Year End Wrap 2011

The behaviour of markets this year has confounded expectations. It is useful to step back and view the landscape from a high level as daily market monitoring can lead to myopia and inability to distinguish between noise and signal. It is also useful to avoid over reliance on established or sophisticated financial or economic models particularly when a simple one will suffice. To understand the present it is necessary to understand the past. It is hoped that with this we might have some idea what the future might look like.

The crisis of 2008 while manifesting itself in the space of 6 months was the culmination of a much longer term phenomenon. For reasons dealt with elsewhere, debt, both public and private, was allowed to accumulate to levels which were no longer sustainable. It is not clear when the point of unsustainability was reached, but this problem began to be discovered by the market in mid 2007 accelerating to panic by the end of 2008. It was the reaction of investors attempting to shed direct or indirect exposure to this unpayable debt that led to acute market volatility and the demise of Bear Stearns, Merrill Lynch, AIG, Lehman Brothers and Northern Rock among others.

In order to maintain the functioning of the financial system, the payments system and the nexus between savings and investment, regulators and governments in their wisdom chose to bail out the system. To restore confidence, it was necessary to transform and transfer this unpayable quantum of debt from private to public balance sheets to signal adequate support for these assets or to remove them from scrutiny and analysis.

Debt can be reduced in a finite number of ways. It can be paid down, reorganized or defaulted upon. Given the size of debt in the global economy none of these was a viable short term option. It was necessary therefore to transfer such debt from institutions with credit risk to institutions where credit risk was academic, mostly arising from their ability to print money to satisfy their liabilities. Sovereign balance sheets.

One flaw in this strategy is where a sovereign is unable or unwilling to monetize debt, such as the Eurozone where monetary policy has been abdicated to a common central bank over which no single country in the union has unilateral or arbitrary control. The symptoms are plain to see.

All other central banks will likely continue to monetize the debt that their governments have assumed on behalf of credit risky holders. Even so, even the US has faced a credit rating downgrade. New and more creative ways of transforming and transferring the massive stock of debt needs to be found. Time can be bought if current holders of debt repackage the debt so as to assume first loss risk while seeking less indebted investors to provide senior funding. The devil is in the details as the European Financial Stability Facility's initial plan to do this was rebuffed by potential senior funding providers.

The prosperity of this planet in the last few decades has been financed by debt. The calculation of GDP does not account for debt creation and therefore includes future output. This is an error. Be that as it may it is an accounting standard that our species has generally accepted. By this metric therefore, since the world collectively seeks to reduce its debt, global GDP growth must slow down and depending on the rate of debt reduction, may be negative. This result holds for the closed system as a whole.

Failure to recognize this or indeed a stark recognition of this will likely lead individual regions or nations to attempt to grow their economies at prior rates regardless. If the world's total debt is to be reduced, debt must be redistributed and locally somewhere, it must increase. A case in point is China's attempt to maintain growth while its single channel of growth, exports, collapsed in the wake of a severe dearth of trade finance and retrenching US consumers, which resulted in substantial credit creation. Beggar thy neighbour policies are likely to rise. Incipient signs of this are unilateral currency interventions by the Swiss National Bank and the Bank of Japan and the exchange of rhetoric between the US and China over the value of the RMB. Periods of slow economic growth or contraction can be contentious ones. As domestic demand slows and government finances are burdened by excessive debt the natural tendency is to attempt to export. Not all countries in a closed system can have a net positive trade balance. The likelihood of contentious and hostile trade policies is elevated. Currencies are likely to be co-opted as instruments of trade mercantilism.

The large scale transformation and transfer of debt or credit risk can potentially be contentious as well. During the third comprehensive plan for the Eurozone where a haircut of 50% was proposed on Greek sovereign debt, ISDA regarded this as a voluntary exchange and therefore not a credit event. This has raised questions as to the probity of ISDA. Consider also a situation where defaults in one region impact that region’s banks but where these banks have transferred their credit risk to another region through the use of credit default swaps triggering contagion. How willing will the authorities of one region be in providing relief directly or indirectly to another region at a time when fiscal austerity looms over most developed nations’ public finances?

A less apparent theme is the failure of the principal-agent relationship. This relationship is never perfect and its imperfections typically come under scrutiny in recessions. The last time this was examined was in the 2001 Dotcom bubble where stock options rewarded management for success without appropriate penalties for failure. There is a wider manifestation of this problem. The most visible is in the banking system, especially because they required bailouts paid for from public funds. Banks serve several functions, among which are safe custody of depositors’ assets, and a safe and efficient transmission between savings and investment. As management remuneration is asymmetrical, it is possible to earn a positive bonus but not a negative one, excessive risk taking and cavalier stewardship arose which culminated in the financial crisis of 2008. As a result the trust has been broken between banks and depositors.

A similar lack of trust has arisen between people and their governments. The troubles in Middle East North Africa which began earlier this year have not abated. Even in democratic and apparently democratic regimes, election results are equivocal and represent a lack of clear mandate to any government. Governments are agents to their people who are the principals. As stewards of their welfare the rise of income and wealth inequality is an indictment of their performance. Gini coefficients have risen in Communist, Socialist and Capitalist countries alike. High rates of inflation in the developing world are potentially destabilizing and investors may underestimate the priority of price stability in agrarian societies. Debt monetization is fundamentally inflationary adding to the complexity of policy that faces governments.

There is no new crisis, only the ripples and aftershocks of the first one in 2008. Time is what is required for the global economy to heal itself. Patience unfortunately is lacking. The result may be interim solutions which defer inefficiencies and imbalances but do not dissipate or address them. Unfortunately, for me, I have no answers and am only an observer in these dramatic proceedings.