GLOBAL riskupdate

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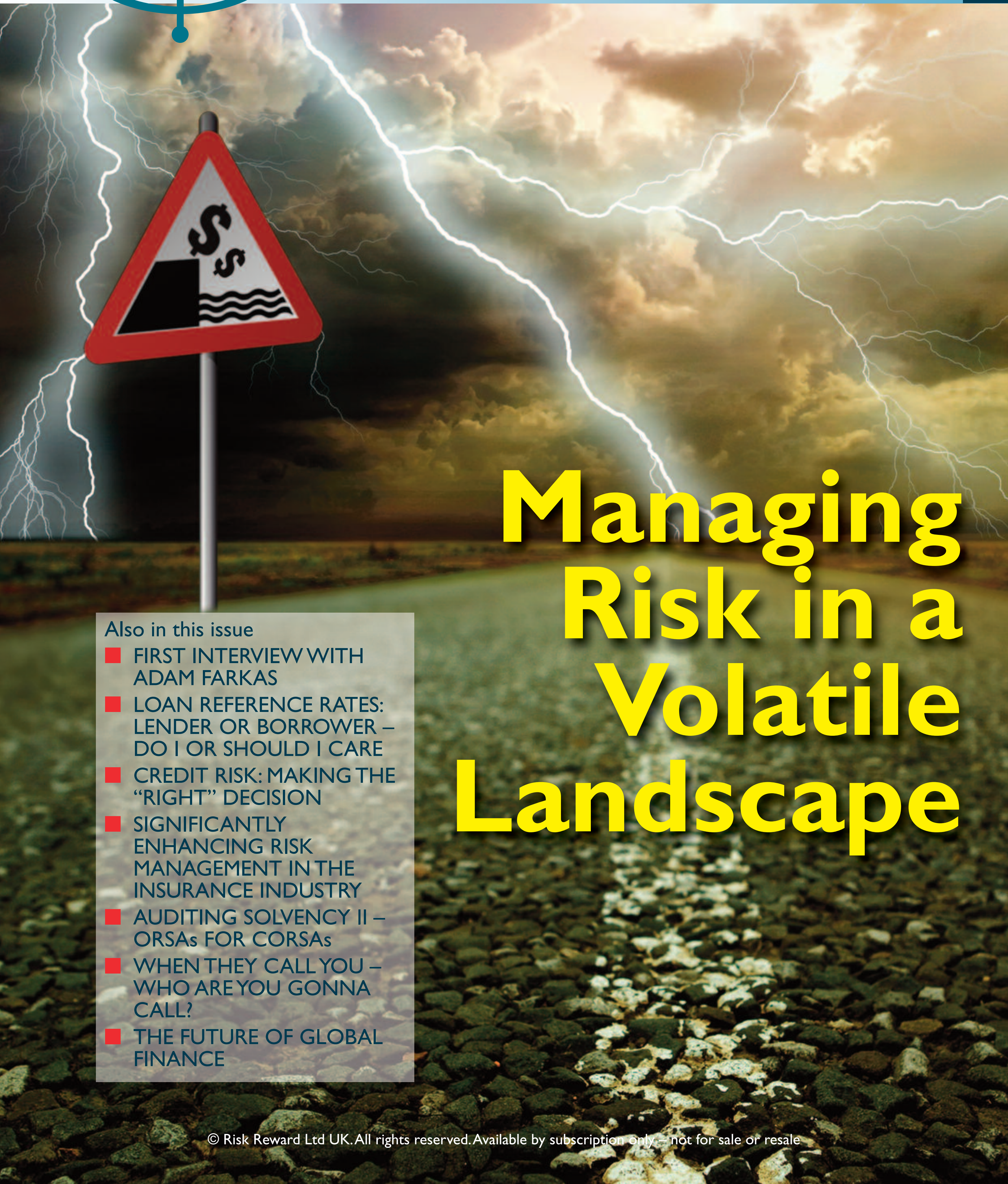

Managing Risk in a Volatile Landscape

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FUTURE OF GLOBAL FINANCE

In this article Dennis Cox, CEO, Risk Reward Ltd, addresses the problems of Europe, the case for European integration, the demise of the Euro, and the ultimate impact of Basel III on the global banking sector.

