Euro crisis update. Will the Euro break up? The Fiction of Banks and Sovereigns. And China.

A few months ago the ECB’s long term loans to the banking system appeared to have staved off risk of default or breakup for at least as long a term as the facility. The fears of default and breakup have returned with a vengeance.

My assessment was that the LTRO was sufficient to postpone the problem for at least a year if not two, subject to a few assumptions, but that they did nothing to address the fundamental issues causing the cash flow and balance sheet insolvency of peripheral Europe. The LTROs 1 trillion EUR will at least cover the Eurozone’s 2012 maturing sovereign debt if one assumes no further government largesse is required for unforeseen circumstances. This covers it for a year, assuming that the European banks cover 100% of all new issues. If they cover half, the money will last longer, perhaps 2 years. No government largesse means everyone sticks to their imaginary budgets, and more importantly, no government or bank has been misrepresenting their financial position. These are strong assumptions.

It seems that government finances are hard to define and quantify rigorously. Some people call this accounting fraud. As the only practical prosecution (there can be many plaintiffs), is a connected party, its unlikely that any legal recourse can be sought. In times of stress, one cannot rule out accounting fraud. Even if we assume that government financials have not been embellished, there is the question of whether the proposed budgets are realistic. Austerity takes care of one side of the profit and loss. With taxation at its limits, in terms of already high marginal tax rates, it is difficult to envisage higher rates. Indeed

both austerity and taxation beg the question of the elasticity of output, and thus tax revenue, to taxes and fiscal austerity.

The qualitative and quantitative variability of banks’ balance sheets, even apparently strong US banks, is also cause for concern.

When banks had large scale proprietary operations, (some would say a negligent or fraudulent misuse of funds), the riskiness of banks was indeterminate. Bank CEOs would struggle to understand the nature of their balance sheets due to their complexity. The static risk of the balance sheet presented sufficient complexity but the dynamic risk resulting from the non-linearity of the exposures and additionally, the prop traders’ trading behavior made a thorough understanding of the risk not difficult but impossible.

With the winding down of prop desks one element of balance sheet complexity has been reduced. However, this is not all. The agency business has its own complexities. Typically the agency business exists to serve clients and thus the risks undertaken on behalf of clients are either transient, or hedged away. Here the financial engineers have outdone (and perhaps undone) themselves and introduced a level of complexity that confounds the concept of risk pass through in an agency business.

As profitability falls due to increased regulation and capital adequacy requirements, the reduction of prop trading and the creep of financial oppression, agency businesses need to work harder to increase returns on assets just to maintain returns on equity. The result is more aggressive financial engineering, more complex deal structuring, mostly to camouflage more aggressive fees.

As more complex structures or payoffs are sold to clients, the resultant complex risks have to be laid off in the market. There are several ways to do this. One is to find a matching less sophisticated counterparty in a clear breach of good faith. Guess who is the least sophisticated counterparty? The theoretically robust way of laying off the risk in the market is to hedge each basic element of each product individually using

its theoretical replication strategy. There is almost always one, but it may not be feasible or practical. Many replication strategies have asymptotic properties that involve zeroes and infinities and may in fact exacerbate risk by requiring inordinate notional exposures. The third way is to aggregate the risk exposures of the entire client book, and to hedge the aggregate exposures rather than the individual ones. This usually works if the risk models and systems are good and there are no unexpected deviations from model. The more complex the book, the greater the risk that either the model is inadequate for handling the individual non-linearities, or a significantly large deviation from the neighbourhood of calibration confounds the model.

Banks have in the past appeared to be in more control than they actually were. The current stressed environment and post 2008 crisis conditions may present characteristics which their models have not taken into account.

And even if they were in control, in the current stressed environment, human behaviour has taught us time and again that good faith is a rare commodity.

The bottom line is that nobody, possibly not even the management of the banks, knows what the current and near term expected positions of the banks really is.

It this lack of information, about banks and about sovereign balance sheets, that the financial destiny of the Eurozone faces. Lack of information or lack of clarity leads to fear which can lead to capital flight. Despite most European banks passing so-called stress tests, and raising more capital, deposits have been consistently flowing out of Eurozone banks.

This hints at another purpose of the LTROs, since most of the money raised by the banks still sit with the ECB earning a negative carry of 75 basis points per annum. They need the liquidity.

For all the financial wizardry that has been deployed in search of a

solution, the Eurozone is poised at the point of a limited collapse. Greece is at the door and may be forced to exit the union. If Greece is ejected, the market will surely push Portugal and Ireland to the door.

For these smaller economies, the principal members of the Euro, France and Germany, may tolerate exit. Italy and Spain are problems of a different scale and would certainly pose an existential question to the Euro. This is contagion risk.

It is interesting to consider that in the absence of a Euro, local currencies, Drachma, Escudo, Pound, would be plunging, and it is almost sure that some pundit would propose pegging these to the Deutsche Mark.

Yet we currently have currency union and discuss selective exits. Perhaps it is Germany who should consider exiting the Euro. For the Euro members, the Euro itself is analogous to the gold standard which while it provides an anchor to the value of each backed currency, takes away important policy tools. Policy tools which the ECB has attempted to recover through creative and alternative means but which have interesting and exciting side effects.

The unfolding saga of the Euro makes dramatic reading and gives everyone a lot to talk about over ouzo and beer, but a storm is brewing in a teacup, a very large red teacup half way across the world where accounting principles are all but generally accepted, the shadow banking system has grown alarmingly and the banking system has an air of fiction about it. China.