The Absolute Return Letter
June 2012

First Mover Advantage

"The problem with socialism is that you eventually run out of other people's money."
Margaret Thatcher

Bubble? What bubble?

Sometimes I wish I could have a second go at my writing. Last month, and not for the first time, I realised that what had seemed pretty clear and unequivocal to me was misunderstood by many readers. More specifically, I am referring to the concluding remarks in last month's Absolute Return Letter where I stated that Asia has the potential to become a re-run of Europe. My argument was based on the simple but undeniable fact that policy rates are well below where they ought to be when taking into consideration the overall level of economic activity and inflation (the so-called Taylor rule).

Those comments were interpreted by many readers as if I expect an imminent crisis in Asia of the sort we currently suffer from in Europe. Nothing could be further from the truth. Allow me to explain:

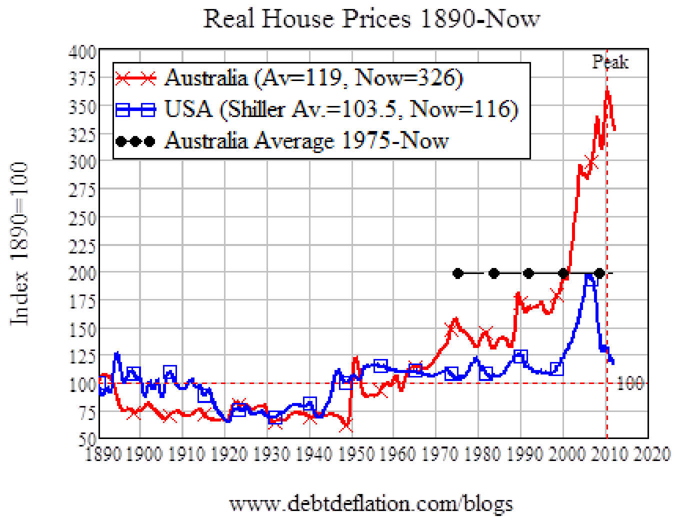
Following the introduction of the euro, Spain and Ireland, and to a lesser degree Portugal, experienced an enormous construction-led economic boom which was the direct consequence of easy access to cheap capital. The ECB was certainly aware of the potential problems this might create down the road; however, it had no choice but to set the policy rate at a 'one size fits all' level, and the German economy badly needed some stimulus back in the early stages of the euro era. By choosing to support the weakest link in the chain, the ECB had effectively sown the seeds of a bubble which would blow up almost a decade later.

There are at least two lessons to be learned from that experience, the first one being that bubbles take a long time (as in *many* years) to build up and, in the meantime, there is usually a great deal of money to be made. Secondly, when the ECB responded to the bursting of the dot.com bubble, as most central banks did in 2001-02, the law of unintended consequences kicked in. By their very nature, bubbles create echo bubbles. What is currently happening in Asia - and I throw in Australia for convenience - could very well turn out to be an early to mid stage echo bubble.

I had been planning on writing on the topic of Asia in much more detail this month, partly to clarify my views expressed in last month's conclusion (which I hope I have accomplished now) but also to address some of the nearer term issues Asia is facing. Then things in Europe got out of hand again, following the Greek elections, so Asia will have to wait until next month.

As a primer to next month's letter, I couldn't resist the urge to throw in just one chart, produced by the great economist and blogger Steve Keen from Down Under. Steve has produced a long term chart of Australian versus US property prices (see chart 1 below and the whole paper here). Steve finds it outright comical that Australians are in complete denial as to where they are in the property cycle. Bubble? What bubble? Much more on this topic next month.

Chart 1: Are Australian Property Prices in Bubble Territory?



Source: Steve Keen's Debtwatch

It is a banking crisis idiot!

Now back to Europe. The eurozone crisis has always been a banking crisis. It only morphed into a sovereign crisis because of political incompetence. Solve the banking crisis and you have solved the euro crisis. That is my prediction. On the other hand, as long as the Germans continue to say *Nein* to pretty much anything that anyone puts on the table, we are still a long way away from solving the crisis. Only a few days ago Angela Merkel reiterated her rejection of the idea of mutualising eurozone sovereign debt. The proposal came from SPD, the major opposition party in Germany, with the idea being that all eurozone debt within 60% debt-to-GDP should be mutually guaranteed. However, Merkel said *Nein*. Again.

