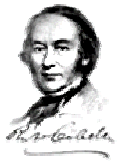

Cobden Partners

Helping Nations Solve Banking Crises

Cobden Partners Paper

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Resolving Eurozone Countries' Monetary and Banking Crises

1. Introduction

Whilst we believe in prominent roles for national governments in the resolution of the crisis, country by country, we must recognise that the root cause of the current financial crisis lies in erroneous state decisions resulting in fiscal and monetary profligacy on an unprecedented and unsustainable scale. This has brought much of Europe to the brink of economic collapse. The only solution is to restore fiscal and monetary discipline, and this can only be achieved by a return to fiscal prudence, sound banking, and hard money, combined with effective agencies empowered to enforce the basic laws prohibiting false accounting and fraud upon which stable societies are built.

The following is a fair summary of the present position:

- The latest Eurozone bailout cannot work; nobody has the money that would be required to calm the markets and another bailout funded by debt or money printing will fail like its predecessors.
- After 40 years of uncontrolled fiat money and deficit finance, public debt has reached such levels that the ECB is now increasingly funding member nations directly via the desperate expedient of debt monetization.
- Indeed, the crisis is now so out of control that it threatens to cause our fiat paper money system to collapse (though this point is by no means confined to the Eurozone).
- The banking systems of many countries are insolvent and in far worse shape than presented by their accounts (see Section 3).

Much of the crisis in the EU stems from the policies of the European Central Bank (ECB). The ECB has adopted a policy of propping up failed banks by waiving its originally strict criteria for assets it will accept from banks as collateral for loans, and has proceeded on the assumption that it can solve the problems of Eurozone debt by buying toxic assets paid for by printing money.

Yet a closer analysis of the ECB's recent documents reveals that the thinking underlying its stewardship of monetary union is not just flawed but in logical tatters.

To illustrate, in its July 2011 Monthly Bulletin, the ECB acknowledged that the "smooth functioning of Economic and Monetary Union (EMU)" requires national governments to balance their books and ensure the competitiveness of national economies.[1]

The text is replete with statements that the solution cannot be one that creates "moral hazard".

At page 71 the ECB set out the two cornerstones of EMU aimed at curbing excessive sovereign indebtedness:

- the "no bailout" clause (Article 125 of the Treaty)
- the monetary financing prohibition (meaning no Eurozone wide monetisation of individual nation's debt) – Article 123.

Yet on page 72 the ECB noted:

> "The fiscal rules (laid down in the Stability and Growth Pact, SGP) have…not been implemented. This weakness is to be addressed by a new enforcement regime, but confidence is low among markets that such a regime could be effective since no attempt was ever made by the old regime to enforce any of the provisions of the SGP."
>
> The European Financial Stability Facility (EFSF) structure is described as "bridge" financing, allowing countries to buy time. But no country in recent times has ever avoided default on its national debt when its level has reached 90% of GDP, and of the 17 Eurozone countries Spain is at about 90%, and each of Portugal, Ireland, Italy and Greece are in excess of 100%. It should also be noted that the 17 countries include states with very small economies such as Malta, Luxembourg, Slovenia and Slovakia. Of the major countries, only Germany is still fiscally sound by this criterion, and only just.
>
> As part of the moral hazard argument, the ECB confirmed at page 73 that "financial assistance must be granted on non-concessional (i.e. sufficiently unattractive) terms to increase the incentive for the country to return to the market as soon as possible."
>
> Yet even though the 2010 rate struck most market commentators as small enough, 5.5%, the EFSF 2011 interest rate has been set to 3.5%. This is substantially below the market rate for any of these countries as a brief review of present credit default swap rates reveals.

On the same page the ECB noted that in 2008 "sovereign bond spreads were clustered in close proximity to each other". The ECB then blamed inefficient markets for allowing this clustering and argues that the perceived mutual strength of EMU led to the underpricing of certain sovereign states' debt so encouraging overborrowing and contributing to the present crisis.

At this point the ECB is simply contradicting itself. Just as it is arguing for a massive fund to be used to boost the credibility of the overindebted nations, so tending to recluster sovereign bond spreads, it also argues that such reclustering is itself an undesirable objective.

We therefore reach the conclusion that the ECB is living in a world of its own contradictions:

- it insists that bailouts must the problem of respect moral hazard, but it endorses the EFSF structure which is riddled with moral hazard;
- it claims that the emergency funding must be on "sufficiently unattractive terms" to encourage nations to return to the markets on their own standing as soon as possible, yet the terms on offer are the most attractive ever offered by the ECB or EFSF, and

are a fraction of the levels at which the overindebted countries could borrow on their own;

- it blames low spreads emanating from the perceived strength of EMU for the crisis yet imposes one low spread for the worst credit risks in the Eurozone.

