The Absolute Return Letter
September 2012

How to Unscramble an Egg

"I think we will look back in ten years' time and say we should not have done this, but we did because we forgot the lessons of the past."

U.S. Senator Byron L. Dorgan in 1999 on the repeal of the Glass-Steagall Act.

John Mauldin often jokes that when a banker becomes a central banker he is taken into a back room where he is re-programmed to say and do only what central bankers are meant to say and do. Following John's logic, the Bank of England's 'DNA adjustment' team was obviously on leave when Andy Haldane[1] was recruited, such was the audacity of Haldane's speech in Jackson Hole last week. Mind you, Jackson Hole has developed a bit of a reputation for being the one venue where central bankers can speak their mind without taking too much career risk and last week's annual gathering didn't disappoint in that respect.

This year's 'cat amongst the pigeons' award went to Haldane for suggesting that bank regulators should tear up the Basel III rule book and start all over again with a few simple rules on borrowing and capital standards (see here for details). When Haldane made his speech I had already written most of this letter, so his delivery came as manna from heaven. I couldn't have asked for a better endorsement of what is to come in this letter.

Having spent much of the summer on a mountain side in Mallorca where there is not much else to do but read and think, I have given a great deal of thought over the last few weeks to what I call 'root problems' versus 'symptoms'. Excess leverage in UK households or Spanish banks is a symptom, not a root problem. If we are going to give ourselves an odds-on chance of disentangling the almighty mess we have created for ourselves, we must begin to address the root problems in earnest. 'Fixing' symptoms fixes nothing. All you achieve is to kick the proverbial can another 10 metres down the road.

A root problem, on the other hand, is usually a policy mistake created by policy makers – not as a result of any ill intentions but because our political leaders are often misguided or misinformed. So let's jump straight in. I have identified five policy mistakes all of which must be sorted out but none of which are straightforward. Addressing them will be painful, it will take time and, lo and behold, if certain elements inside the Republican Party get their way, we will soon add a sixth root problem to the already long list - more about that at the end of the letter.

Policy Mistake # 1: *The repeal of the Glass-Steagall Act*

The U.S. Banking Act of 1933, better known as the Glass-Steagall Act, limited the ability of commercial banks to engage in investment banking activities. Unwinding the Glass-Steagall act in 1999[2] allowed for the

[1] *Andy Haldane is Executive Director responsible for financial stability issues at the BoE.*

[2] *Strictly speaking, the Glass-Steagall act was gradually unwound over the prior decade, making the 1999 decision to repeal the 1933 Act a formality more than anything else. It should also be noted that, although the 1933 Act regulated U.S. banking activities only, the Europeans followed suit with similar types of deregulation.*

introduction of financial supermarkets and resulted in a massive escalation of leverage on the banks' balance sheets.

You know something is not quite right when the leading proponent of financial supermarkets – none other than former Citi boss Sandy Weill – openly admits that it was a mistake to repeal the Glass-Steagall Act (see here). Although Sandy only said what the rest of us have been thinking for at least a couple of years, his remarks should prompt some soul searching amongst everyone involved in the running of our banks, and that would include regulators and policy makers as well.

Now, the 1999 repeal alone is not to blame for all of the problems in the banking industry today. The rating agencies did their very best to get in on the act by adopting a more lenient approach when applying their ratings. Junk was magically turned into investment grade and everyone was happy. The Basel II rules, which took a risk-based approach to leverage, suddenly allowed sleepy retail banks, which had never before ventured into anything more exotic than commercial property loans, to fill up their balance sheets with Ladas and Trabants, labelled as Audis and BMWs.

The balance sheets of the banks ballooned in the process. In Europe, banks that had hitherto never gone beyond 10-12 times leverage, suddenly found themselves with a balance sheet over 40 times the size of their equity capital. In fairness to the American banks, the madness over there didn't go quite so far. At the peak of the leverage bubble, if my memory serves me well, the average U.S. bank balance sheet was 20-25 times leveraged, yet enough to cause serious constipation, when it was found out that the emperor wore no clothes.