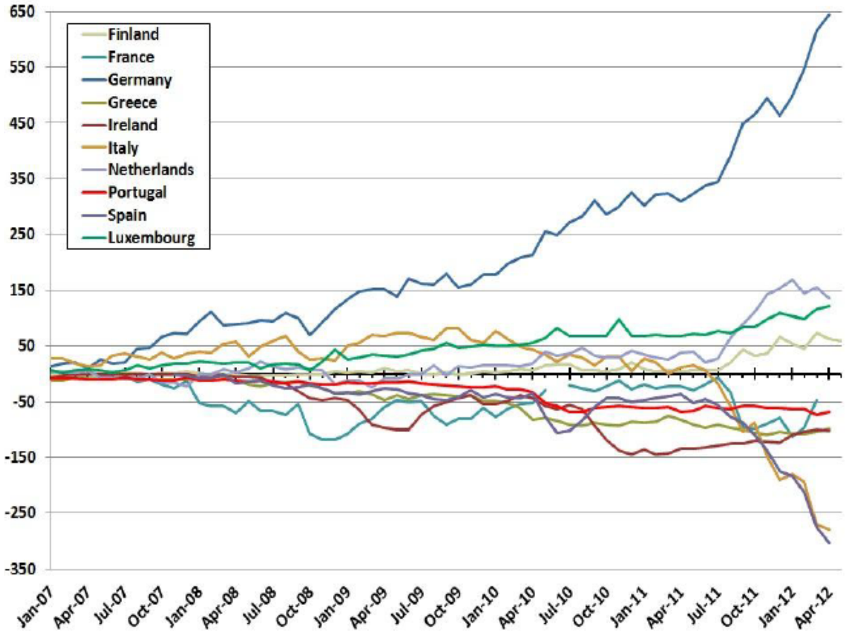
Quite what German intentions are remain lost in the murky underworld of European politics. They have repeatedly discarded the idea of increasing the financial muscle of the European Stability Mechanism. They continue to oppose the monetisation of Europe's large budget deficits. They have flatly rejected any talk of a banking union. Apparently, the only policy they can't get enough of is austerity but, as we can all testify to at this stage of the crisis, an overdose of austerity will do to European economic growth what fertiliser does to my lawn if not accompanied by ample supplies of water.

Maybe the Germans *are* seeking a break-up solution through blatant inactivity as some commentators have suggested – most notably Martin Wolf in the FT (see here) – but, then again, is it really in the best interests of Germany to see a break-up of the euro? I would have thought not. Germany's largest export market is not China as some seem to think; it is the eurozone itself. A re-introduction of the deutschmark would make German exports to countries such as Italy and Spain at least 30% more expensive if not more so.

A break-up would also expose Germany to massive losses due to the large accumulated imbalances in TARGET2 - the settlement system that clears payments between central banks within the eurozone. As you can see from chart 2 below, the German central bank is easily the largest creditor in TARGET2. As at 30 April 2011, German TARGET2 claims amounted to €309 billion. One year later, those claims have ballooned to €644 billion.

This is the result of a dysfunctional banking system. European banks no longer trust each other so instead of, say, Deutsche Bank having a claim on Banco Santander in order to facilitate trade between the various eurozone members, the central banks have had to step in and provide the necessary credits. As long as the euro remains intact, these imbalances are largely academic; however, if the euro were to break up, the German central bank would find it next to impossible to recover the monies owed through TARGET2.

