

## The Gutenberg Economy

By Michael Lewitt, Editor, The Credit Strategist

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“In meritocracies, though, it’s the very intelligence of our leaders that creates the worst disasters. Convinced that their own skills are equal to any task or challenge, meritocrats take risks that lower-wattage elites would never even contemplate, embark on more hubristic projects, and become infatuated with statistical models that hold out the promise of a perfectly rational and frictionless world.”

Ross Douthad<sup>1</sup>

Adam Smith is spoken of as the father of modern laissez faire capitalism, as well he should be. But the market system Smith described in *The Wealth of Nations* (1776) no longer exists. Instead, it has morphed into a system of fiat money that owes its existence to another man: the German printer and publisher Johannes Gensfleisch zur Laden zum Gutenberg (1398-1468). Gutenberg was, of course, the inventor of movable type and the modern printing press, a device without which the modern economy could not function.

As commentators near and far speculate on what 2012 will bring to the global economy and markets, there is little question that one factor will be decisive: the central banks’ printing presses. **As I recently said in an interview on MSNBC, both the Federal Reserve and the European Central Bank (ECB) will keep printing dollars and euros around the clock until their presses run out of ink.**<sup>2</sup> This vomitoria of paper currencies is the major force driving financial markets around the world. There may be a lot of “known unknowns” to worry about, but central bank money printing is one “known” that can be taken to the bank. The only question is whether the bank will still be able to cash the check when it is asked to.

Whatever the problem, the Federal Reserve has given the same answer over the past three decades – PRINT!! The stock market crashes in 1987? PRINT!! Computers might shut off at midnight on 12/31/99 (we should have been so lucky...)? PRINT!! The Internet

<sup>1</sup> Ross Douthad, *The New York Times*, Nov. 5, 2011.

<sup>2</sup> The interview can be found at <http://www.msnbc.msn.com/id/31510813/#45828718>.



Stock Bubble bursts in 2001? PRINT!! The housing bubble implodes in 2008? PRINT!! Europe got into the act during the 2008 financial crisis but is now taking the art of printing money to a new level. As of the end of 2011, the ECB's balance sheet has swollen to €2.7 trillion (\$3.4 trillion), even fatter than the Federal Reserve's \$2.7 trillion. Without exception, every proposed solution to the European debt crisis involves the printing of huge amounts of money in the form of debts that can never be repaid in real terms.

## **Europe**

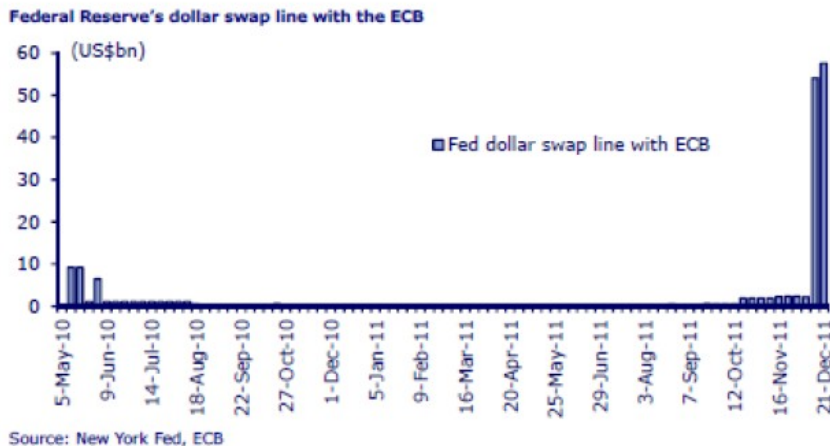
### **LTRO**

In their latest scheme, European leaders have decided in their infinite wisdom to further swell the ECB's balance sheet through the LTRO (Long Term Refinancing Operation) program. In the week before Christmas, the ECB loaned €489 billion to European banks. Only €210 billion of these loans added to systemic liquidity; the other €279 billion was used by the banks to refinance existing debt obligations. This is only the first LTRO operation planned by the ECB; further loans will be issued under this program in 2012.

