The Issues

September 1, 2011

DYSFUNCTIONAL FINANCIAL SYSTEMS

During the 1970s and 1980s, recessions were driven by central banks' monetary tightening and hikes in interest rates, implemented to fight inflation as economies overheated. However, over the past two decades, major regional and global recessions have resulted from complex dysfunctions in financial systems which have caused dislocations in the real economy. The reasons only became apparent in the aftermath. Witness the following recent examples.

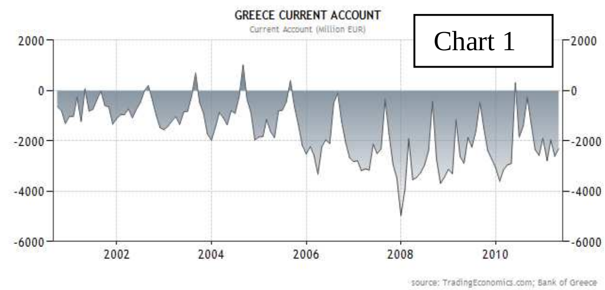
The Asian financial crisis in 1997-98 resulted from a system of exchange rates pegged to the U.S. dollar (the dysfunctional element), which kept interest rates too low for too long; that, in turn, led to over-consumption and over-investment. For years foreign credit funded expanding current account deficits. When those funds exited, the Asian economies collapsed.

In 2004-07, the proliferation of asset-backed securities (ABS), the dysfunctional element, fueled U.S. credit creation and the bubble in subprime loans. Securitization increases the velocity of money because the same dollar is loaned more than once. When the U.S. housing market rolled over, ABS valuations became problematic since potential losses on lower-quality loan components in the securitized pool expanded as the economy slowed. Because banks had ABS on their books, counterparty risks rose, and banks became reluctant to lend to one another. The resulting credit squeeze spread throughout the global banking system, ending with the 2008 global recession.

<u>Origin of the Eurozone Problem—over a Decade of Current Account Deficits in Debtor Economies</u>

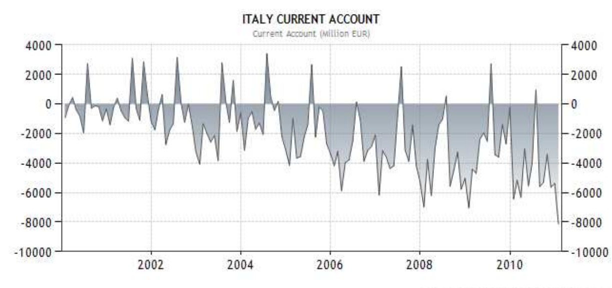
The current eurozone crisis is often cited as a sovereign debt issue but the roots are much deeper, having to do with the structure of the eurozone system itself, which allowed current account deficits of PIG (Portugal, Italy, Greece) and Spain to balloon for over a decade (see the following series of charts, labeled as Chart 1, in euro billions). The flow of credit from surplus economies within the eurozone fueled accumulation of these deficits.

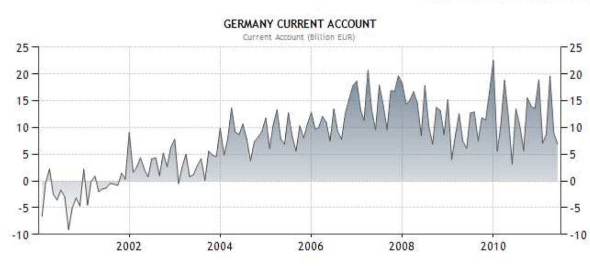
Chart 1

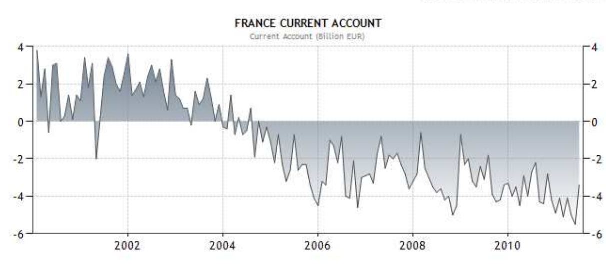


From 2000 to 1H11, the accumulated current account deficits of PIG were equivalent to 90% to over 100% of their 2010 GDP. Spain was at ~80% and Italy at ~30%.

Ignoring FDI (small by comparison to current accounts), the numbers serve as broad proxies on the degree of (private + public) debt that debtor economies borrowed from foreign creditors over the past decade, particularly from Germany, the key trade surplus country.