Chart 2: Net Balances in TARGET2 Euro Clearing System (€ Bn)



Sources: Veneroso Associates, http://www.iew.uni-osnabrueck.de/en/8959.htm

For those reasons I very much doubt that Germany would aim to provoke a break-up of the eurozone. It has simply got too much to lose. It is more likely that Merkel's tough words are designed to please the domestic electorate in preparation for next year's parliamentary elections. However, that is a high risk strategy. Southern Europe is rapidly losing its appetite for Germany's austerity demands. Admittedly, not many Germans will be going to Greece this summer but the few who have already been are telling stories about the atrocious treatment they have received – tomatoes thrown after them in restaurants, etc. The revolt against Germany is growing and it is growing rapidly.

The first mover advantage

From a game theory perspective, the moment one of the 17 eurozone member countries realises it would be better off outside the eurozone, it has everything to gain from being the first mover. We have all been led to believe that a break-up will be devastating for everyone. That is not entirely the case. It could certainly prove disastrous for those left inside a dysfunctional currency union but for the first mover the advantages are numerous and it is only a question of time before someone in Greece, Spain, Portugal or Italy reaches that conclusion.

An exit from the eurozone would create another set of challenges but it wouldn't necessarily spell the financial Armageddon widely predicted. The media – in particular the British – clearly enjoy the prospects of a bit of drama and do not even attempt to restrain themselves. Neither do politicians when spelling out the consequences of a break-up. Only the other day did Joschka Fisher, Foreign Minister and Vice Chancellor of Germany in Gerhard Schröder's government between 1998 and 2005, utter the following warning:

"Let's not delude ourselves. If the euro falls apart, so will the European Union, triggering a global economic crisis on a scale that most people alive today have never experienced."[1]

[1] *Source: http://www.telegraph.co.uk/finance/comment/ambroseevans_pritchard/9309669/The-week-that-Europe-stopped-pretending.html*

The armies of financial analysts and economists employed by banks worldwide (who really should know better) do not exactly paint a rosy picture either. Cascade after cascade of dire predictions about the "end of Europe as we know it" do little for overall confidence. The problem with all these doomsday prophecies is that the history books of currency union break-ups offer little support for all that negativity. In fact, most currency union break-ups have confounded the so-called experts and led not to a collapse of society but to renewed prosperity. The hard facts suggest that this is a hurdle that can indeed be overcome and that those countries that break with the euro would most likely benefit in the long term.

Jonathan Tepper of Variant Perception (who co-wrote the book *Endgame: The End of the Debt Supercycle and How It Changes Everything* with John Mauldin) has produced a paper on the eurozone crisis called *A Primer on the Euro Breakup: Default, Exit and Devaluation as the Optimal Solution* (which you can find here). Jonathan is no lightweight in our industry and, in the paper, he sets out a compelling case in favour of a euro exit combined with a sizeable devaluation of the currency of the departing member country.

History is on Jonathan's side. According to data from the IMF, the majority of large devaluations in recent years have had exactly the effect one would expect; economic growth was reinvigorated - if not immediately, then within 3 years of devaluing the currency (see chart 3). Economic growth is precisely what is needed around the Mediterranean. Austerity may bring you all sorts of things but certainly not economic growth.

Chart 3: Major Recent Devaluations and Ensuing GDP Gain/Loss

	Devaluation					GDP Decline		
	Date	Mos. until Trough	National Currency per US Dollar: Before	National Currency per US Dollar: Trough	Size of Devaluation	Quarters until Trough	Loss of GDP	Change in GDP 3 Years After Devaluation
Argentina	Jan-01	5	1.0	3.6	-72.2%	1	-0.3%	+25.8%
Finland	Sep-92	11	4.4	5.8	-23.9%	3	-1.2%	+9.2%
Georgia	Dec-98	2	1.5	2.3	-36.8%	0	0.0%	+10.1%
Iceland	Oct-08	1	91.2	135.3	-32.6%	5	-11.3%	-9.3% [1]
Indonesia	Jul-97	12	2,446.6	13,962.5	-82.5%	4	-16.6%	-9.8%
Iran	Mar-93	2	67.3	1,635.7	-95.9%	3	-9.1%	+3.1%
Italy	Aug-92	12	1,102.6	1,605.1	-31.3%	1	-0.6%	+7.9%
Malaysia	Sep-97	4	2.7	4.4	-37.8%	5	-8.5%	+6.7%
Mexico	Dec-94	3	3.4	6.7	-48.6%	3	-15.1%	+6.2%
South Korea	Dec-97	1	1,025.6	1,701.5	-39.7%	2	-9.1%	+14.0%
Sweden	Nov-92	9	6.2	8.1	-22.8%	1	-0.6%	+10.0%
Thailand	Jul-97	6	25.8	53.8	-52.1%	4	-13.8%	-3.7%
UK	Aug-92	12	0.5	0.7	-23.1%	0	0.0%	+10.4%
Latvia	*2007Q4*	*24*	*0.49*	*0.48*	*2.1%*	*8*	*-24.1%*	*-21.3%*