The LTRO provided much-needed liquidity to European banks, which were experiencing increasing difficulties in accessing short-term financing (especially in USDs – see Figure 1 below). This of course begs the question that the banks are suffering from an insolvency problem as much as a liquidity problem, but the authorities are trying to deal with one crisis at a time. The LTRO facility lends money at one percent in the hope that banks will relend this money at a higher rate and earn money on the spread. Some expect the new loans to be in the form of purchases of European sovereign debt. One can only hope that the banks will not be tempted to repeat their previous mistakes by further burdening their balance sheets in that manner.

The equity markets greeted this operation with glee, rallying sharply into the end of the year on the hope that the ECB was stepping up its market intervention. Previously, the ECB's efforts had been limited to the repurchase of a bit more than €200 billion of European sovereign bonds. The LTRO was seen by many as a break-out move by the central bank, an admission that stronger measures were needed to prevent the crisis from truly becoming a systemic threat.

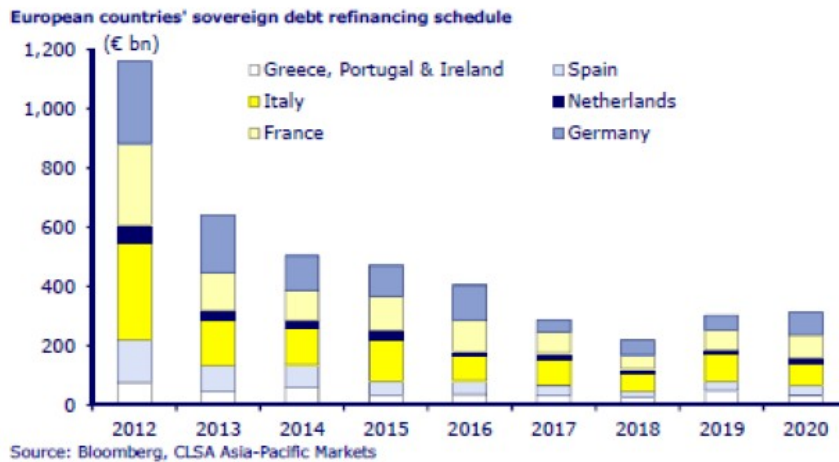
**Figure 1**  
**Intensifying Search for Dollars**



Of course, the LTRO is nothing of the kind. It does little more than put a small Band-Aid on a bleeding artery. A scheme that simply piles more debt on effectively insolvent European banks is doomed to failure. It would be surprising if the banks actually loaned out these additional funds; they are far more likely to retain them to prop up their liquidity. Further, it is difficult to see how the banks will be able to repay these funds when they are due in three years. During that period, they will be operating in contracting economies, hardly the type of environment that will enhance profitability or their ability to generate free cash to reduce debt. Instead, the banks will have to refinance these loans at higher interest rates (unless the program is extended) or restructure them (i.e. default). Moreover, a mere €210 billion of additional liquidity is a drop in the bucket in terms of the €2 to €3 trillion of capital that appears to be needed to return Europe to economic stability (these are not TCS's numbers but numbers provided by outside sources that are, as it is said, "deemed to be reliable"). This program may have given hedge funds and other equity managers the chance to dress up their disappointing 2011 performance, but it did little to solve the European debt crisis.

Figure 2 below shows the €1.2 trillion mountain of debt that must be refinanced in 2012. In the first quarter of 2012, €157 billion (\$203 billion) of debt matures in the European Union (EU). Italy has €53 billion (\$68.9 billion) of debt maturing in that period and ended the year with a 10-year borrowing cost of just below 7 percent. If Italy is forced to pay much more than that to refinance its debt, the crisis will take a decided turn for the worse. Italy's success or failure in refinancing its debt will be the markets' first important test of 2012. As Figure 2 illustrates, Europe's refinancing needs are front-loaded. If the EU can somehow refinance itself through 2013, financing pressures should ease considerably (although how considerably will depend on their ability to extend maturities by more than a year or two, which is why 10-year rather than 2-year rates will be so important for the outcome of the crisis).