The financial crisis continues to rumble on. Now a variety of soothsayers and journalists are making their views known. Each sees a different problem yet each problem is essentially the same. Each provides a different solution yet each solution is also essentially the same. Regardless of what you consider to be the cause of the crisis or when it started, the current crisis clearly demonstrates a couple of obvious statements. These are that

- **Governments have been profligate for far too long**
- **Governments have spent rather than invested for growth**

The basic problem is that when you give people the keys to the cookie jar they are tempted to open it and eat the contents. Governments in a variety of countries have seen that it is relatively easy to borrow money and that if they fix the local rules in favour of government debt then this becomes even easier to achieve.

As funding becomes fatter with borrowing governments could avoid taking any action that might be considered to be unpopular such as increasing taxation or reducing expenditure. The consequence of this has been ballooning government expenditure. The unbalancing of the global economy and perceived security of state employment resulted in some of the brightest and the best going into the state sector. There is a real problem here. Since the state sector rarely adds value to society these resources are lost to the income generative segment of the economy.

The Problems of Europe

It is now widely recognised that the Euro was always at best a poorly designed political idea. The economics of the Euro were always weak and the benefits overstated. A currency that is effective in benign market conditions but is found wanting in times of stress is essentially a disaster waiting to happen. It seems to be a car crash in slow motion which we are now all watching with concern. Without full and complete financial and fiscal integration you cannot operate a single currency – it just will not work. As you try to stimulate the weakest you essentially continue to stimulate the strongest. So as a solution is found for Greece so you stimulate Germany; just as the US stimulation package effectively stimulated Asian economies.

Given that the euro was always a political fix with a variety of countries trying to show that their economies were aligned when they patently were not it will need a political solution. That means that there must either be only one Central Bank and one system of taxation for the entire Euro zone or the end of the currency. Nothing else will really work long term.

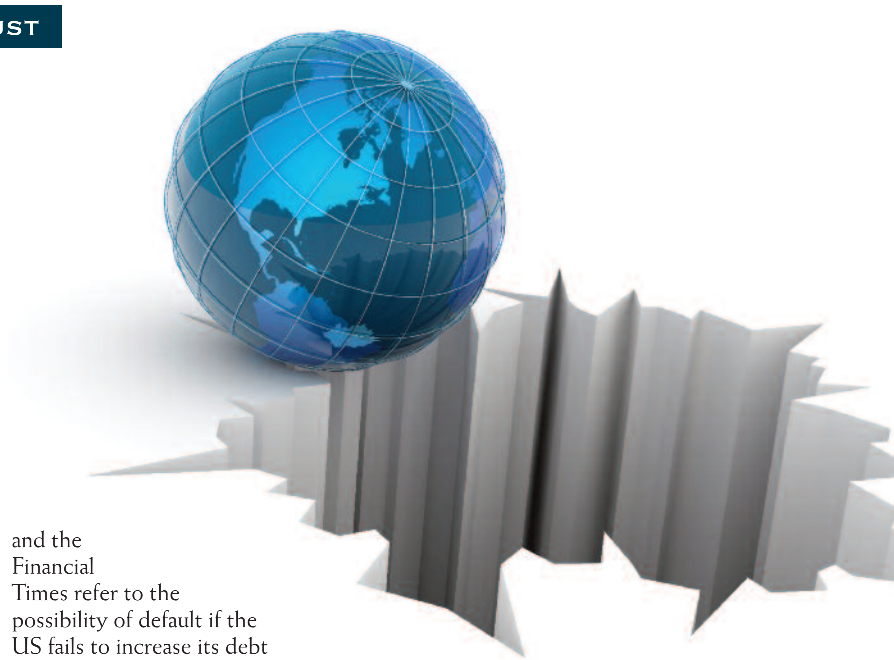
The Case for Euro Integration

The Euro zone consists of economies that are either industrial based (eg Germany) or agriculturally based (eg Greece) while others are a combination of the two (eg Ireland). That these economies can achieve correlation is in reality a mirage. The logic of integration is that since countries clearly cannot function apart with a single currency then they should function together. One system and one government leading to unified taxation and stimulus. The political ideology of integration takes little interest in the consequences of this action. Based on post Second World War ideologies and driven by politicians and bureaucrats the impact will be severe.