<u>Current Account Deficits = Deficits in Domestic Savings = Borrowing from Abroad</u>

When a country borrows from abroad to sustain domestic spending/investment (e.g., in property), *over*-indebtedness begins**.** The risk for a debtor country is thus its overall *indebtedness (private + public)* to *foreign* creditors, as credit withdrawal will send its economy into a tailspin. The risks facing creditors include not just sovereign debt exposure but also potential NPL (non-performing loans) made to private sectors of debtor economies.

In Spain, the private sector borrowed heavily from abroad (its sovereign debt only equaled ~65% of GDP), whereas over the years in Greece, the public sector became the key borrower from abroad with debt rising to 150% of GDP. This was possible because politicians touted the eurozone as one economic bloc with one currency, and investors had mistakenly believed for years that sovereign debts of eurozone countries were alike in credit quality. The Greek government was thus able to issue bonds to raise funds, recycle liquidity via domestic loans and spending to the private sector, and thereby prop up the Greek economy over a prolonged period.

A Sequel to Chapter 1

Thus, what the eurozone is currently witnessing is the unfolding of a sequel, "Chapter 2," to the 2008-09 global financial meltdown of "Chapter 1." Both chapters have the same origin: problem loans in the banking system. At the end of Chapter I, the eurozone central banking system helped take more than €480 billion in ABS off the books of problem eurozone banks. Chapter 2, developing now, is a surfacing of remaining problematic loans from over-extension of credit by creditor banks in the eurozone's "sound" creditor economies (mainly Germany) to the debtor economies of PIIGS (Portugal, Ireland, Italy, Greece and Spain). Loans to the private sectors of PIIGS amount to many times greater than the creditor banks' exposures to problematic sovereign debts. When debtor economies weaken, the risk of NPLs rises, hence, the rise in counter-party risks on interbank lending. The problems bisecting the eurozone have their roots in the architecture of the eurozone monetary system, which we shall review next.

European System of Central Banks (ESCB)

The ESCB consists of the legally independent European central bank itself (ECB) and the legally independent national central banks (NCB) of each eurozone-member country. The ESCB influences money supply by providing loans to credit institutions against eligible collateral (e.g., eurozone sovereign bonds), either in the form of a pledge or repurchase agreement. Amounts are not limited if a credit institution has enough collateral. At the same time, by taking on deposits from credit institutions under its "standing facilities" operation, the ESCB absorbs excess liquidity. Two important points are of note:

1. The liquidity creation mechanism of the ESCB is *passive*, reliant on the *behavior of bankers* (to lend or borrow). Unlike the Federal Reserve System in the U.S., where the Federal Open Market Committee has sole authority to decide, in its open market operations, to buy or sell bonds outright to *proactively* influence money supply, there is no liquidity creation in the eurosystem if credit institutions do not lend and borrow. Banks in Germany and France have been major conduits for recycling current account surpluses to deficit economies, i.e., from Germany to PIIGS using **bank loans (interbank and direct)** and **investment banking** activities such as distribution of PIG sovereign bonds.

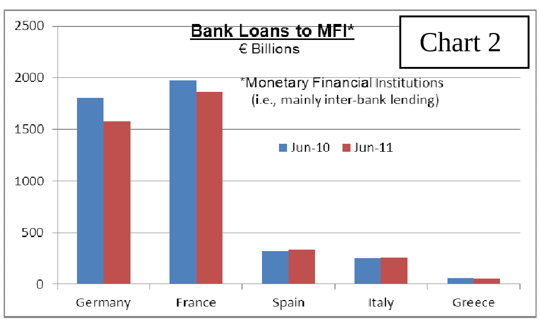
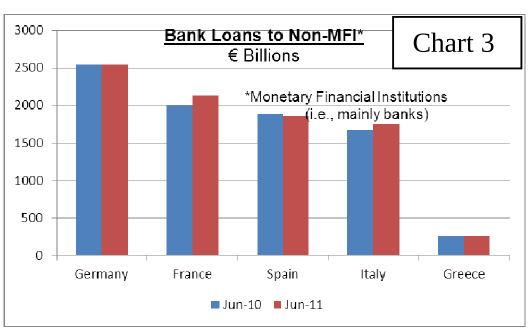


Chart 2 shows the huge interbank business of German and French banks relative to others in the eurozone. The former recycles the large current account surplus of Germany. The French (a current account deficit economy, albeit small relative to its GDP) is in for the transaction profits but, at the end of the day, they are funding loans from the savings pool of surplus economies such as Germany.