This was standard practice in the U.S. as well and one of the major contributing factors in Lehman's demise.

In one of the banks I worked for before I started Absolute Return Partners, the then CFO even bragged to me one day how he could – and did – 'play the system' by ramping up the balance sheet as soon as a new month had begun, only to bring it back down to more modest levels again as the next month-end approached. This way the stated leverage was rarely more than 25-30 times whereas, in practice, it was almost always over 40 times – sometimes well over. There wasn't even a hint of shame when he told me the story. He was in fact quite proud that he had it all figured out.

The problem with such an approach is that, for the model to work, you need liquidity – in fact a lot of it – as the same bank was later to find out. The true lesson of this story, though, is that more regulation isn't always the answer. On balance, Canada's banks are not more regulated than US or European banks, yet they weathered the financial crisis much better than their colleagues south of the 49th parallel.

Enter Haldane. The rules need to be simple to work. Keeping retail banking separate from investment banking is a simple rule. We can then all go to bed every night not having to worry about our hard earned dosh, should the derivatives desk blow up overnight, because the retail bank that holds our deposits doesn't *have* a derivatives desk. And should the investment bank that *does* speculate in those markets get it horribly wrong, there will be no need to apply taxpayers' money for a rescue mission as there is no systemic risk. (And I note that the mere fact that the investment bank operates under the knowledge that there is no tax payer financed rescue package waiting for them, should things go haywire, should be enough to change the attitude towards risk.)

Maybe we should learn from the lessons learned in the Dutch town of Drachten[3]. A number of years ago the local council took the seemingly drastic step of removing all traffic lights, most road signs, lane markers and other devices designed to control the traffic flow through the city centre.

[3] *The Drachten example has been borrowed from Dylan Grice at SocGen with gratitude.*

The result? The local residents complained at first because they *felt* less safe, which was exactly the objective of the exercise. When you feel less safe, you slow down and you seek eye contact with your fellow drivers and pedestrians. The experiment has since been repeated elsewhere and the result is the same – a dramatic reduction in the number of accidents everywhere the 'naked street' approach (as they call it) has been introduced.

What has this got to do with risk taking in the financial markets you may wonder? A lot, I would argue. The rating agencies told us that any AA or AAA rated paper was safe, just like the little green man does when he shows up at my local traffic junction to tell me that it is now safe to cross the street. Human beings have an inclination to switch their brains off when operating within a system that is perceived to be safe. Hence a (part) solution to the financial crisis could very well be to make it appear as if the financial system is less safe. Fewer and simpler rules will achieve precisely that. Regrettably, policy makers - bar Haldane - appear to be moving in the opposite direction.

Policy Mistake # 2: *Permitting mercantilism*

The Asian financial crisis of 1997 was resolved through massive devaluations in the foreign exchange markets. Along the way someone forgot to insist on the devaluing countries gradually bringing their currencies back to 'fair' level, resulting in the mercantilist approach that continues to permeate the region and which has resulted in monstrous imbalances in global trade.

Mercantilism refers to countries engineering artificially low exchange rates to make their goods attractive to foreign buyers. This has allowed Asian economies to be more competitive versus U.S and Europe.

I have discussed this topic before – most recently in the July 2012 Absolute Return Letter (see here) – so I shall spare my readers too much added colour; however, this topic is too important to let go.

For well over a decade now, China has managed to persuade the West that what is good for Chinese stability (i.e. more job creation in China) is somehow good for the rest of the world. The argument has been used to justify a closed capital account combined with a currency pegged to the U.S. dollar. And the amoebae running the show in the West have taken it at face value and let the Chinese get away with 'murder', resulting in the loss of millions of jobs in the West.

More specifically, when China entered the WTO in 2001 it was on the strict condition they opened the capital account which they promised to do. At the same time they agreed to remove a number of other trade policies designed to protect their industries. When the Chinese didn't deliver on their promises, the amoebae sat back and did nothing.

