

# When You Find Yourself Going through Hell...Look for an Exit

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**WHAT IS THIS REALLY A CRISIS OF?**

# Growth?



# Unemployment?



SOURCE: [WWW.TRADINGECONOMICS.COM](http://WWW.TRADINGECONOMICS.COM) | EUROSTAT

# Government Debt?

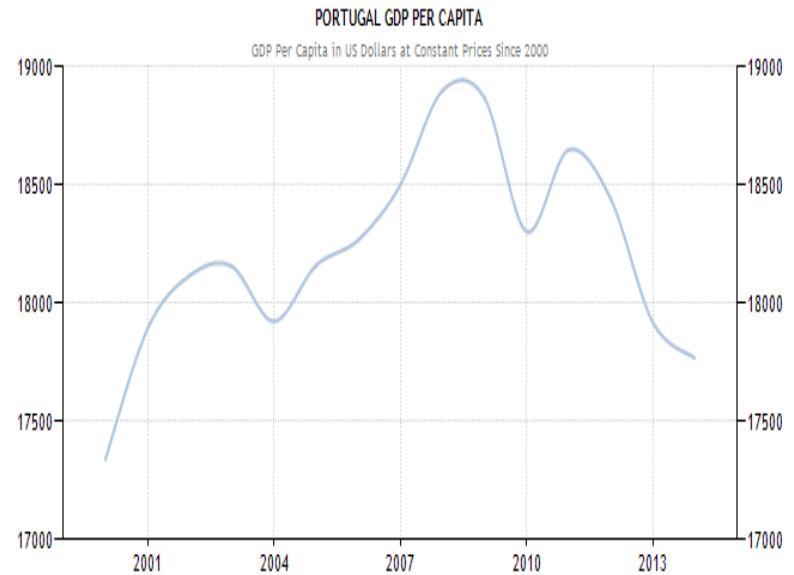


SOURCE: WWW.TRADINGECONOMICS.COM | EUROSTAT

# Government Spending?



SOURCE: WWW.TRADINGECONOMICS.COM | EUROSTAT

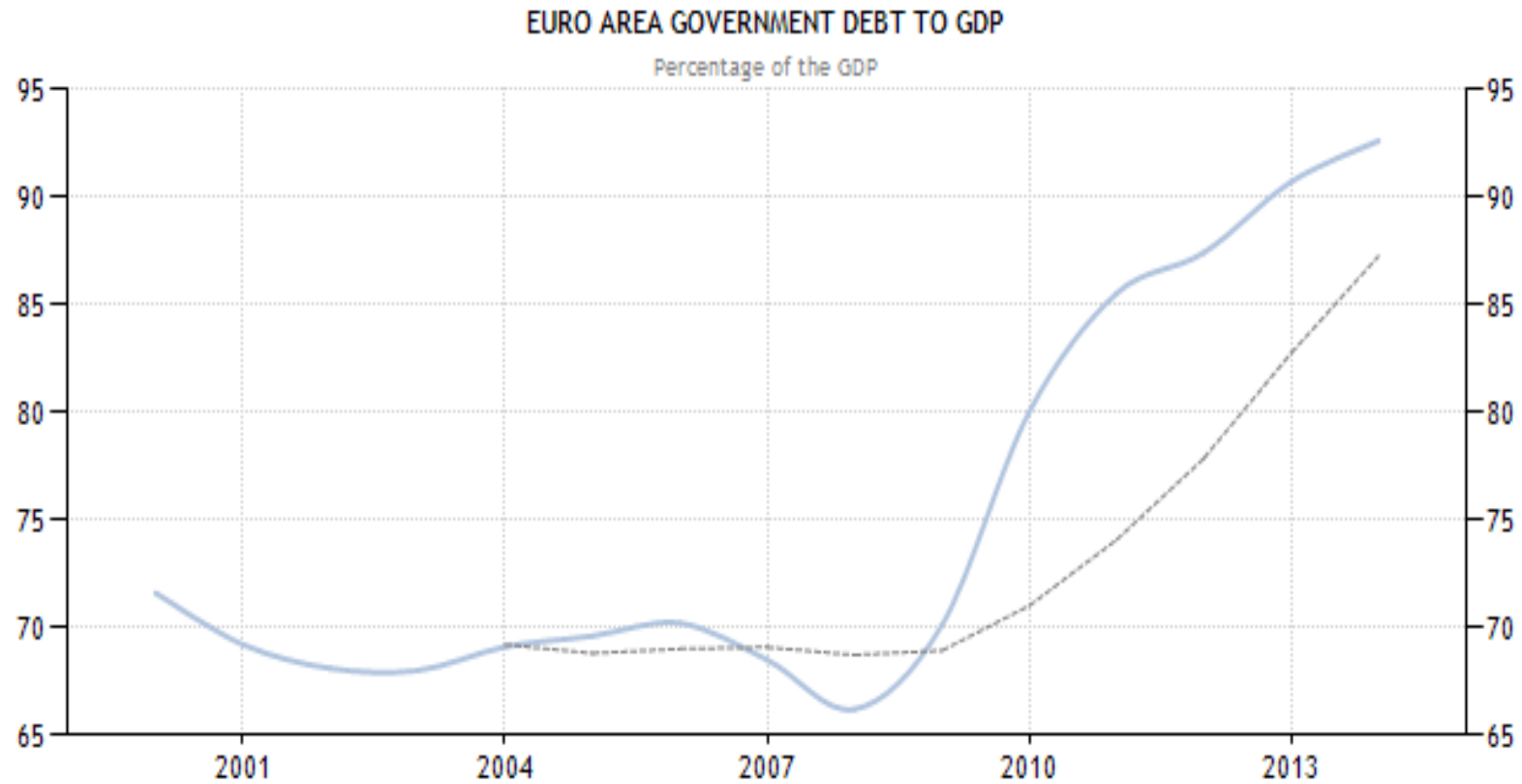


SOURCE: WWW.TRADINGECONOMICS.COM | WORLD BANK