For perhaps a generation or more southern Europe will continue to decline. Younger vibrant populations will migrate to the north putting additional pressures on southern services. Civil unrest and poverty will be the unacceptable result. The integrationists judge that this is a price worth paying. With regret the author disagrees.
There being no rational reason for integration does not mean it will not happen. A political ideology can overcome any barrier even common sense.

The End of the Euro?

Can the Eurozone cope with a default of a sovereign? The answer to that question is a guarded yes. It will weaken the European currency and further defaults are likely to follow the initial default. However the currency can survive. Perhaps the right question is whether it is good for all countries and whether any country would have the political nerve to leave. It has been noted before that it is easier for the strongest country to leave the currency but since every turn within the currency has the effect of stimulating the strongest there is no reason why they should want to leave.



FUTURE OF GLOBAL FINANCE

It is also extremely unlikely that a country will be thrown out of the Euro so the only way out would be to liquidate the whole thing or for a weak country to leave. Considering the first option a political idea is hard to kill politically so that option is unlikely.

The second option is also rather unlikely due to the pressure that is certain to be put on the minor country to remain. Without a clear and certain mandate from its electorate and brave politicians it will not happen. However if it did, what would be the impact?

If a weak country leaves the Euro the Euro strengthens. This hurts the strongest exporters in Euro zone (eg Germany) which loses competitiveness. This could stimulate the weaker country now relying on its own currency. The question is who would provide the funding? Looking at the rate that countries such as Greece are required to pay currently for their debt, a minor increase on this would be a small price to pay for being able to reduce its currency. This would increase Greek competitiveness and stimulate its economy at the expense of the remaining Euro zone countries.

So there is a compelling reason for Greece to leave the Euro zone, although once again it is doubtful this would be allowed to happen.

So what will actually happen?

Our expectation is that there will be further integration in Europe and that all countries will stay in the Euro zone. The consequence of this is that there will be a migration of talent from the southern European states to the north resulting in increasing disparities in living standards.

Europe does not stand alone in its weakness. The USA and Japan are but two major players with similarly intractable issues to deal with. The difficulty of dealing with ballooning deficits haunts the US and the press openly identifies the possibility of default. With the following comment the author recognises its significance. There is no way that the US is actually AAA under any rational basis. On a day that both the Wall Street Journal and the Financial Times refer to the possibility of default if the US fails to increase its debt ceiling then a foreseeable default event can occur. That is not AAA nor is it the only challenge the US faces.

Perhaps a more appropriate rating would be A+ which of course is investment grade but identifies that there are foreseeable events that could impact the ability of the country to meet its obligations. The US cannot continue to use the world's resources without adding value. Investing for growth and value is one thing but just spending it is another matter entirely. The US economy needs to get back into balance and quick to enable the debt markets to return to normality. It is the continued overhang of deficits which means that debt markets continue to be distorted.

We need to create a financial environment in which companies that create wealth and employment are able to flourish. The current position whereby lending to government becomes the mainstay of financial innovation has to come to an end. Further it is small company growth that needs to be encouraged. If every small company hired one more person then unemployment would reduce and wealth increase. However the current international policies have the opposite effect and small companies unable to raise capital wither and die.

The Impact of Basel III

We now have the major discussion about identifying those institutions that are too large to fail and then to impose additional capital requirements on them. These are of course the same institutions that have managed to survive the crisis and they are not to be penalised because they have been successful.

This will all change and quite quickly. The argument is expected to move from "too big to fail" to "too small to succeed". If you move the playing field against the larger firms what normally happens is that other participants move into their space. The fallacy of current thinking really relates to what it is to be a bank. Remember that it is deposit taking which makes a bank a bank. Other firms can lend money, undertake funds transmission or treasury services. You do not need a banking license to undertake these profitable and risk – weighted, asset- heavy activities.

The consequence is obvious. The profitable areas of business will separate from the deposit taking activities and leave the banking industry. Fiduciary responsibility will be maintained for the declining band of banks holding on to their historic banking models while newer, younger non- banks take advantage of the ill -designed regulation to undercut profitable business.

However the next crisis (which will be different to the last crisis) will hit smaller firms hard and will highlight that capital is not the best way to regulate the financial services industry. Better ideas from leading bodies are needed, something that is not even being allowed to be discussed at present. Global coordination, reduced government deficits, reduced capital requirements innovation and growth will all have their time in due course. Let us hope that most of us will be still around to benefit.

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