**Figure 2**  
**2012: A Sovereign Maturity Peak**



Printing can (literally) paper over a lot of mistakes. Today, it is being used to paper over a misbegotten fiscal union and ten years of profligate lending to subprime borrowers and failing sovereigns by European institutions. But this is not merely a European operation; the United States is also in the money-printing business both for itself and for the sake of the global system. The U.S. is indirectly contributing to European bailout operations through its funding of the International Monetary Fund (IMF), something we are likely to hear about during the 2012 Presidential Election.<sup>3</sup> More directly, the Federal Reserve is busy printing money to the tune of more than \$1 trillion a year in order to fund the U.S. government and its seemingly bottomless obligations.

Painless solutions do not solve economic problems. There can be no capitalism without risk and loss, and a system that is willing to do virtually anything to avoid pain will never heal itself. While it is difficult to know where to begin criticizing current responses to the European debt crisis, there are at least two points that should be considered indisputable. First, all of this newly created money is in the form of debt that theoretically has to be repaid at some time in the future. It is highly likely that repayment will take the form of currency devaluation and/or inflation (which are two sides of the same coin). And second, none of this new debt is backed by new assets or discernible economic value. While central bankers are printing money hand over fist, nobody is printing collateral at anywhere near the same pace. Accordingly, the volume of money is accelerating far faster than the

<sup>3</sup> Complaints are already coming from some Republicans, who are typically oversimplifying the issue for election gain. While it is unpalatable for the already overindebted U.S. to be using precious capital to prop up Europe, this is being done because the costs of a European economic collapse on the U.S. economy would be far more significant. The difficulty, from a political standpoint, is quantifying the benefits of contributing to the IMF and what it might cost the U.S. if Europe were to go into free-fall. Strong leaders can make that case if we can find any strong leaders.

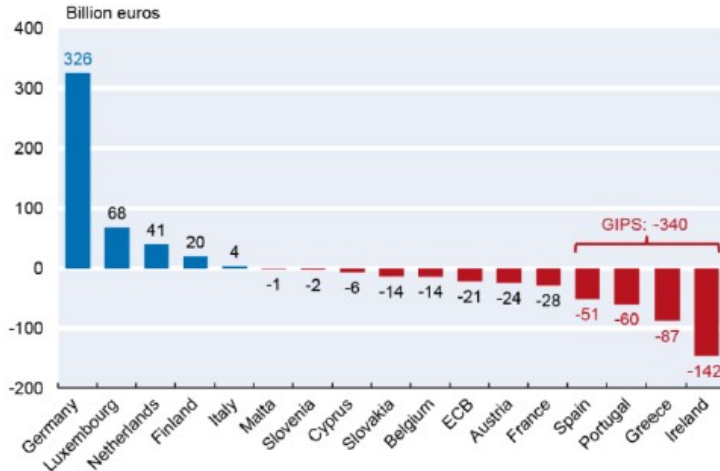
growth in the assets it is supposed to finance. It is obviously much easier and faster to manufacture money than to manufacture tangible goods. Money is simply being minted out of the air and injected into a system already drowning in debt. Anybody who thinks this is going to end well has been reading different history books than we have.

## Target2

It should be noted that there is another little noticed areas in Europe in which huge debts have built up: the ECB's interbank lending system known as Target2.<sup>4</sup> Since 2007, Target2 has been a mechanism whereby Germany's Bundesbank has loaned €495 billion to the ECB that has in turn been loaned to the central banks of Greece, Ireland, Portugal and Spain (PIGS). More recently, Italy and France have been net borrowers under this system. Until 2007, the Target system did not create imbalances and acted primarily as a back-office transaction processing system. For example, Germany had net claims on the ECB of only €5 billion at the end of 2006. But when the interbank system began to seize up in 2007, Target2 began to serve as a major funding mechanism for European businesses.