As we will explain in more detail in section 2, the Treaty initially expected to be signed at the end of January 2012 by 25 countries, represents no substantive agreement at all and therefore will do nothing to restrain the most heavily indebted countries from further indebtedness. Indeed it is likely to have the opposite effect and encourage further borrowing under the guise of compliance.

All ECB and centralized euro area proposed solutions will fail for the above reasons. There is, therefore, no collective Eurozone-wide solution – and even if there was, the Eurozone lacks the means to implement it or even recognise it.

Consequently, we would advise Eurozone countries to seek their own salvation via a return to fiscal and banking reform, hard money and free markets.

Let us consider the options available to a generic Eurozone nation that we might call "Ruritania".

2. Fiscal Problems

A further reason why each of the 27 countries should break away from the central organs of the EU and 'go it alone' is that the Eurozone has decided upon a Treaty to compel further fiscal integration. Unfortunately the Treaty is yet another chimera that would fail to bring about fiscal integration and would result in even deeper fiscal chaos.

Known as a "fiscal compact" closer analysis reveals that it is an agreement to a vague and unenforceable set of targets with such a gaping exception in Article 3 that it would not be recognised as a contract under English law. In detail and again from the perspective of our generic country "Ruritania".

- This Treaty has always been presented as a contract since its genesis in early December 2011, its draft title was an "International Agreement between Contracting Parties", and although it is now entitled a "Treaty on Stability, Coordination and Governance in the Economic and Monetary Union", it nevertheless opens with the words "The contracting parties….." and is couched throughout in the language of a contract.
- Signature by Ruritania would expose it on the one hand to geopolitical pressure to restrict its own fiscal and economic freedoms. On the other hand, if Ruritania is fiscally sound it would derive no benefits and would be unable to hold any of the other countries to account.

More detail:

1. What is the Nature of this 'Agreement'?

The draft Agreement is described as a contract. Under English Law the accepted definition of a contract is "a promise or set of promises which the law will enforce".[2] The law will not enforce agreements whose terms are unclear or vague, nor will the court enforce "agreements to agree". Article 3 exemplifies precisely the type of indeterminate wish list of future actions which the English courts have repeatedly dismissed as non-contractual.

The later enforcement provisions are meaningless since a recalcitrant party would claim that, no matter to what degree it has exceeded any or all of the headline 3% GDP deficit, 0.5% structural deficit and 60% debt to GDP targets, it had not infringed the terms of this Agreement which allow each party to "deviate" in "exceptional circumstances" as defined in Article 3 paragraph 3 as "an unusual event outside of the control of the Contracting Party concerned which has a major impact on the financial position of general government or to periods of severe economic downturn…" This exception is broadly drafted and would encompass capital market price hikes and dislocation and is therefore fatal to the assertion of the existence of any contractually binding promise.

2. Geopolitical Pressures – Downside to Ruritania

This Treaty is in essence a renewed plea to enforce existing budgetary commitments. Its central innovation is Article 8; the European Commission, or any Contracting Party which considers that another is in breach, can bring the matter before the EU Court of Justice.

This seems plausible at first sight, but the new mechanism is not substantially different from the present mechanism under the 1997 SGP. Under the SGP the Commission reports sinners to EcoFin who makes recommendations for fines. The ultimate sanction of fines under SGP is no different here. Furthermore, under SGP, the constitutent countries have the ultimate say in enforcing the penalties and to date no country has been fined.

There is, therefore, no mechanism to enforce existing obligations, and Article 8 would do nothing to remedy this problem: the only parties that can bring a court action against miscreants are governments of countries that would have signed up to the draft Agreement, most of whom are likely to be in breach of their own obligations.

Consequently, countries in breach are unlikely to instigate legal action against any other for fear of inviting retaliation. Further, will any country be minded to report a slew of countries in breach to the European Court of Justice? Ruritania, for example, could hardly report only one, for fear of being accused of singling out, say Greece for political reasons. But if Ruritania reported all of the infringers the question would be raised as to why Ruritania signed up in the first place?

Finally, we would also note that none of the mischiefs which the Agreement aims to cure would apply to a fiscally sound Ruritania, so why should Ruritania voluntarily submit to potential restrictions on budgetary and fiscal sovereignty contained in Article 5? The inapplicable mischiefs are:

1. Article 1, Contracting Parties agree to strengthen their budgetary discipline, yet unlike the Eurozone countries, Ruritania already has a strong fiscal discipline.

[2] Sir Frederick Pollock, quoted by Smith, J.C. and Thomas, J.A.C. *A Casebook on Contract – 6th Edition* 1977 (Sweet & Maxwell)

2. Article 1(2) states that the provisions of the draft treaty apply to Eurozone countries, except in so far as non-Eurozone Contracting Parties are covered under Article 14. The relevant part of Article 14 provides no coherent protection to Ruritania.