[1] Not enough time has elapsed to measure Iceland's GDP three years after devaluation. Shown here is the most recent data: 2.5 years after devaluation.

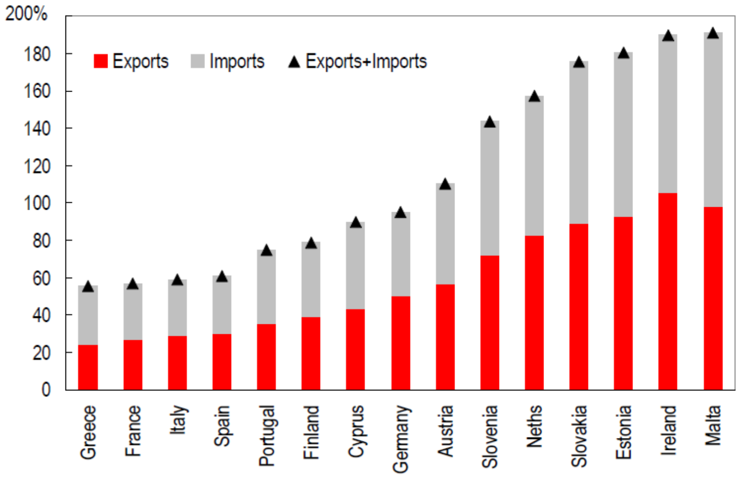
Sources: http://www.cepr.net/documents/publications/latvia-2011-12.pdf, IMF, Variant Perception

It is generally assumed that because the Mediterranean countries are all relatively weak export countries (see chart 4), an exit from the eurozone combined with a large devaluation of the re-introduced local currency would be of limited value to them. Furthermore, or so the theory goes, the problem is compounded by the fact that the main trading partners of Greece, Spain, Portugal and Italy are other European countries. What good would it do to devalue by 50% if consumer demand in the rest of Europe is so weak that the renewed competitive advantage cannot be capitalised on?

However, this argument sorely misses the point that Greece, France, Italy, Spain and Portugal all compete with each other for the global tourist trade and the first country to devalue its currency will be handed a monumental first mover advantage. I am writing these lines from Mallorca. As most readers will be aware, tourism is enormously important to the Spanish island. Summer hotel bookings in Mallorca are the strongest ever and up almost 15% over last summer. Apparently, during the peak of the summer holiday period, there is not a single bed available on the island.

The reasons are straightforward. Bookings from France are strong because the Arab spring damaged the North African tourist industry, traditionally a big taker of French tourists. Bookings from Germany are up because no German in his right mind will go to Greece this summer. Last but not least, bookings from the UK are ahead of last year as sterling has strengthened meaningfully against the euro since last spring when bookings were made for the summer of 2011, showing the importance of exchange rates in the tourist trade.

Chart 4: Exports of Goods and Services as % of GDP, 2011



Sources: Citi Research

I can only reach one conclusion. If Germany doesn't back off soon and relaxes its 'Nein Policy', it is only a question of time before one of the Mediterranean countries reaches the same conclusion I have come to, i.e. that life outside the union might in fact be better. And that country is not necessarily Greece.

If one or more Southern European countries were to leave the eurozone, it would most definitely result in a substantial devaluation of the re-introduced local currency and it would almost certainly lead to a (non-quantifiable) default on its sovereign debt all of which suggest that the country in question may not be able to access international capital markets for some considerable time to come.

