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The Current State of our Wealth:

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The Greek Bail-Out: Still Spinning the Plates

Do you remember the circus act where a clown set first one plate, then two, then four, then eight, then more and more plates spinning until finally, running around frantically to shake the pole of the spinning plate losing momentum fastest, he would inevitably lose control and as more and more plates fell the exhausted clown would himself sink to the floor, exhausted and defeated? Of course, the number of plates one can keep spinning at any time is finite. Spin one too many, and you will eventually lose them all. The current world record for plate spinning is held by David Spathaky, assisted by Debbie Woolley, who spun 108 plates simultaneously in Bangkok in 1996. That record has now been broken in a totally different kind of circus. After hair-raising weeks of posturing and positioning, officials from the EU, EU member states, the ECB, the IMF and the Institute of International Finance have once again taken steps to keep the plates of the 10.7 million odd inhabitants of Greece spinning... for the time being. They shook the poles by first extracting more promises of good behavior from Greek officials in exchange for emergency funding to meet near term debt maturities, then produced a "solution" aimed at extending the maturity of most of Greece's debt well into the future while ensuring the country does not have to go back to global bond markets until the end of the decade. The plates are thus once again set to spinning. Everyone in Europe has gone on holiday for August, as Europeans must. But like all the clowns before them, they will discover that at some point if you try to keep one too many plates spinning, all your plates will eventually come crashing down.

Why it the current approach will not work.

We all know that Greece has government debt outstanding of around \$480 Billion or somewhere approaching 160% of GDP. We also know that in April of 2010, when it first became evident that Greece's debt burden could not be managed by the country on its own, the EU and the IMF rode to the rescue with a €110 Billion against promises from the Greek government of tax collection initiatives, spending cuts and a program of state asset sales that would purportedly enable Greece eventually take back control of its own finances. Roll the clock forward to 2011 and it emerged quite plainly that no meaningful progress has been made under Greece's austerity measures. In 2010, its economy shrunk, its budget deficit worsened, and its debt burden grew. It became apparent that much more support was required and that, if the plates were to be kept spinning, a much larger bailout was needed to avoid a debt default. German leaders, under severe political pressure at home, insisted that part of this burden must somehow be borne by the private holders of Greek debt,

and not just by EU taxpayers. The French and the ECB quite correctly pointed out that if the chosen method of burden sharing constituted a “credit event” as that term is defined in standard bond and credit default swapmarket documentation the knock on consequences in financial markets would be largely the same as a full blown payment default, and so pushed back hard against the German position. Total exposure of European and UK banks to Greek sovereign debt is around €200 Billion, with the French banks most exposed at €71 Billion and the Germans hard on their heels at €45 Billion. Finally, a wheeze of sorts has been agreed. Banks and other private investors will *voluntarily* swap Greek debt maturing between 2012 and 2020 for new 15 and 30 Year bonds, with the long bonds cash collateralized using AAA rated zero coupon bonds covering 100% of their nominal principal.

Will this plan constitute a credit event? No, because it is voluntary. Now here’s the catch. It is voluntary (and expected to be accepted by 90% of bondholders) for two reasons: first, it is a great deal for the bondholders. Second, it gives banks liquidity for their Greek positions immediately, and at a much lower cost than would be available in current markets.

For the most part, bondholders will suffer relatively little accounting pain. Most importantly, banks’ capital will not be so affected as to raise meaningful recapitalization requirements. The current market value of the new bonds is estimated at about 79% of their face value. Most of the debt they will be exchanged for was trading well below that. The Greeks will still owe the money, and will actually effectively pay about 1% higher interest rates on it.

The banks will have access to liquidity as the new bonds will be eligible as collateral at their fair value the ECB discount window. Which of course means that, as was the case with America’s Federal discount window activities during the financial crisis and subsequent “quantitative easing”, this time it will be Europe that is printing more Euros, in effect to bail out the European banks. The debt exchange is expected to cover around €110 Billion in debt.

In addition to the wheeze, additional loans of €109 Billion will be made available to Greece by other Euro member states (excluding Portugal and Ireland) and the IMF for terms of 15-30 years. The rate they charge to Greece, as well as Ireland and Portugal, on bail-out loans will be reduced from 5.5% to 3.5%. Finally, the rules on use of the €440 Billion European Financial Stability Fund have been loosened to allow the fund to be used to recapitalize Greek and other euro zone banks if required, and for open market purchases of bonds of Euro zone issuers should they experience undue market credit constraint. The ECB already engages in open market transactions to stabilize sovereign debt market conditions, as it did by buying heavily into issues by Spain and Italy in recent weeks as markets wobbled and drove bond yields for both countries higher. In short, euro zone politicians are threatening still more quantitative easing, thinly disguised at best.