3. The principle of Ruritania contributing to EU institutions that break their own rules and violate fiscal discipline is itself inconsistent with Ruritania's own commitment to fiscal discipline.

Article 3(1a) states:

"Revenues and expenditures of the general government budgets shall be balanced or in surplus."

This is an entirely sensible provision, but is inconsistent with the rest of the Treaty. Bailout packages not only endanger budgetary sustainability in the medium term, but also in the immediate short term. This clause therefore requires that bailouts be prohibited and effective mechanisms be put in place to enforce this prohibition. But the rest of the Treaty is at odds with this core assertion, and yet again we conclude that fiscal problems will be enhanced, not addressed by measures such as this 'fiscal compact' treaty signed January 30 2012.

The bottom line? Countries should address their own fiscal problems and stay clear of EU 'solutions'. In some cases – Greece being the most obvious but by no means the only case – these solutions will involve a structured default combined with long-term fiscal retrenchment to return public finances to a healthy condition.

3. Banking Crisis

Any restoration of European prosperity also requires a resolution to the banking crisis: many (most?) Eurozone banks are effectively insolvent. The root problem is out-of-control moral hazards in banking that have caused a collapse of effective corporate governance and risk management.

This problem also manifests itself in inadequate accounting and capital adequacy standards. These rules have allowed bank executives to overstate their profits, feeding through into multi-million pound bonuses for themselves and short-term gains for their shareholders, with losses dumped on taxpayers through subsequent bailouts.[3] Moreover, the rules introduced in reaction to the crisis – rules aimed at making the banking system more transparent and its capital more secure – have retained the weaknesses of International Financial Reporting Standards (IFRS) accounting rules that encourage profit exaggeration and secret capital depletion.

To give just two perverse examples from amongst many:

- Banks need not make provision for expected losses when calculating their profit.
- There is the widespread practice of banks recording profits in respect of falls in the market value of their own debt. Because IFRS rule IAS 39 requires banks to assume that

[3] Examples of transactions illustrating each of these points are contained in Kerr's paper. See Kerr "The Law of Opposites" section 3 for detailed example http://www.adamsmith.org/sites/default/files/research/files/ASI_Law_of_opposites.pdf.

they could repurchase the entirety of their own debt issuance at present market prices, operating losses can become accounting profits. So, for example, if Greece adopted the accounting policies used by British banks, they could instantly record a surplus equivalent to 50% of their total issued debt and the Greek debt problem would be instantly transformed!

Similarly, the proposed new international Basel reg cap rules do little to address most of the underlying problems with earlier Basel rules – the use of inadequate risk models, etc. – and continue to incentivise banks to game the system and decapitalize their banks.[4]

As another example of inadequate financial regulation, consider the stress tests conducted by the European Banking Authority (EBA) in the case of the Franco/ Belgian Dexia Bank. This bank not only produced reasonable Basel capital numbers, but was also pronounced safe under EBA stress tests in July 2011 before being declared insolvent in October.

Banking is accordingly now so dysfunctional in most European countries that it needs fundamental and radical reform. Without such reform banking systems will repeatedly bring down the economies they are meant to service. To put this into context, imagine that the EU were to launch an intergalactic space expedition in search of gold. Imagine that this search was successful and that several trillion tonnes of gold were found on Mars, brought back to the Eurozone, and the proceeds of sale were used to extinguish all of the sovereign debts of all 27 member nations. Sadly, even if this nirvana scenario transpired, if the banking systems were not reformed along the lines now set out then banks would silently destroy their capital all over again and within a few years would require further bailouts from countries who considered their banking systems too important to be allowed to fail.

The solution we propose is radical but would be effective, and without reform along this or similar lines the crisis will deepen, and would recur even if it magically disapeared in the near future. In addition to reforming accounting standards, abolishing capital adequacy regulation and putting insolvent banks into bankruptcy, each country should enact a law, preferably constitutionally not easily capable of repeal, to implement a series of mutually reinforcing measures to make the bankers responsible for their own actions, so reining in rampant moral hazards and excessive risk-taking, whilst also putting insolvent banks into bankruptcy. A possible template is as follows:

- Board members of financial institutions should be strictly liable for any losses reported by their institutions. They should also be subject to unlimited personal liability for any such losses, and be required to post personal bonds that would be potentially forfeit in the event that their banks report losses. These measures would create the strongest possible personal incentive for board members to ensure that their banks are managed responsibly. This is the key requirement to resolving the banking crisis: with the key decision-makers' own wealth most at risk, they would ensure that the excess risk-taking would soon disappear.
- The payments of any profit related compensation that are awarded in any given year should be deferred for a period of, say, 5 years. The amounts involved should be invested on beneficiaries' behalf in an independent money market mutual fund, and bonus

[4] "Capital Inadequacies: The Dismal Failure of the Basel System of Bank Capital Regulation." (K. Dowd, M. Hutchinson, S. Ashby and J. Hinchliffe) Cato Institute *Policy Analysis No. 681*, July 29, 2011.

payments will be made after that 5 year period from whatever remains of the bonus pool by then. The bonus pool would provide an additional form of junior capital that could be used to make good any reported losses.