I rest my case. Woody Brock, our economic adviser, puts it better than I ever could: *"The governments of the West really do rate a D– in Bargaining Theory 101, whereas China rates an A+."*

One day the West will appoint a government, be it in Europe or the U.S., who won't play to the Chinese tune anymore and trade war will be the inevitable outcome. In the meantime, the Chinese and, not to forget, many of the ASEAN countries in South East Asia will continue their mercantilist approach to the detriment of jobs in the West. Sadly, the amoebae will continue to think that it is over-consumption in the U.S. that is the root problem when it is in fact the West permitting many countries not to play by the rules of true capitalism that is the root cause of today's imbalances.

The solution is astonishingly simple. Do not make empty threats. The moment Asia realises that Western threats are to be taken seriously, their behaviour will change. It will be a true game changer.

Policy Mistake # 3: *The European Monetary Union*

Most currency unions fail, and they do so because the building blocks for a successful union are not in place. The euro has been no exception. In short, the economic conditions of all member countries must be

The U.S. can be thought of as a currency union with 50 members, but each of those members is required to operate with a balanced budget unlike the countries of the EMU.

broadly similar for a currency union to prosper. Introducing the euro back in 2002[4] was in principle a good idea but it was poorly executed. The public was led to believe that the 'experiment' was successful, which was possible only because economic conditions in the first six or seven years of last decade were extremely benign. The moment the economy turned ugly, the wheels came off one by one.

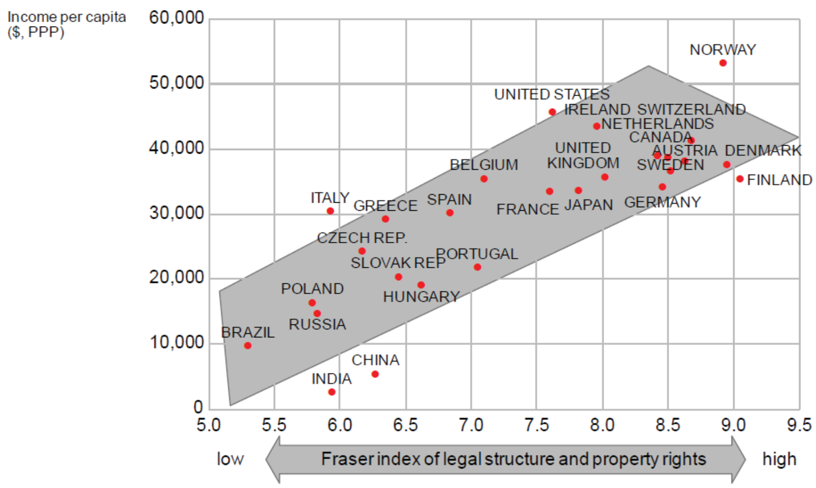
Throwing money after Greece is akin to applying morphine to a cancer patient. The euro will not become a sustainable currency before its root problems are addressed. The good news is that it is indeed possible to do so but it will take years to fix these problems.

When you follow the eurozone crisis in the media you are frequently led to believe that the root problem is just that – a single, easy to understand, problem. At least nine out of ten commentators have pointed at the lack of competitiveness in the periphery due to an escalation of unit labour costs relative to those of the core; however, unit labour costs are only half the story. The truth is somewhat more complex.

It should come as no surprise that the key drivers of economic output within a country include factors such as the size and growth of the workforce and the capital available for investments. What is less obvious is that a number of 'soft' variables such as labour market flexibility, economic freedom, the quality of the legal system (contract rights and property rights are particularly important in this respect) and the intrusiveness of the government into the business sector all play a role in defining the quality of a country's economic life. Jointly, all these soft factors are known as the *incentive structure*.

Back in 2010, Woody Brock invited management consultant Dietmar Meyersiek to do a study on the link between incentive structures and the quality of economic life in many countries around the world[5]. Meyersiek measured a country's incentive structures through a number of variables, and found that many of these had a significant impact on income and wealth in a country[6]. I have included a couple of Meyersiek's tests in charts 1-2 below.