So, as Professor Pangloss would have said, is all now for the very best in the very best of worlds? Hardly. Reality has already re-asserted itself as market jitters around Spain and, more ominously, Italy, re-emerged within days of the bail-out plan announcement. Only the lazy haze of Europe’s... and the bond market’s... long summer holiday is preventing reality from reasserting itself.

When markets return from holiday in September, I believe the ineffectiveness of the current approach will become progressively more obvious. The inadequacy of the existing Portuguese and Irish bail-outs, and eventually of this second Greek bail-out will come into focus as the extent of those countries’ insolvencies also becomes more apparent. Spain’s financial woes will come under increasing scrutiny, in particular the solvency of its domestic banks and state governments. Italy’s fiscal balance and its ability to refinance the world’s third largest sovereign debt balance, a staggering €1.6 Trillion, will continue to be questioned unless the Italian parliament show non-partisan support for decisive deficit reduction. €420 Billion or 26% of Italy’s debt pile matures in

2011 and 2012 Markets will continue to be volatile. The Euro will come under increasing pressure. Funding costs will rise across the Euro zone, most painfully of course in the weaker economies. Default risks will increase in size and magnitude. The Banking system will remain vulnerable and subject to increasing scrutiny and skepticism. Ultimately, some event will cause the plates to start crashing down. When that happens, it is not just Greek plates that will crash. 4.5 Million Irish plates, 10 Million Portuguese plates, 48 Million Spanish plates and most crucially 60 Million Italian plates will also be falling. And if that happens, the global economy will once again head into meltdown. Why? Because the total exposure of European banks to Euro zone sovereign debt is €2.8 Trillion, of which €820 Billion is in Spain and €1 trillion in Italy. At those kinds of numbers, the wheeze just won't work. Put into this context, as the Economist pointed out this week, the €440 Billion EFSF looks more like a pea shooter than a bazooka. There is simply no way Europe can print as many Euros as are needed to support its debt balances. Or more correctly, if it does, it won't matter because its banks will still fail and its economy will collapse under the burden of its current account deficit. Add in the fact that US money market funds have more than half their assets (over US\$ 800 Billion) in exposure to European banks and that the five largest US Banks have more than US\$ 2.5 Trillion in exposure to Europe, and you have a recipe for something potentially much nastier than 2008-09.

Unfortunately, the bail-out is perceived as running away from rather than resolving Europe's broader debt woes. The approach won't ultimately work for Greece, and therefore doesn't inspire any confidence in European leaders' ability to come to terms with much deeper looming debt problems. Europe's arsenal for preventing a perilous rise in southern European bond yields appears weak and lacking in coherence. The Greek bail-out has therefore not succeeded in allaying fears of contagion and further crises.

Why is the Greek bail-out not good enough? The simple reason is that it does not solve for Greece's insolvency. Greece has incurred debt that it can never afford to repay. If it remains within the Euro Zone as it is presently structured it will continue to sap the resources of solvent members. Greece's government debt is more than 6 times its tax revenues. Given that 45% of Greek GDP is related to government spending, spending cuts inevitably reduce tax revenue, making the country's insolvency more intractable, not less. In effect, EU-IMF reliance on Greece's austerity promises is like trying to put out a fire by pouring gasoline on it. Nor can Greece even begin to be expected to export its way out of its problems. Greece's debt is more than 24 times its annual goods exports. Amazingly, Greece's debt has actually not been reduced by the bail-out! Instead, the whole rotten mess has been placed in suspended animation for 15-30 years by way of the wheeze and new long term loans from euro-zone members. In the meantime, the ECB will continue to print money to keep the euro zone banks afloat. Greece will go on borrowing (just not from banks) at the same rates as Germany, or more correctly at rates effectively subsidized by Germany. Eventually, a more debt restructuring will be needed. There is no likelihood that any meaningful portion of euro-zone, IMF or EFSF funding for this bail-out will ever be repaid.

Like the sub-prime crisis, this mess arose because of a gross mispricing of credit due to politically led economic policy having gone terribly wrong. In Greece's case, it was the decision to admit Greece to the Euro despite the fact that its economy lacked the structural ability to align with the major northern European economies, in particular Germany's, which would inevitably drive the price of credit for the whole Euro region following monetary union. As a result, interest rates dropped and credit availability soared in Greece, leading the country to an orgy of borrowing and spending, most of it on expensive imported consumer goods, government waste and corruption. The resulting debt is too large to ever be repaid. In such circumstances, inflation would normally dictate

a currency correction which would inflate the problem away (with attendant inflationary losses to lenders). Within the framework of the Euro zone common currency, the necessary currency correction simply cannot take place. For Greece to achieve a balanced current account the Euro would need to trade at around \$0.30 to the US\$, a devaluation simply too deep to contemplate. For Germany to achieve a balanced current account the Euro would need to trade at around \$2.30 to the US\$. In either case the magnitude of the correction would be intolerable. Obviously keeping the Euro under the current common currency arrangements is not an option. That hard fact is the reason the current bail-out plan, and in particular the wheeze, cannot possibly work.