Again, history does not support this thesis. Even the worst abusers of creditor trust have been able to return to international capital markets relatively quickly following a default. In the capital markets it is not so much about what happened in the past but more so what is likely to happen going forward. If creditors judge that Spain, Greece, Italy or Portugal would be in a stronger position to service their debts following the reincarnation of the old currency 50% below the old parity level, loans will be made.

Only in the last couple of days has Cristobal Montoro, the budget minister of the Spanish government, admitted that Spain no longer has access to international capital markets (see here). This is happening to a country with one of the lowest debt-to-GDP ratios in the eurozone and at a time where Spain is doing pretty much everything the austerity hawks have been asking for. It is all about perception.

And the perception is that Spanish banks need fresh capital more than ever. If you ask the Spanish government how much is required to recapitalise the Spanish banking industry, they will throw a number of around €40 billion at you. If you ask the same question to the research team at RBS who recently did an in-depth analysis of the Spanish banks, the number required is more like €350-400 billion!

Since I apparently have a history of confusing my readers (!), let me make it crystal clear that I don't think a Spanish euro exit is on the cards at the moment. The Spanish really want the euro to work; however, as with most other things in life, the Spanish will continue to conduct a simple cost/benefit analysis and, at the speed events unfold at the moment, the benefits associated with an exit could soon outweigh the costs.

The recipe for exit

In order to implement a successful exit from a currency union, some strict rules must be followed. Some governments are undoubtedly already preparing contingency plans, so this is the kind of action plan you should be prepared for (greatly inspired by Jonathan Tepper at Variant Perception). Please note that the list below is not a complete list of required steps. I have only focused on the main action points. Many smaller and more administrative items have been intentionally left out.

1. The announcement will almost certainly come over a weekend with banks staying closed for at least a few days into the following week, allowing the government and the banks time to prepare for the new currency.

2. Capital controls will be implemented instantly although they will be temporary in nature. Note that the more capital that has left the country prior to the exit announcement, the faster the capital controls will be lifted again.

3. The new currency should begin to trade as soon as the banks re-open for business so that the desired devaluation can take effect immediately.

4. All interest payments on public debt will probably be suspended with immediate effect; however, the government would be wise not to make any declarations as to what haircut to expect on sovereign debt. Let the dust settle first but expect the IMF to be paid back in full. It is important to stay on good terms with your influential friends!

5. Expect a nationalisation of all systemically important banks that require financial aid. Expect shareholders to be wiped out; bond holders should expect a significant haircut. The banks need sorting out once and for all. Remember, they are the root problem.

6. Expect drastic labour market reforms to be introduced sooner rather than later. There is a window of public sympathy that the government must take advantage of, but the window will close again relatively quickly. The devaluation will improve the competitive advantage almost instantaneously, but the labour market reforms will secure that the advantages gained shall not be lost again over time.

7. One last 'wild card' (and this is Willem Buiter's idea – not mine): The government should consider an elimination of all physical money and move to electronic money only. This carries two significant benefits. With such a move, the interest rate floor has effectively been removed and rates can be set at whatever (negative) level shall be required to stimulate investments and consumption. Imagine overnight rates at -3% with no coins and notes available to hide under your mattress. What do you think that will do to investments and consumption? The problem is that it might only work in conjunction with strict capital controls or if we all move to a moneyless society at the same time. Even more importantly, in the tax shy Southern Europe, tax revenues will improve markedly as a result of the reduction of the black market economy. We have all the technology available today to make such a move. Any takers?

The mother of all bull markets

If structured correctly, a eurozone exit is *not* the Armageddon it is so often portrayed to be. When the perma bears realise that, and as they begin to see the benefits bestowed upon the first mover, the mother of all equity bull markets will be unleashed in Europe. As I have frequently pointed out in recent months (see for example here), European equities are extraordinarily attractively priced at levels not experienced since the dark days of the early 1980s. We are just waiting for the catalyst, but remember one thing – banks will not be the place to be.

Niels C. Jensen
6 June 2012

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