Chart 1: Quality of Legal Structure Correlates with Income



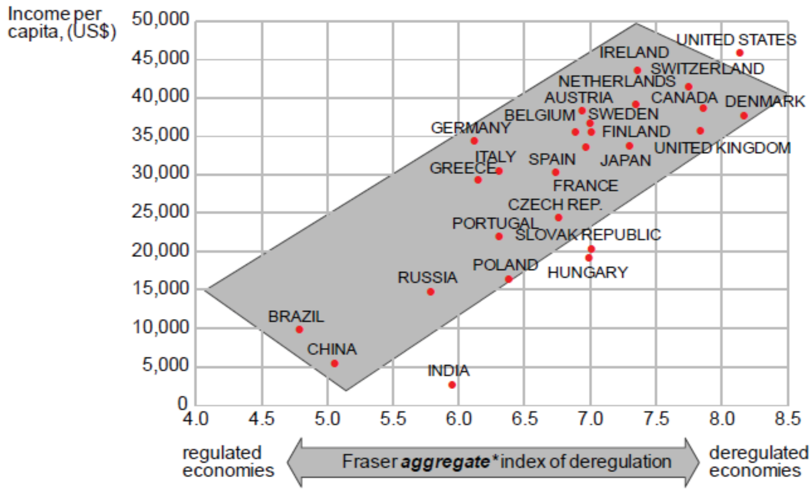
Source: SED Profile # 102, October 2010, Dietmar Meyersiek, Fraser Institute

4 *The euro was actually introduced as an accounting currency in January 1999 but only came into circulation in January 2002.*

5 *See Strategic Economic Decisions, Profile # 102, October 2010.*

6 *In his study, Meyersiek was very cognizant of the risk of confusing correlation with causality and consequently used an exploratory statistical technique called CHAID which is particularly appropriate when using a large number of variables. Meyersiek had about 140 countries in his database and up to 75 variables for each country, covering the period 1970-2009.*

Chart 2: Less Regulation Means Higher Income



Note: Regulation refers to regulation of credit, labour and business.
Source: SED Profile # 102, October 2010, Dietmar Meyersiek, Fraser Institute

Meyersiek subsequently went beyond a simple bi-variable analysis and found that three variables between them - property rights, government intrusiveness and business regulation – explained about 77% of the variance of GDP per capita amongst the approximately 140 countries in the study.

These results have profound implications for the eurozone crisis because, on all three factors, Latin Europe falls well short of Northern European countries. The conclusion is obvious: For the euro to become a sustainable currency, not only must Southern Europe deal with its unit labour cost problems but it must also change some far more fundamental things in life, such as the quality of its legal system, how it regulates businesses, etc. etc. Issues such as these are not easily changed and will, even under the best of circumstances, take many years to address.

Policy Mistake # 4: *Austerity misunderstood*

Austerity has been brandished as the all-singing, all-dancing solution to Europe's problems, but it carries severe side effects. It destroys economic growth, leading to a fall in tax revenue (how could that possibly come as a surprise?) and thus to a rise in sovereign debt – precisely the opposite of the policy target. Worst of all, it leads to a sharp increase in unemployment with potential catastrophic consequences - social unrest at best, possibly worse, which is an extraordinary price to pay for an economic experiment.

The solution is simple, yet poorly understood. Let's start by lining up a simple piece of arithmetic. Take country X which runs an annual budget of £700 billion a year of public spending. Tax revenues amount to £600 billion so, according to conventional thinking, there is a deficit in the public finances of £100 billion. This country has a government that has been led to believe that the deficit must be eliminated at all cost, so it engages in some rather severe cost cutting. The size of the public sector is cut back, new public investments are curtailed, more children are stuffed into each class room, etc. etc. You know the drill.

What the rather one-dimensional finance minister (some might know him better as the Chancellor of the Exchequer) didn't quite understand when implementing these spending cuts was the effect the cuts would have on taxes and unemployment benefits. Taxes collapsed. Unemployment benefits took off. Suddenly, what looked like a brilliant idea on paper didn't quite work in practice. The country got stuck in economic quicksand from which it is finding it near impossible to escape.