Let's leave Greece for a moment. What about Ireland, Portugal and Spain? In each case the conclusion as to why their sovereign debt reached unsustainable levels is the same: given their structural incompatibility with the German and northern European economies, admission to the Euro resulted in credit becoming far cheaper and far more easily available than would have been the case outside of the union. The resulting cheap and plentiful credit fuelled borrowing binges the proceeds of which were deployed either in unproductive or investment or unsustainable consumption levels. That in turn led to debt growing to unsustainable debt levels. Portugal is rather like Greece, only just not quite as bad. In the case of Ireland and Spain, the credit binge fuelled huge property development booms and property price inflation that has severely stressed domestic lenders and, as a result, governments when the inevitable tightening of credit following the binge resulted in catastrophic property market collapses. In all likelihood agricultural, manufacturing and domestic consumer economies in Ireland and Spain would have the potential, over a protracted period of economic reconstruction, of repaying accumulated debt to acceptable levels. It is however unlikely that either country's taxpayers will accept the amount and duration of the austerity that would be required for this to be achieved.

Can the crash be avoided?

The answer is yes, maybe.

What is of the essence is that Europe's leaders should deal decisively and with debt relief for the insolvent members of the union, in particular Ireland and Portugal. It is foolhardy to try to rule out coercive debt restructuring for insolvent members, now or in the future. Greece, for example, clearly needs its debt reduced to something below 50%...perhaps to below 70% of current levels to have an even chance at restoring growth and living within its own means. Similar debt reduction must be achieved at appropriate levels for Ireland, Portugal and Spain. In return, Ireland should not persist in insulating its banks' improvident bondholders from loss at the expense of its taxpayers and the Euro zone. Spain should not guarantee its improvident domestic banks' unsustainable mortgage exposures. Like bankruptcy proceedings, comprehensive coercive restructurings should be effected concurrently and on a "once and for all" basis, and should be accompanied by stabilization measures to re-capitalise the worst affected banks, and to avoid systemic contagion through CDS and derivative markets.

At the same time, the Euro zone's leaders should begin to discuss, openly and credibly, a comprehensive review of the Euro arrangements directed to resetting the mechanism of currency union going forward in a credible manner. This will require amendments to the fundamentals of Europe, and to the treaties that govern the EU and the Euro monetary union. The objective should be rules and enforcement mechanisms which ensure that access to credit and credit pricing in future is effectively tied to members' actual economic fundamentals. This means a system that ensures that

the amount of total of the Euro zone money supply available to Greece, Ireland, Portugal or Spain... or indeed any other country going forward... at any time will be constrained to acceptable levels having regard to countries' actual ability to repay, measured against tax and other revenue bases, spending, and export-import balances. Simple debt and deficit to GDP measures are not enough. In addition, the new rules will need to be enforced by a Euro zone fiscal authority with power to legally issue or remove Euro zone guarantees from member countries debt issuances. Euro zone guaranteed debt should carry priority over any other sovereign debt issued by the country in the event of a credit event. If such a system were in place, markets would quickly correct bad economic behavior by members by pricing non-euro-zone guaranteed debt at appropriate levels reflecting the individual member's risk profile.

Needless to say this implies a meaningful delegation of fiscal independence by member states. That may be anathema to some, but it is quite simply the price of retaining the Euro. Simply put, the overall Euro zone balance sheet must be made strong, and a system must be devised such that the benefits of zone membership are shared fairly on the basis of contribution to the combined balance sheet. If the European project really does make sense, this will be its test. A level of coordination of inter-state fiscal balances adequate to support a single currency is not impossible. The US achieved it after the War of Independence, and has maintained it ever since, albeit through a system of fiscal transfers rather than debt ceilings.

If Europe's leaders cannot rise to this challenge, then their plates will certainly crash. The European experiment will come to a sorry end, and the world will be plunged into an economic nightmare. Let us hope they understand the limitations of spin.

PS: What about America?

Considering that I am writing 2 days before the US notionally runs out of sufficient cash to meet its obligations it may seem odd that I have focused on risks in Europe. America is locked in fiercely partisan gridlock over a debt ceiling increase that shows little prospect of a resolution satisfactory to anyone. The Europeans, after all, did actually reach *some* agreement at least!

I believe that the current debt ceiling issue in America simply does not imply market risk anything like that which the ongoing failure to deal with Europe's structural problems does. There will be an increase to the US debt ceiling. America will not default on its debts. Its creditors will continue lending to it. Its politicians will continue to debate near term deficits, taxes and spending. None of this matters to the reckoning that America will ultimately face. That reckoning involves ebbing growth prospects and a revenue base that cannot hope to meet soaring health care, welfare and retirement costs. Many of America's bargains with the future cannot be kept, and will need to be re-traded. But that is for another paper and another day. Europe's testing moment is much closer to hand, and represents by far the higher near term risk to the state of our wealth.