Sources: Annual Reports of ECB and the NCB.

The Interbank Conduit—the Credit Creator (and Now Destroyer) within the Eurozone



Source: Aggregate Balance Sheet of the Eurosystem, ECB.

German and French banks have, however, been shrinking their loan books since the 2008-09 financial crisis. **This is why the issue is not just about sovereign debt, but a systemic banking problem of tightening liquidity as creditor banks become averse to counter-party risk, rising NPL, and potential losses**.

Chart 2, above, shows the decline in interbank loans by German and French banks. It's a vicious cycle—as liquidity tightens, NPL rise, further driving up banks' risk aversion. The adjacent Chart 3 shows the absence of eurozone loan growth over the 12 months to June 2011 in Germany, Italy, Spain and Greece.

With no expansion in credit, it is no surprise that overall economic growth, even in Germany, has been faltering. This slowdown will continue, given the dependence of the ESCB on banks' willingness to lend to create liquidity and bankers now wanting to degear and downsize. This is the dilemma facing the ESCB.

2. **Being legally independent, the NCB is the lender of last resort for domestic banks needing liquidity** in unlimited amounts until "eligible" collateral (ESCB rules include any sovereign debt and guarantees) runs out. The aggregate balance sheet of the ESCB, bloated by NCB bail-out loans, nearly doubled from end 2006, to €2 trillion in total assets by end 2010—bigger than that of the U.S. Fed even without a eurozone equivalent of QE1 and QE2!

This mechanism merely postponed the day of reckoning. Such bail-out loans do not provide new liquidity for debtor banks nor improve their balance sheets (see section on intra-eurozone debt, below). Bad loans are still in the system; losses will eventually have to be accounted for.

Risk of Bad Interbank Loans Falling Back onto the German Public

What happens when an NCB, e.g., the Greek central bank, makes loans to domestic banks on their home turf to help settle interbank credit withdrawals by foreign banks? This is done via book entries in the accounting structure of the ESCB monetary system. No money is created and no liquidity is injected.

Intra-Eurosystem Debt from Cross-Border Transactions

Claims on Other NCBs		Liabilities to Other NCBs	
Germany	325.5	Ireland	146.1
Luxembourg	68	Greece	87.1
Netherlands	40.5	Portugal	60
Finland	19.7	Spain	50.9
Italy	3.7	France	28.3
		Austria	23.7
(All figures in Euro Billions)		Belgium	13.9
		Slovakia	13.8
*Up from ~€125bn end 2007		ECB	21.2
		Others	12.2
Total	457.1*		457.1

Sources: Annual Reports of ECB and NCB

Table 1

When commercial banks, e.g., German banks, decline to extend interbank lending on cross-border transactions (e.g., with Greek banks), the debts are settled via their respective national central banks. As a result, Greek banks now owe their Greek NCB. The German central bank, the Bundesbank, credits German banks with deposits (interbank repayments) and holds claim on the Greek NCB. No funds actually change hands; the transactions are merely book entries with the loan risks (now those of the Greek NCB) assumed by the Bundesbank and, therefore, the German public.

Claims among central banks in the eurozone can be found in the adjacent Table 1 (Sources: Annual Reports of the ECB and NCB). By the end of 2010, intra-euro system debt had shot up to **€**457 billion from ~**€**125 billion at the end of 2007. By now, the figure is probably much greater. This was one of the factors pushing the expansion of aggregate assets of the ESCB to €2 trillion, the other being the ABS bail-out in Chapter 1.

Over 40% of loans outstanding in Greece's commercial banking system is now "funded" by borrowings from the Greek central bank. In other words, the advance-to-deposit ratio of the Greek banking system is over 140%! With eligible collateral now used up, the Greek banking system is 100% stretched, with *zero* capacity to provide liquidity—a desperate situation. Budget deficit cuts, the focus of the ECB, in Germany and France *will not* relieve the credit crunch and repair broken banking systems. An ongoing credit crunch is why the Greek economy will continue to implode as, likewise, will Ireland and Portugal. Credit withdrawal is threatening Spain and Italy with recessions.

Political Impasse

At the end of 2010, the ECB itself had a tiny base of €163 billion of assets vs. €2 trillion in total assets for the whole ESCB system (including all NCB). This means that despite the dire state of some of the NCB and their domestic banking industries, the ECB has not made use of its balance sheet much at all to lessen the credit crunch. The ownership structure of the ECB, which includes all the respective eurozone sovereign entities as shareholders, inhibits decision making. It has become a very hot political potato for ECB creditor shareholders to agree to help debtor shareholders.