Now, let's assume that the £700 billion this country spends is divided into £600 billion of what I will call *unproductive* spending and £100 billion of *productive* spending. Productive spending means anything that the government can earn a return on in the future, e.g. toll roads, airports, and other income-generating, infrastructure-enhancing projects. Unproductive spending is everything else - interest on public debt, public administration, defence, social benefits, etc. This distinction is critical because the bond vigilantes will see a rise in unproductive spending as a problem for future generations, hence the cost of borrowing may go up. On the other hand, a rise in productive spending will be seen as a non-event as it will be self-financing over time.

The solution is thus glaringly obvious – the aim must be to re-distribute public expenditures away from unproductive spending towards productive spending. By doing that, our country in question can continue to run a deficit whilst maintaining its good standing with the bond vigilantes (and the ratings agencies, should anyone still care what they have to say). Most importantly of all – the economy continues to grow which is a pre-condition for digging itself out of the mountain of debt that it is currently stuck in.

We all know that there is tremendous waste in government programs. Why is it so hard for politicians to eliminate it?

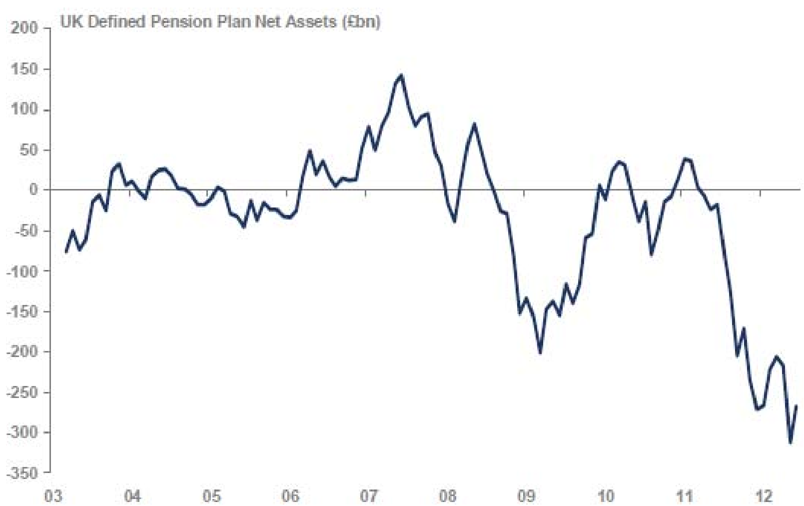
The obvious challenge is that unproductive spending buys votes (mainly through transfer payments such as social benefits) whereas productive spending does not. Since most policy makers find it next to impossible not to bribe the electorate, it would require an altogether different mentality amongst the political leadership to steer the country in our little example towards long term prosperity through such policy change.

Policy Mistake # 5: *Ignoring pension liabilities*

Another topic where politicians choose current votes over long-term viability of Social Security and Medicare.

Pension and other age related liabilities have been largely ignored by our political leadership in recent years; however, ignoring the problem will only make it bigger with potentially devastating consequences, as the ostrich found out a long time ago. I have written about unfunded pension liabilities before so no need to dwell too long on this topic. However, the problem continues to grow and *nothing* is done. It is quite simply a disgrace. The newly elected French president even had the nerve to increase the retirement age for some people. Admittedly a small number of people were affected, but it sent all the wrong messages in terms of what is required to solve the pension crisis.

Chart 3: UK DB Plans' Pension Deficits at Record Levels



Source: Morgan Stanley, UK Pension Protection Fund

Meanwhile, here in the UK, unfunded pension liabilities for defined benefit plans have reached £300 billion (see chart 3) whilst our political leaders continue to sit on their hands in the belief that it will be the next generation of parliament who will have to deal with this little 'inconvenience'. And do not for one second believe that this problem is confined to the UK. To varying degrees, virtually every country with a pension industry has a massive task ahead of it in terms of explaining to its people that the pension model as we know it is bankrupt.