**Figure 4**

**Target2 Balances in the Euro Zone (end of 2010) The Credit Strategist January 1, 2012**



Target2 has facilitated a growing balance of payments problem within the Eurozone. Moreover, it has done so in the dark. The weaker PIGS countries have insufficient reserves to fund domestic purchases of goods and services from other European countries, but the ECB has been making up the shortfall through Target2 with funds that it borrows from the Bundesbank, which has more than sufficient reserves to fund Germany's needs. These Target2 loans dwarf the official loans granted to the PIGS by the EU

<sup>4</sup> Target stands for Trans-European Automated Real-Time Gross Settlement Express Transfer System. The expansion of Target2 was described in an excellent article in the December 19, 2011 issue of *Bloomberg Businessweek* entitled "Germany's Hidden Risk."



member countries under formal bailout programs. In effect, the ECB has infused an enormous amount of liquidity into Europe in the form of debts owed by the PIGS to Germany through the medium of the ECB. One can only wonder how much deeper into recession Europe would have been plunged without this additional €500 billion of liquidity that is being used primarily to finance inter-European trade. One of the reasons that this program is just coming to attention is that Target2 imbalances are not shown on the ECB's balance sheet and can only be found on the balance sheets of individual central banks (and it takes some detective work to pull out the data). A study in unanticipated consequences – another study – the Target2 loans are another source of systemic fragility in Europe. The Bundesbank has to be seriously concerned about lending additional money through this program to its weaker neighbors. A shrinkage of this facility, of course, would exacerbate the deflationary contraction of European bank balance sheets. It seems the deeper you dig in Europe, the more debt you find that can never be repaid.

### **The Rehypothecation Crisis**

MF Global's collapse has shined a light onto a hitherto hidden part of the financial system – what *Forbes'* writer Robert Lenzner describes as “the shadow banking system of unregulated hedge funds, money market mutual funds, family investment offices, sovereign wealth funds, exchange traded funds and the dealers involved in the very murky business of finding and lending securities as collateral for leveraged finance.” This shadow banking system operates without oversight by the Federal Reserve and is not addressed by either The Dodd-Frank Act or Basel III. There is no market or central clearing house where this collateral is maintained or monitored. Like other aspects of the modern financial system that have avoided regulatory scrutiny – think, for example, of the credit default swap market, the ETF explosion or the previously discussed Target2 – this shadow banking system operates beyond the purview of any formal oversight.

This shadow banking system is where financial institutions finance themselves on a short-term basis, and it is fair to say that its operations remain opaque and arcane to most of the public and even to regulators such as the Securities and Exchange Commission (SEC). Yet the markets in which banks and others finance themselves on a short-term basis are among the most important in the entire system. Money markets came under severe pressure in 2008, but the Federal Reserve was able to stick its finger in the dike and prevent the system from collapsing. The European debt crisis is again causing strains in these markets. As MF Global demonstrated, regulators are nowhere to be found in the shadow banking system. Unfortunately, neither is a lot of money when a firm collapses.

This system is described in an important new IMF Working Paper by Zoltan Pozsar and Manmohan Singh entitled “The Nonbank-Bank Nexus and the Shadow Banking System” (IMF Working Paper, December 2011). The authors of this paper point to the fact that financial intermediation<sup>5</sup> in today's system is dominated by asset managers as the main

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<sup>5</sup> Financial intermediation is the term of art for the system through which financial intermediaries (banks and other financial institutions) channel funds between those who want to lend them out and those who want to



source of funding for banks in the shadow banking system. These asset managers engage in a massive process of “reverse maturity transformation,” which is a fancy name for turning long-term obligations into short-term obligations. Asset managers need short-term funds to manage their liquidity and facilitate their trading (often of derivatives), and they obtain these short-term funds by posting long-term assets as collateral.

Mssrs. Pozsar and Singh note on page 4 of their paper that “[t]his reverse maturity transformation is the dominant source of marginal demand for money-type instruments in the financial system.” Asset managers serve as “collateral mines” for the shadow banking system. The securities that asset managers house at a bank are not left sitting in brokerage or bank accounts. Instead, these assets are routinely loaned out by their custodians to finance their own businesses. Banks use this collateral to provide loans, settle trades, enhance their own returns and hedge counterparty risk on OTC derivatives trades.