# In the Eurocrisis the official narrative is that it's a crisis of government spending

- **Note the causality in this statement...**
- "It is an **undisputable fact** that **excessive state spending** has led to [unsustainable levels of debt](#) and deficits that now threaten our economic welfare. Piling on more debt now will stunt rather than stimulate growth in the long run."
- *W. Schauble, FT, 2010*

# Problem: Note the Timing...



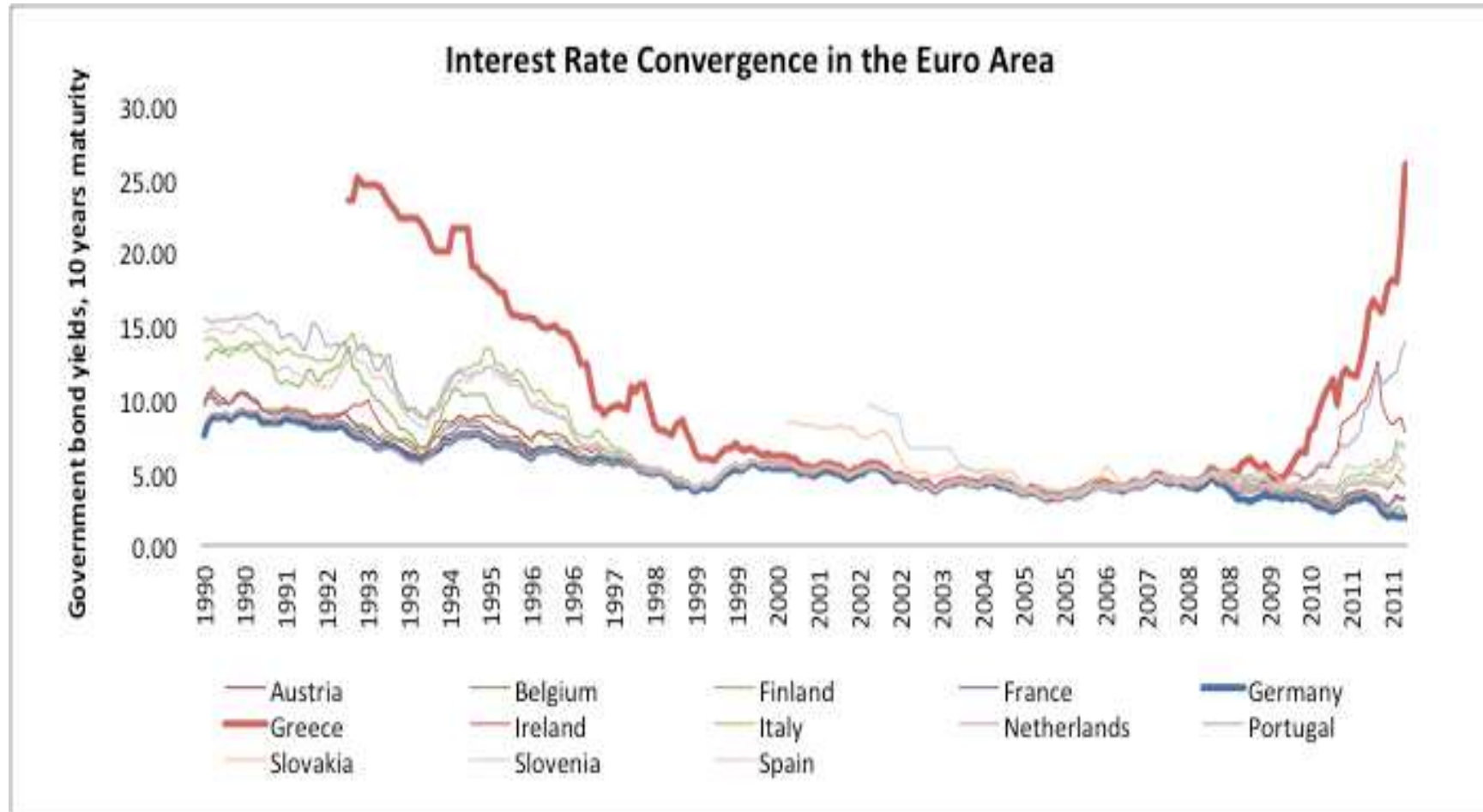
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**SO IF THAT'S BALONEY, WHAT'S  
ACTUALLY GOING ON?**