- The core capital of the bank would be the sum of the shareholder equity capital, the current value of the bonus pool and the personal bonds of the board members. (This is a robust measure of core capital, and is far better than the core capital definition of Basel II, which is open to widespread abuse.) Should the ratio of a bank's core capital to its assets fall below, say, 3%, then the bank would be be deemed to be insolvent: a bank with a capital/assets ratio below 3% is essentially a zombie and is not fit to continue in operation anyway. In the event of insolvency, the bonus pool and the personal bonds of board members would be forfeit to the creditors of the bank, and court proceedings would be instituted to recover their remaining personal property.
- There should be an end of all state support for banks including: all bailout support, all lender of last resort support, all public shareholdings in banks, all central bank holdings of bank assets and any form of state-supported deposit insurance.

4. A New Gold Standard

The third element of the package is to withdraw from the Eurozone and establish a new monetary regime. The initial step is to replace the euro domestically by a new local currency, say, the krown. Control of the new currency would now have passed to the Ruritanian central bank, and the next stage involves the selection of a new Ruritanian monetary policy or monetary regime. In principle, there is a wide choice of alternatives that include: a peg against the euro, an independent monetary policy (as followed by, e.g., the UK, Sweden, etc. leading to a fluctuating exchange rate against the euro) or some other form of peg, such as a gold standard.

Of these, the first is pointless unless it is intended that the krown move away from the euro at some point, and the latter may or may not be an improvement on the euro depending on the local monetary policy subsequently followed. But in either case, these choices still boil down to a continued dependence on the monetary policy of *some* central bank, i.e., there is still a dependence on managed fiat monetary policy that we would reject for reasons set out in the Introduction.

This leaves the third possibility, a gold standard, which would be attractive for a number of reasons: it provides for an effective control against the over-issue of currency, it has a credible historical track record providing for reasonable long-term price stability, and it has growing public support.

A gold standard involves fixing the price of gold in terms of the local currency, the krown, with the intent being that the krown price of gold, once fixed, should be fixed permanently. So what should this price be?

This is an important question: if the krown is overvalued relative to gold and given existing price levels, then the resulting macroeconomic imbalance can only be corrected by downward pressure on wages and prices, increased unemployment and recession, and drains of gold to other countries. This makes for a painful macroeconomic adjustment and a potentially brittle gold standard.

The natural historical example – and an example to be avoided – is Winston Churchill's restoration of the UK gold standard in 1925. This involved the resumption of the pre-WWI gold parity whilst UK prices and labour costs were perhaps 10% too high. In these circumstances – exacerbated by the difficult labour market conditions of the time – the resumption of the gold standard entailed considerable deflationary pressure and resulting unemployment not to say civil unrest, including a General Strike the next year. It also ensured a current account deficit and the loss of gold abroad, and these put further pressure on the gold standard, which then fell apart in the international financial crisis of 1931.

A comparable mistake was made again by Norman Lamont in 1990 when the UK joined the European Monetary System's Exchange Rate Mechanism at an overvalued exchange rate, and this peg also turned out to be unsustainable.

If a new gold standard is to be maintained without undue macroeconomic adjustment pain in its early years, it is therefore critical to choose a suitable krown-gold parity.

This is where the structure of the gold standard varies from country to country, and Cobden Partners would propose to work closely with Ruritania to ensure the optimal structure is implemented. After the initial structuring Ruritania would be on a gold standard, and the gold standard would be maintained by the central bank buying and selling its paper currency at a fixed price relative to gold.

The final stage is to harden the link to gold and make the gold standard as far as possible permanent. The key to this is a new currency law based on the model of the 1819 Resumption Act in the UK, the abolition of monetary discretion and free currency competition. Further details have been discussed elsewhere in internal Cobden Partners discussion papers.

7. Conclusion

The scale and depth of the crisis result from a form of crony capitalism whereby financial institutions have captured their eager-to-be-captured scrutineers and regulators. There is no point in looking to the established failed Eurozone organs for the solution. The current debt-addicted fiscal, banking and paper money systems are severely threatened and the governments of each country should first and foremost protect their own citizens' interests. Therefore, individual nations should carry out their own domestic reforms as appropriate by resolving their own fiscal and banking problems and harden their currencies by linking them to gold.