

### **Strange are the ways ...**

The longer I work in financial markets, and the more I study them, I often find market reactions even to major events sometimes strange. To quote a few recent instances,

- ⇒ The U.S. bond yields fell after the debt was downgraded;
- ⇒ After Mervyn King, Governor, Bank of England, described the current problems as “the most serious banking crisis in Europe since the 1930s”, the euro has actually strengthened from its low of below \$ 1.32 (on 4.10.2011) to \$ 1.36 yesterday.
- ⇒ Investors worried over the safety of euro zone sovereign bonds, are flocking to Japanese bonds which yield even lower – and Japan has a far bigger sovereign debt as a percentage of GDP.
- ⇒ Even as U.S. stocks slide, S&P 500 earnings per share this year are expected to hit a record high.
- ⇒ The disconnect between capital ratios of banks and CDS premia.

To be sure, all these responses would have plausible, *post facto* rationalizations: and some of them were predictable.

But this apart, there is one major difference between the recent developments on two sides of the Atlantic. In the U.S., there is a fiscal crisis, partly for ideological reasons, but principally because of the huge expenditure in two wars “of choice” in the Middle East which look increasingly foolish in terms of the clarity of the objectives, their feasibility and the ways to achieve them; it is also the result of the financial market crisis of 2008 and the following recession which both reduced revenue and increased expenditure through the fiscal stimulus.

Across the Atlantic, in the euro zone, the sequence has been the reverse: a sovereign debt crisis in the southern countries, which now looks like escalating into a first class banking crisis. (No wonder of course: the credibility of sovereign debt is the cornerstone of all credit markets.) The principal reason for the banking problems is of course the exposure of European banks to the sovereign bonds of, and banks in, the southern countries.

The case of Dexia, a Franco-Belgian Bank was the first one to be engulfed by the crisis. The immediate problem was the overdependence of Dexia on market borrowings to fund its assets. As confidence and liquidity in the interbank market dried up, Dexia found it difficult to raise money and a liquidity crisis quickly escalated into a solvency crisis. One would have expected European banks and banking regulators, to have learnt from the experience of Northern Rock in U.K. just four years back – but they obviously have not. Parts of Dexia are now being nationalized and the European Central Bank is providing huge short term liquidity to the banking system. Nor has UBS been wiser after its losses in complex derivatives in 2008: it has recently reported another trading loss of \$ 2.3 bn.

Northern Rock and Dexia also manifest the futility of relying on capital ratios as a measure of confidence in the banks: both had much larger capital ratios than not only the prescribed minimum but also their competitors. (Basle III is bringing in stringent liquidity norms and capital charges based thereon, but these are going to be phased in only over this decade.) The European banks underwent stress tests as recently as July – and they did not evidence any significant shortage of capital. To be sure, the stress test administered by the European Banking Authority assumed that there would be no sovereign default in Europe! However, this possibility can hardly be overlooked now. The first assistance package of Greece envisaged a “hair cut” of 21% on Greek bonds. This was based on the assumption that Greece would be able to meet the agreed fiscal targets. It has already admitted that the 2011 budget numbers will not be met. IMF/EU have now demanded even stricter deficit standards but the question remains whether

any democratic country would be able to adhere to them in practice. The conditions require house taxes to go up by 80%; pension cuts from 20 to 40%; 30,000 public sector workers to go on a year's compulsory leave at 60% of the pay, and may never be able to come back! (In population terms, 30,000 in Greece is equivalent to 3 mn in India!) Greek GDP is expected to fall 7% in the current year. Like Greece, Portugal too is unable to meet fiscal targets and in both countries the people on the street are revolting against the savage expenditure cuts. In contrast, Ireland is sticking to its budget targets – and markets have reacted: bond yields have fallen from close to 14% p.a. just six months back to below 8% now.

Coming back to the preference of investors for Japanese debt, the major difference between Japan on the one hand and, southern countries in euro zone (and, indeed, the U.S.), on the other, is that Japan has a positive savings investment balance and it is not dependent on persistent capital inflows to balance books. Investors realize that this makes the bonds inherently safer: do our policy makers realize the dangers of dependence on persistent and increasingly large capital inflows?

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