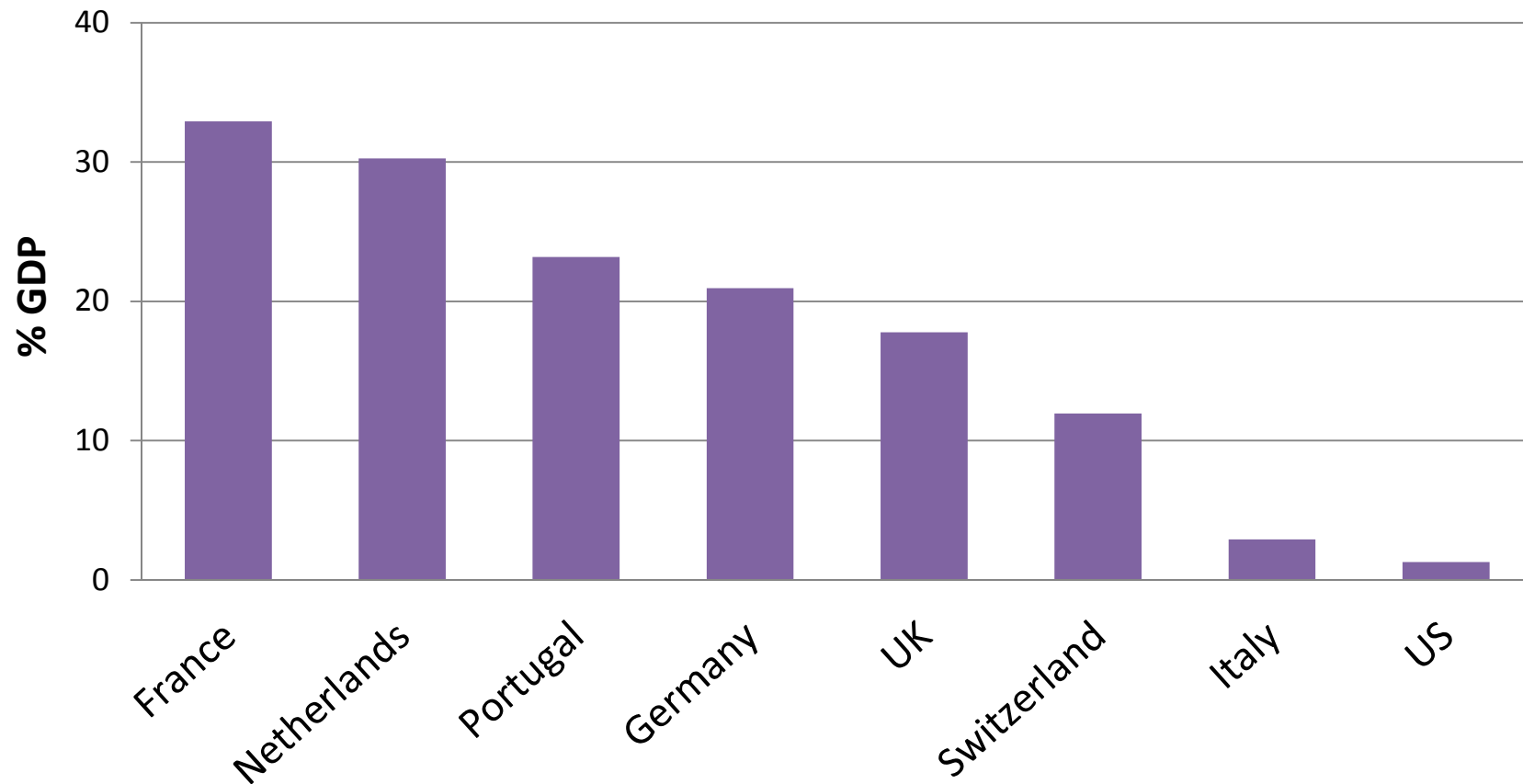
# The Great Convergence

ECB Credibility or the Greatest Moral Hazard Trade in Human History?



That trade gave us Euro bank Balance Sheets filled with periphery debts-gone-bad

**Foreign banks combined consolidated claims on Greece, Ireland, Italy, Portugal, Spain (% GDP 2011)  
BIS March 2011**



# Which today means a whole bunch of NPLs going on...

## *NPL by country 2008-2013*

In billions EUR	2008	2009	2010	2011	2012	2013
Spain	66	97	111	136	167	197
Italy	42	59	78	107	125	157
Germany	142	204	192	179	179	157
United Kingdom	88	155	172	172	164	136
Ireland	15	88	109	119	135	130
France	51	77	133	133	125	122
<b>Sub-total</b>	<b>404</b>	<b>680</b>	<b>795</b>	<b>846</b>	<b>895</b>	<b>899</b>