The following discussion is somewhat technical but necessary to understand the dynamics of modern money. Banks borrow securities from customer accounts primarily through repo transactions in which the assets are pledged as collateral for the loan. As Pozsar and Singh note, “[t]he most ‘valuable’ form is...collateral that can be re-used or in other words re-pledged.” In other words, from a bank custodian or prime broker’s viewpoint, the best kind of collateral is a security that can be pledged multiple times. The repeated use of collateral is known as “rehypothecation.” Rehypothecation creates “leverage-like collateral chains between banks and asset managers.” In plain English, assets are loaned out serially in a chain of borrowing that increases systemic leverage without increasing the amount or value of the underlying collateral. The same piece of collateral – for instance, a U.S. Treasury bill – can be used to finance a growing edifice of debt. It’s no different than pledging the same piece of property for multiple mortgages – except rehypothecation of securities is legal while rehypothecation of real property lands you in jail. In the U.S., there is a limit on the amount that a custodian bank can borrow from a client’s assets (equal to 140 percent of the client’s debit balance<sup>6</sup>). In the UK however – where MF Global and Lehman before it migrated a lot of its funds – there is no limit on this type of borrowing.<sup>7</sup> If by now you are figuring out that this system has the potential to spin out of control, you are reading correctly.

There are (at least) two huge systemic risks posed by the shadow banking system. The first is the mis-match between short-term borrowings and long-term assets/collateral. As we saw during the 2008 financial crisis, this mismatch is a major source of systemic fragility. In 2008, a large number of highly leveraged special purpose entities (known as SIVs, or Structured Investment Vehicles) collapsed after borrowing on a short-term basis

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borrow them.

<sup>6</sup> A “debit balance” is the amount of money that the client has borrowed from the custodian through margin or other borrowing.

<sup>7</sup> Readers will remember that one of the reasons that the UK refused to join the most recent European Union bailout was concern about European interference in the regulation of the financial industry. One of the areas of regulation raising concerns in Europe and elsewhere is the lack of any limits on hypothecation in the UK.



to purchase investments in long-term and relatively illiquid (on a good day) assets such as mortgage-backed securities (many of them subprime) or other types of Collateralized Debt Obligations. When the U.S. housing market fell out of bed, the value of mortgages and by contagion all other risk assets plunged, their access to short-term borrowing evaporated. A mis-match between the tenor of an obligation and the tenor of the asset serving as collateral for that loan is a recipe for disaster. Poser and Singh point to the very troubling fact that the lessons of 2008 have not been learned; asset managers continue to engage in a massive exercise in borrowing short to lend long.<sup>8</sup>

The second risk results from a disturbing phenomenon highlighted by the authors of the IMF paper: a diminishing portion of the debt that banks and other institutions are using to finance themselves is backed by collateral. This is reminiscent of what occurred when the credit default swap market exploded in the early 2000s, creating a situation in which a single \$1 billion bond issue could give rise to \$10 or \$20 billion of credit default swaps on that bond. Poser and Singh estimate that there were \$5.8 billion of off-balance sheet borrowings of this type among the largest U.S. and European banks (plus Nomura), down from about \$10 trillion at the end of 2007. This means that “there are large volumes of source collateral accruing to global banks which they can ‘freely’ recycle in financial markets.”

Like naked credit default swaps and flash trading, rehypothecation is an area that cries out for immediate regulatory attention. As noted above, the shadow banking system falls outside the purview of Federal Reserve as well as The Dodd-Frank Act and Basel III. Moreover, “[t]hose operations lead to cross-border intermediations that straddle multiple jurisdictions.” In other words, rehypothecation is an area ripe for abuse. Regulators can’t get up to speed on this quickly enough.

## **Investment Recommendations**

*This section is available only to paid subscribers.*

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<sup>8</sup> Had a firm larger than MF Global run into trouble, the systemic fall-out would have been much greater. As it is, the damage has been bad enough. The fact that Jon Corzine didn’t understand the risks associated with financing investments in distressed European sovereign paper on a short-term basis is remarkable if not inexplicable. Hubris goeth before a fall.



## Disclosure Appendix

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