In response to the Greek sovereign bond crisis, in May 2010 the ECB implemented the Securities Markets Program and bought €79 billion of PIG sovereign bonds that year. Currently, the ECB probably holds €110 billion following the most recent purchases of Italian and Spanish sovereign bonds. But bond purchases will not address the credit crunch within the eurozone banking system, which is driven by banks burdened with problematic loans. The books of the German and French banking sector are being threatened with rising NPL from their lending binge to debtor economies in the eurozone plus losses on holdings of their sovereign bonds. Creditor banks will thus continue to downsize their loans. As discussed, this is a vicious, self-feeding process. The immediate risk is a self-feeding contagious spread of fear over counter-party risk which can only be arrested by bank recapitalizations and bad debt write-offs, i.e., a cleansing of balance sheets.

However, proper write-offs of bad loans and bank recapitalizations are prospects eurozone politicians have so far steadfastly refused to even talk about in public, citing instead excessive sovereign debt as the cause of the current malaise and shifting political and public attention to the need for debtor countries to implement budget discipline as the cure. No German or French politician will admit that for years, under their ‘oversight’, German and French banks have been the main conduits feeding excessive credit to deficit-running eurozone members.

Quantifying the Amount of Questionable Eurozone Debt and the Outlook

Accumulated current account deficits (again assuming FDI inflows are small) would approximate the borrowing by a debtor economy from foreign creditors. The accumulated current account deficit of PIG is ~€700 billion. As noted above, the interbank part of the debt would have already surfaced under the €457 billion of NCB intra-eurozone claims. The rest, ~€300 billion, would mostly be in direct bank loans to PIG borrowers still on the books of creditor banks. Residual holdings of PIG bonds by German and French banks are small.

The time bomb now ticking for creditor banks is the €800 billion (accumulated current account deficit) loaned to Spain. Given the low level of Spanish public sector debt, we can assume that the majority was in the form of loans to private entities and banks in Spain. Italy has an accumulated current account deficit of ~€350 billion, or <30% of its GDP and, thus, a much smaller debt issue. The savings rate of Italians has been high enough to fund most of the economy’s borrowing needs, including that of its public sector.

Total debts owed by PIIGS to foreign creditors is thus ~€1,450 billion. Actual NPL are a fraction of this sum, large enough to cause trouble for individual banks in Germany or France, but not the whole eurozone system, which has an aggregate GDP of over €10,000 billion. The ABS crisis of 2008, US$4 trillion in size, was a far scarier story.

Our Investment Policy

So, fortunately, according to the above estimates, we are not staring at the abyss. However, we believe it is wise to be prepared for more jolts from the eurozone. It is still early days, given continued policy indecision. The contagion of fear of the unknown over counter-party risk is spreading, as indicated by the rise in the TED spread, albeit modest thus far. TED spread is worth monitoring as it may well be market forces that push a sizable bank in Germany or France into a liquidity bail-out situation, forcing German and French politicians to finally admit their own bankers have been contributing to excessive debt creation, and that their own banking industries are now having to face loan write-offs and are in need of bank recapitalizations. And by the way, the €146 billion owed by the Irish central bank is only worth the value of Irish government bonds, so even the Bundesbank has to get a haircut.

Our funds are currently 35% to 40% in cash, which has helped cushion NAVs from the recent market selloff and offers a measure of protection against any further market volatility. Market selloffs on emerging signs of stress in the German and French banking system will present buying opportunities, and we will begin bargain hunting in Asia where economies are net savers and fairly well insulated from liquidity issues affecting western banks. In a slow global environment, Asia remains one of the few growth regions. Bailouts of their own banks by Germany and France and bank recapitalizations will likely mark the end of Chapter 2.

We also moved 8% of the NAVs into gold in early August, not from fear of inflation but to hedge against further deterioration of investors’ confidence in the world’s leading financial systems. Thanks to authorities’ lack of discipline regarding the paper money standard and loose regulatory oversight that gave bankers a free hand in credit creation, the world economy has suffered from the ABS meltdown and now the aftermath of the PIIGS debt bubble. At this stage, further money printing will not result in greater economic growth. Instead, it will only reinforce investors’ worries that all is not well with the current monetary system and that authorities have run out of policy options.

The Net Asset Values GSI Asian Capital Growth—US$26.68 & the Long Short Fund—US$24.50 (Sep 1, 2011)