Greece	12	19	27	40	56	77
Netherlands	32	58	52	52	57	55
Russia	n/a	27	32	34	39	39
Cyprus	n/a	4	6	9	18	19
Austria	9	12	17	18	21	19
Portugal	5	8	10	12	17	19
Poland	9	12	15	15	17	17
Ukraine	11	11	11	12	16	14
Denmark	8	13	16	17	15	14
Turkey	7	11	11	9	11	11
Romania	1	3	5	6	11	10
Hungary	2	3	5	7	8	8
Sweden	5	8	8	7	6	5
Czech Republic	2	4	5	5	6	5
Norway	2	4	4	4	5	5
Slovakia	1	2	2	2	2	2
Finland	1	1	1	1	1	2
<b>Total Europe</b>	<b>511</b>	<b>880</b>	<b>1,022</b>	<b>1,096</b>	<b>1,201</b>	<b>1,220</b>

Source: Publicly available information, PwC information, analysis and estimates\*



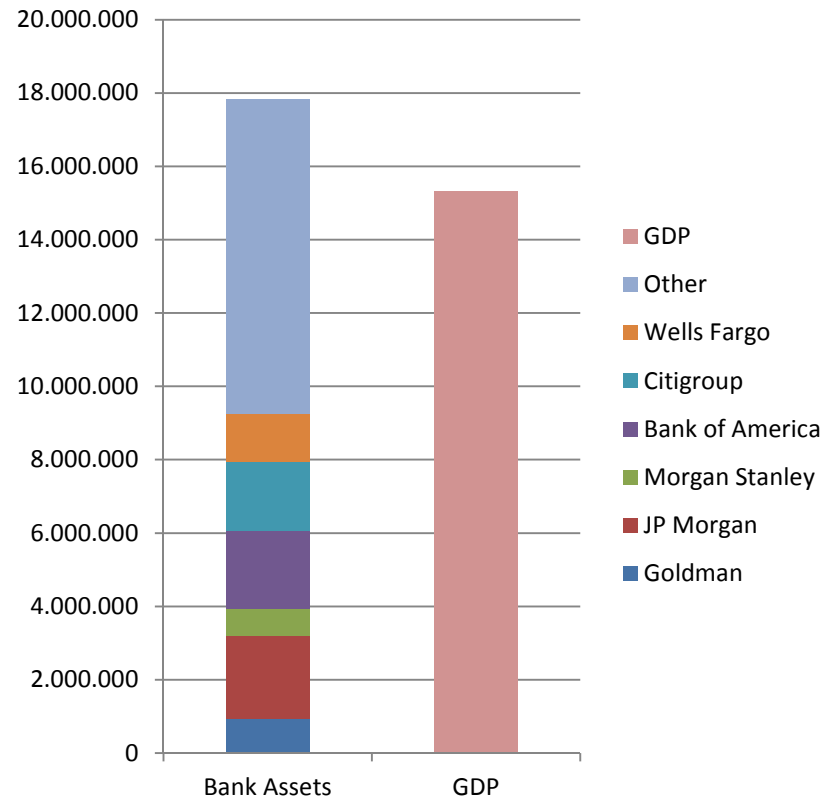
# Euroland has then a Different Problem from The USA

