will be added. Not many members of the eurozone can live up to all these strict fiscal rules. Therefore, expect to see a lot of (forced) saving going on in both the public and private sector as we go ahead, putting a significant break on growth for a very long time.

## An unavoidable haircut

It is no longer a question if Greece will default on its sovereign debt. The question is only when and if it can be controlled. The latter depends on a voluntary agreement with private investors of Greek bonds. If the haircut (i.e. loss on bonds) is set at an unacceptable high level, private sector involvement may not be possible and then Greece cannot count on a second bail-out in time to be able to repay 14.5bn euro (EUR) on bonds maturing 20 March. Greece will be bankrupt. The haircut bond holders are facing could be as high as 60% to 70%.

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## Firewalls high enough?

The EU, the ECB and the International Monetary Fund (IMF) – the troika – are aware of the risk that Greece will default. Therefore, they are trying to build firewalls around Greece high enough to prevent a default having a contagion effect on other vulnerable countries like Portugal, Ireland, Spain and Italy. When Greece got its first bail-out in May 2010 it was agreed to establish a temporary European Financial Stability Facility (EFSF) with the firepower of EUR 440bn. The EFSF is based on credit guarantees from eurozone members and when S&P recently downgraded a number of eurozone countries, including France, the EFSF was also downgraded. Therefore, the EU is planning to bring forward a EUR 500bn permanent rescue fund, the European Stability Mechanism (ESM). The ESM will draw on capital contributions as opposed to credit guarantees. Also, the IMF is seeking a U.S. dollar (USD) 500bn bail-out fund boost. However, demand for rescues are by some experts forecasted as high as USD 1 trillion.

## The ECB has averted a credit crunch

Maybe the single most important and most successful instrument so far has been orchestrated by the ECB. Back in December the ECB launched a Long-Term Refinancing Operation (LTRO), offering banks an unlimited three-year loan facility at favorable rates. Bids came in from 523 banks across Europe totaling EUR 489bn – equivalent to 5% of eurozone's GDP – and, not surprisingly, Italian banks top the list of ECB fund users. With the LTRO program, the ECB has averted a credit crunch, but the structural problems are still the same. Banks need to run down loan books and/or sell assets to free up balance sheets to become solvent. It is estimated that European banks lack EUR 115bn in order to meet a new 9% capital requirement. The new capital requirement should have been effective from June 2012, but luckily the European Banking Authorities have postponed the implementation.

## The euro is fair valued

What does all the trouble in the eurozone hold for the euro? On a long-term measure (the Purchasing Power Parity) the euro is strong compared to a fair value against the dollar a little above 120 USD per 100 EUR. Since 2008 the euro has been supported by the “risk-on” story. However, historically nothing lowers the euro faster than comparison with the dynamic potential of the U.S. and compared to Europe the U.S. is now moving fast ahead on all significant economic indicators. Add to this the eurozone's homegrown crisis and the euro looks vulnerable.

## Reaganomics turned upside down

However, the challenge is that the dollar also looks vulnerable. It has to do with a mix of tight fiscal policy and easy money that the U.S. is pursuing or eventually will have to pursue after the presidential elections. In the first half of the 1980s president Reagan created a policy mix of loose fiscal policy and tight money, driving the US real interest rate up, strengthening the dollar. Now, with fiscal policy turning austere, monetary policy will have to stay easy in order to avoid recession. This policy-mix puts a downward pressure on real interest rates in the U.S. and hence less capital inflow and therefore also less demand for the dollar. The question is which of the two weak currencies – the dollar or the euro – will be the weakest. We believe the combined strength of the U.S. economy and the ongoing eurozone crisis eventually will weaken the euro vis-à-vis the dollar.

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## The anatomy of a possible recovery in 2012

Worldwide, forecasts on growth are far below those expected a year ago. Only Canada, the U.S. and Germany are above or at pre-crisis GDP peak. It is a puzzle why drastic policy actions have only given such modest results. The answer is that deleveraging is holding back growth. However, the U.S. is set for a recovery. Productivity growth, subdued wages, the steady decline in the dollar since 2002 and rapid pay inflation in emerging economies have combined made the US competitive. Therefore, the US manufacturing employment growth now tops the G7. American manufacturing is maybe a dinosaur but it's still alive. Representing 12% of GDP manufacturing is not a trivial part of the U.S. economy. The ISM survey of manufacturing purchasing managers has taken a nice step up and is now north of 50, predicting expansion. A weak dollar is helping but increased productivity is holding back new employment. At 11.8m the U.S. employment is still 2m below pre-recession level.

## Governments of industrial market capitalist societies are bankrupt

Despite the positive outlook for the U.S. economy fact is that the current path of planned spending and revenue collection in both the U.S. and Europe is inconsistent. At present, Europe is teaching us that markets can take significant fiscal problems and make them catastrophic. Therefore, a crucial question is what avenue policymakers will choose as we go forward; the Keynesian way of "demand boost" or the Austrian school of "creative destruction"? With all the elections coming up this year the most likely path will be the Keynesian way of boosting demand, otherwise chances of re-election will be little. Also, in a historical perspective policy makers need to think twice and not make the same mistakes as during the Great Depression of the 1930s. Similarities between now and then are scary as evident from the following modified version of Paul Krugman's introduction to his book "The Return of Depression Economics" (my additions in brackets):

*"Most economists, to the extent that they think about the subject at all, regard the Great Depression of the 1930s (2010s) as a gratuitous, unnecessary tragedy. If only Herbert Hoover (Angela Merkel) hadn't tried to balance the budget in the face of an economic slump; if only the Federal Reserve (ECB) hadn't defended the gold standard (euro) at the expense of the domestic economy; if only officials had rushed cash to threatened banks, and thus calmed the bank panic that developed in 1930-31 (2011-12); then the stock market crash of 1929 (2012?) would have led only to garden-variety recession, soon forgotten."*

## Could China save us?

In 2011 emerging markets equities took a significant hit but maybe markets have taken a too pessimistic view on especially China. It is estimated that during the period 2007-2012 China will grow close to 60% (Emerging markets 50%), whereas growth of high-income countries only adds up to 3%. Furthermore, China's growth potential is far from exhausted as China's real income per head is only a fifth of U.S. levels. The world's best hope for growth is China's "advantages of backwardness". However, short-term China is in a slowdown, but we expect that the Chinese central bank will react by loosening the grip on banks and thereby boost the economy and avoid a "hard landing", i.e. avoid a significant drop in growth.

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## Risky assets could be set for a rally

Risky assets could be set for a rally as the recession fear diminishes. In 2011 we were concerned about four major risks:

- The U.S. returning to recession
- A Chinese hard landing
- A eurozone default
- Threats to eurozone banks

Entering 2012 some of these risks have diminished:

- U.S. growth is looking solid and improving
- China is going to land "softly"
- European banks have got access to unlimited liquidity

However, we still face risks:

- Default in Europe can still happen
- Middle East is unstable

On this background JGAM has entered 2012 with an increased exposure to risky assets while keeping protective investments in place to hedge against the non-trivial risks we still face.

## Editor

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