Again, the solutions are relatively simple, yet immensely painful and cannot exactly be described as vote winners. Increase the retirement age to 70, possibly even 75 (note to President Hollande: dust off your English dictionary - 'increase' means 'up', not 'down'). Convert all defined benefit schemes to market based schemes and have every pension scheme member take a haircut so that the 30 year olds won't wake up in 20 or 30 years' time realising that they have just been subject to the biggest Ponzi scheme fraud in history. Any takers?

Policy Mistake # 6?

A return to the gold standard

On 23 August the FT ran a story that caught the eye of even the most casual reader – *"Republicans eye return to gold standard"* (see details here). The Republican Party in the United States is apparently taking a serious look at whether the link between the U.S. dollar and gold should be restored, yet it remains unclear what the true motive is. Maybe the aim is just to appease the Tea Party movement who have long expressed their dislike of the policy currently being pursued by the Federal Reserve Bank which they believe will ultimately result in (hyper) inflation. Maybe there is another agenda. Maybe, just maybe, they truly believe that a return to the gold standard is the solution to our current predicament.

We won't likely go back to the gold standard - strictly limiting the amount of currency the government can create - but every bout of hyperinflation in history was preceded by a government untying a currency from some standard and then unleashing a torrent of paper money. Lords of Finance is brilliant but requires a bit of patience - 576 pages worth.

Anyone who believes that should be forced to read *Lords of Finance* by Liaquat Ahamed. The book, which I rate as the best business book I have read in recent years, spells out why the gold standard didn't work and why it was a major contributor to the great depression in the 1930s. The gold standard amplified the economic cycle back then just like the modern gold standard – also known as the European Monetary Union – has amplified the economic cycle in recent years.

For those of you with not enough time on your hands to go through Ahamed's masterpiece, I suggest you read Barry Eichengreen's piece from last year called *A Critique of Pure Gold* (see here). Now, if you are still not convinced, I kindly ask you to provide a valid response to the following question raised by Ambrose Evans-Pritchard in the Daily Telegraph recently:

"Quite why gold bugs think that the Gold Standard prevents asset bubbles and excess debt is beyond me. The 1920s saw US debt levels surge to around 300pc to 350pc of GDP. It is very similar to what occurred in our own Noughties up to 2008."[7]

Re-introducing the gold standard would be a monster mistake on par with the (premature) introduction of the European Monetary Union. It will certainly become policy mistake # 6 on my list of major policy blunders.

(For the record, please note that my views on the gold standard have nothing to do with my views on gold as an investment object. Just because the gold standard is a seriously bad idea doesn't mean that gold is a bad investment - actually far from it. We hold gold in virtually all our private client portfolios and are likely to continue to do so.)

Conclusion

I note that several of the policy mistakes listed above date back to the same period, namely the late 1990s. Not only does it demonstrate the gung-ho approach of the time, but it also goes to show that policy mistakes do not necessarily rear their ugly heads immediately and, by the time they do, the damage has been done.

[7] *See Ambrose Evans-Pritchard's blog here.*

The unintended consequence of these, and other, policy mistakes is uncertainty. Uncertainty has a nasty habit of creating sub-par economic growth for the simple reason that it holds back the inclination to invest as pointed out by good friend Sushil Wadhwani in a recent piece in the FT. One study suggests that US GDP growth was impaired by over 3% between 2006 and 2011 due to uncertainty (see Sushil's article here). I can only speculate about the corresponding number for Europe!

Now to the good news. The optimist in me sincerely believes there is a way forward. As I have demonstrated above, there is indeed a solution to each and every of the policy mistakes made in the past. Admittedly, some are more easily addressed than others, but they are all fixable. However, the most important point you should take away from this month's Absolute Return Letter is that the eurozone crisis cannot be viewed, neither can it be solved, in isolation. Several root problems lie underneath it. Only when policy makers begin to realise this will we be able to, once and for all, leave the problems of the past few years firmly behind us.

Niels C. Jensen
6 September 2012

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