- Too Big To Fail
- Too Big To Bail



# The “too Big to Fail” USA

## Bank Assets (millions of USD)

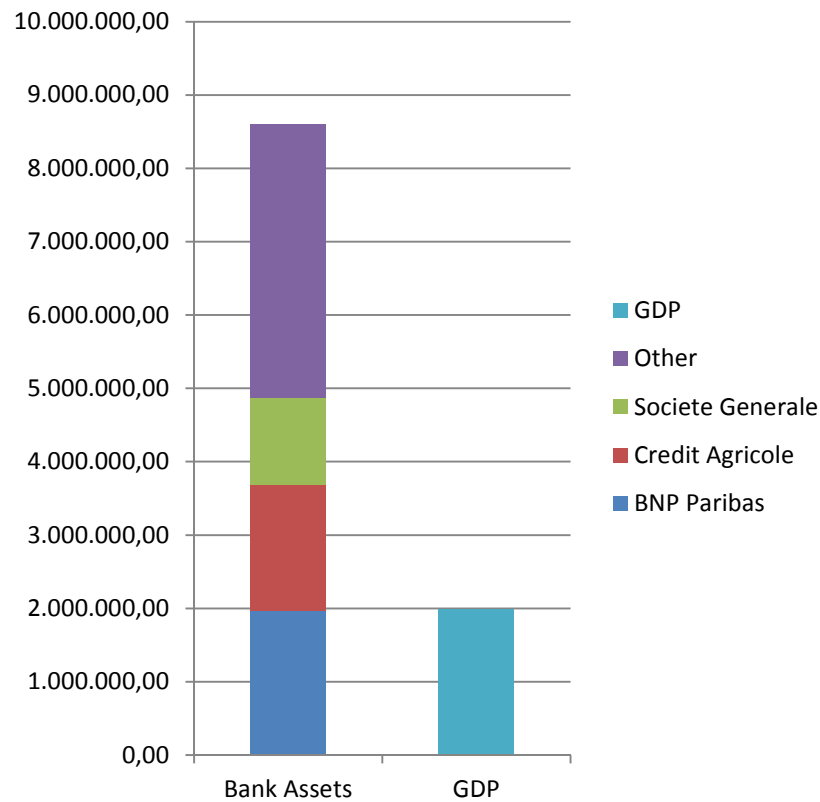


## Bank Assets (% of GDP)



# France is the exemplar of the 'too Big to **BAIL**' problem

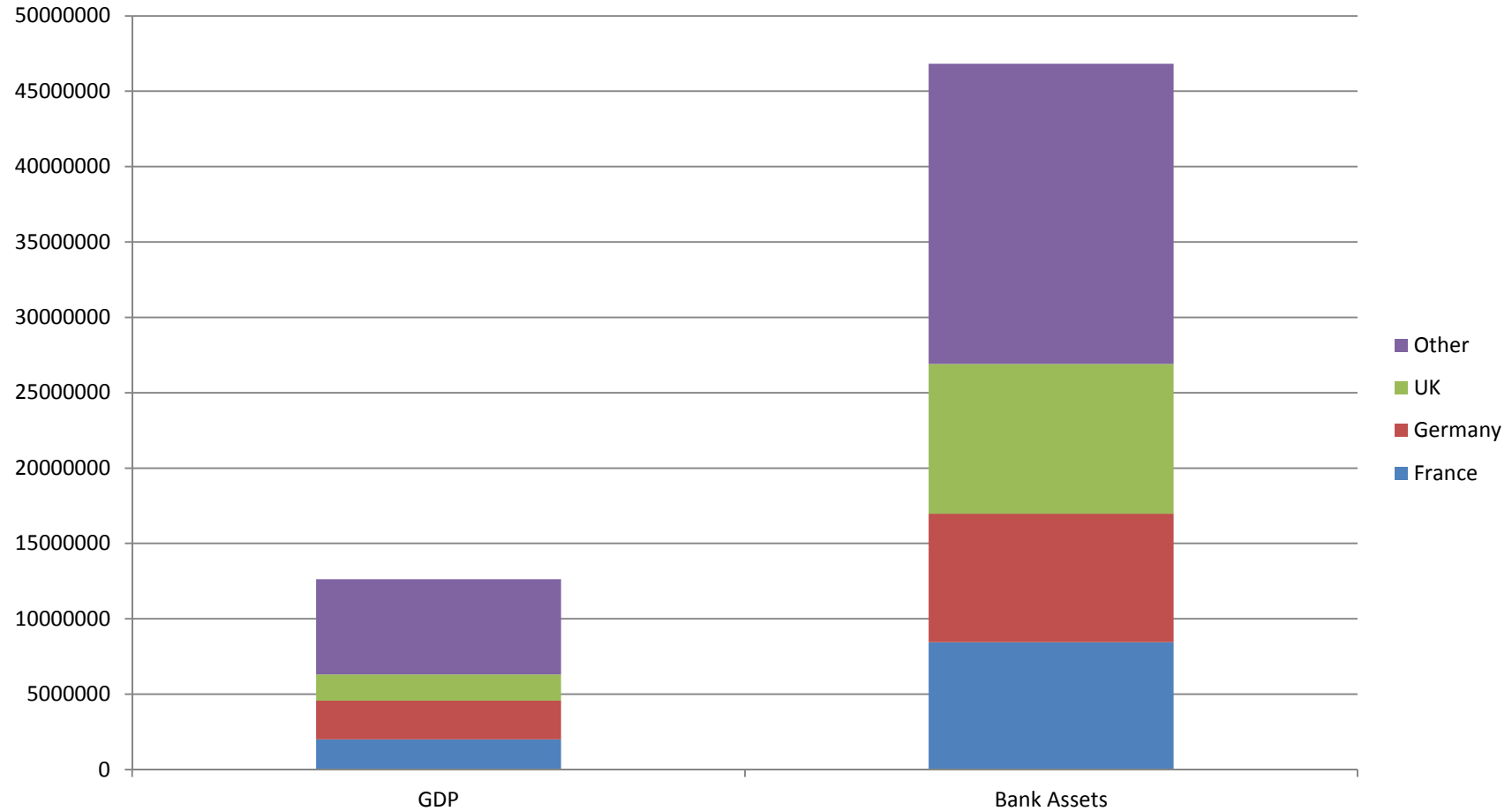
## Bank Assets (millions of EUR)



## Bank Assets (% of GDP)



# Assets held by banks in Germany, France, and the UK are about double the annual GDP of the entire EU



- Gross contribution to GDP and Bank Assets in the EU (millions of EUR) 2012



# Which is a problem if...

- The underlying base capital of the banking system has lost value
- The Sovereigns that house the banks can't inflate, liquidate or devalue
- Austerity shrinks GDP and makes debts bigger and yields greater (the denominator effect)
- **Result:** The basic funding model for running a Euro HLFi comes unstuck...
- ***Which is what the crisis is really all about.***

**IT'S A BANKING CRISIS AND WE  
DON'T HAVE THE TOOLS TO FIX IT**

## Trigger Number One was an 'Own Goal'

- The locally rational Mr. Trichet
- "... the idea is to revive the market [for covered bonds], which has been very heavily affected, and all that goes with this revival, including the spreads, the depth and the liquidity of the market. ***We are not at all embarking on quantitative easing.***" [italics added] (ECB: May 7th 2009)



# Accelerants Number 2-5

- ECB denies lender of last resort function (10/9)
  - Greeks revise deficit figures (10/9)
  - Germany Denies Backstop for Greek Rollover Risk (12/9-3/10)
  - **Result:** *Spreads widen on perception of contagion risk*
- And 20 Summits later...



# Spreads continue to widen in 2010

- Policy response is bailouts (more debt) and austerity (shrinks GDP – denominator effect – still more debt)
- Spreads widen further...
- More summits add more uncertainty
- Attention shifts to funding of European HLFIs geared at 40-60:1

**THE EUROCRISIS PART TWO: THE US CRISIS REDUX  
(JUNE 2011-DECEMBER 2013)**

# The Grim Repo Returns

## USA 2007-8

- HLFi's fund via repo around 50 percent
- Collateral of choice ABCP
- Subprime devalues collateral
- Collateral calls kill shadow banks and start bank run to Lehman
- 20/80 problem is a blessing
- **Result: TBTF is bailed out**

## EU 2011-2013

- HLFi's fund via repo around 70 percent
- Collateral of choice Euro denominated sov debt
- Sov ratings tumble and Repos fail
- HLFi's shut out of US money market paper (May 2011)
- Yields Spike and hit Bunds (November 2011)
- 80/20 problem is a curse...
- **Result: TBTB needs a bail out**

## *Here Comes the Bailout...*

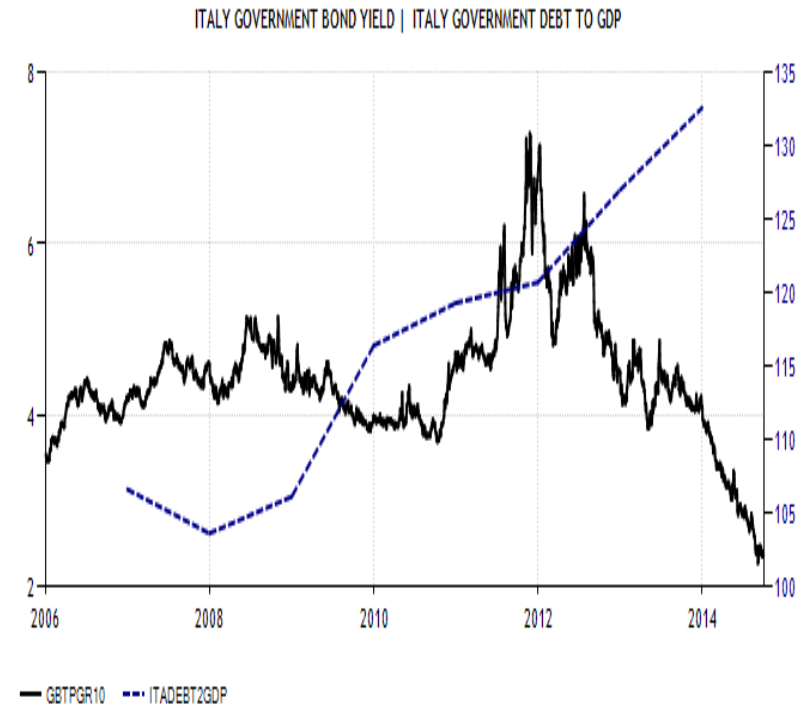
- Enter the Globally Rational Mr. Draghi
- December 2011: Long Term Refinancing Operation (LTRO) (1 trillion Euro)
- March 2012: LTRO 2 (0.529 T Euro)
- June 2012: Emergency Liquidity Assistance (0.4 Euro)
- July 26<sup>th</sup> 2012: Draghi says he will do “whatever it takes...”

- Italian Ten Year Bond Yields June 2011 – May 2013

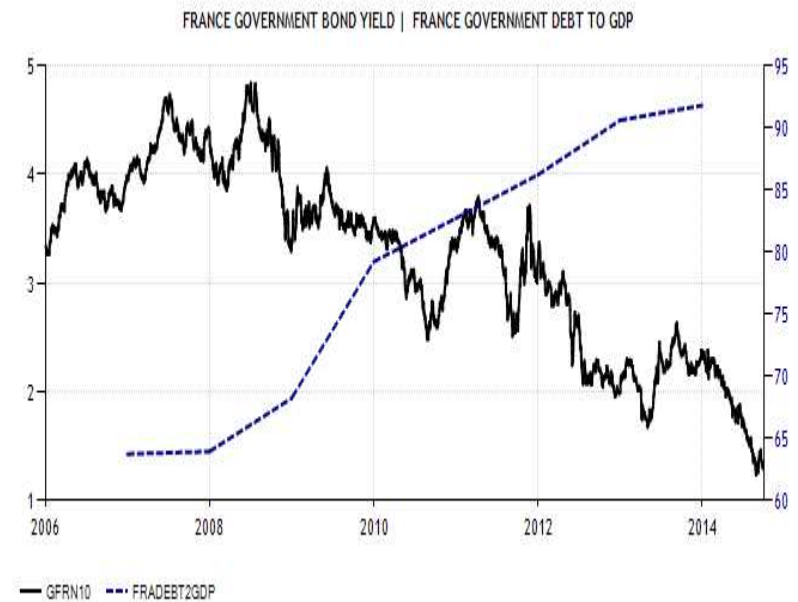
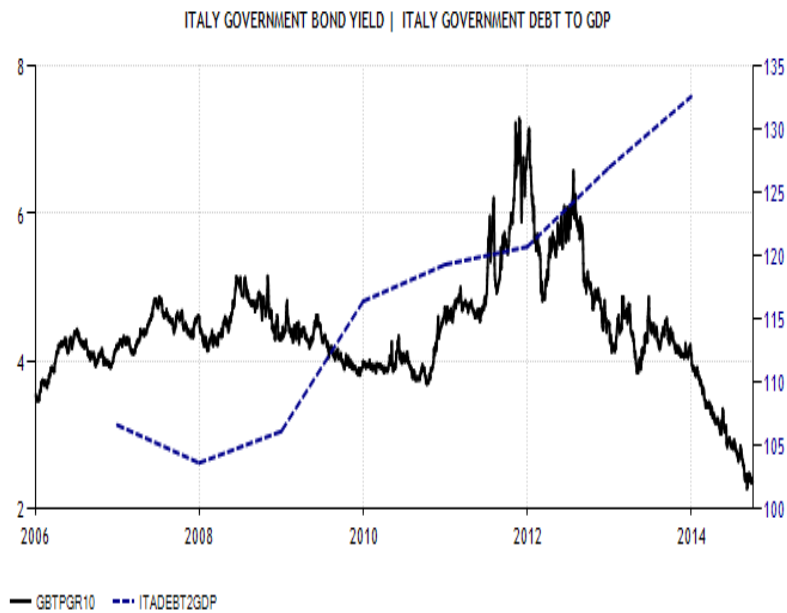




# A Closer look at Italy



# Italy and France: Austerity Rewarded?



# Welcome to the Greatest Class-Specific Put-Option Ever Constructed

- Total state support approved for the EU financial sector totals **more than E5 trillion, equivalent to 40 percent of [eurozone] GDP.**
- Of capital injected into banks to keep them afloat, “only about 10 percent of the original capital injected has been repaid.”
- “Otherwise insolvent banks have been recapitalized and the monetary policies of the ECB and national central banks have allowed themselves at low cost.”
- *Oliver Wyman, “The Shape of Things to Come: What Recent History Tells US About the Future of European Banking.” Oliver Wyman Consulting Group, August 2013: 14*

# And for Portugal that means..?

- Unemployment down from 17.5 to 13.9 percent but Labor participation rate has fallen from 61 to 58 percent
- Youth Unemployment still at 35.6 percent with 200,000 most skilled workers emigrating (future tax base)
- 3 million families earn < 10 Euro
- Running a Chinese level of exports for the next 20 years to balance the books (9.5% of GDP)

**SO IF WE ARE IN HELL, WHERE IS  
THE EXIT?**

# Theater for the Masses

- Austerity worked in the UK and Ireland so hold the course - really...
- Everyone can Run a Surplus (the Madness of the Fiscal Compact)
- Put Your Faith In Structural Reform despite the evidence from Germany

# What's Actually going on

- LTRO 1 and 2
- The Limited Banking Union
- The Asset Quality Review and the ABS Program (Greek and Cypriot Junk)
- (T)LTROs and Negative Rates
- A Banco Espirito Santo for Everyone!

# Why It Won't Work

- The Goldilocks Dilemma
- You can't solve fiscal problems with monetary instruments no matter how hard you try
- Piketty's Warning: Skewness matters for consumption
- Expecting too much from Central Banks and Too Little from Politicians
- No one votes for a 15 year long recession