Louis-Vincent Gave
louis@gavekal.com

A Money-Making Proposal To Save The Euro

Mario Draghi had promised to do everything he could to save the euro. And last week, he delivered. Or at least, the European Central Bank president delivered what he thought he could, namely a promise to buy a bunch of government debt and provide funding to banks to do the same. How very 2010; only much more so. Still, even as euro-skeptics highlighted that this latest plan would allow Olive Belt countries to backtrack on structural reforms, the markets cheered Draghi's promise to put the ECB's money where its mouth is. But is writing ever bigger checks the best the ECB can do? Let me humbly propose another solution, drawn from personal experience.

Lessons from Hong Kong

Southern Europe is trying to get competitive through deflation

I moved from France to Hong Kong in early 1997, just as the Asian Crisis was getting ready to engulf the entire continent and with most Asian countries breaking their currency pegs to the US$. Hong Kong did not, preferring to let asset prices and wages take the brunt of the necessary adjustment. The stock market fell by almost two-thirds in 18 months, real estate prices fell -70% from 1997 to 2003 and wages shrank by quarter over the same period. By 2003, you could get into a taxi and announce that you would pay just 75% of the metered fare and the driver would tell you to hop in. Hong Kong chose the deflation path on which Italy, Spain and others are now engulfed. It was painful, but necessary as costs in Hong Kong in 1997 (especially real estate) had grown far above those that prevailed internationally.

There is, however, one major difference between Hong Kong back then and southern Europe today, namely that all along, Hong Kong had maintained its own currency, the HK dollar. And this is where my personal experience comes in. By early 2003, very obvious value was starting to emerge in the Hong Kong real estate market. Equities were also trading below book value and on single digit PEs. So I gathered up my meager savings, hit my dad up for a loan, and in a decision that gave me a few sleepless nights, decided to buy my first apartment in Hong Kong.

But the risk of a euro break-up, and large currency devaluations, means that private sector capital will continue to stay away

The reason for these sleepless nights was not (for once) the bars in Lan Kwai Fung or Star Street. Instead, like most investors, I was still worried that the Hong Kong dollar might break its peg to the US$. If that occurred, half of my savings (and the money I had borrowed from my dad) would be wiped out overnight. Fortunately, an easy solution existed: I turned to HSBC and sold HK$4mn forward against the US$. The cost? The difference between HK$ and US$ short term rates (plus a little something for HSBC), or less than 0.5% a year. In short, a simple, market hedge existed which allowed investors attracted by the value on offer amongst Hong Kong's deeply discounted assets, but worried about the potential for a large currency devaluation, to deploy capital in Hong Kong's equity, fixed income and real estate markets.

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Private sector capital keeps on leaving the South for the North as currency devaluation fears increase

The ECB's answer? Send public money from the North to the public sector in the South

But will this really boost long-term growth?

This is what is lacking in Europe today where Mediterranean countries (France excepted) are hard at work slashing government spending, cutting the cost of labor, restructuring assets, etc. Private sector capital should normally start to be attracted by the cheaper real estate, cheaper labor, and easier regulations now prevalent across Spain, Portugal or Italy. Yet **instead of rushing in, private sector capital continues to flee.** Most foreign companies operating in southern Europe reportedly now clear out their bank accounts once a week and send the money north while rich Spaniards, Greeks, Italians or Portuguese have long placed most of their assets in Swiss bank accounts or German bunds. And who can blame them? Who wants to stick around for a potential one day -50% drop, or more, in one's savings should the euro break apart and national currencies be re-introduced?

This is the euro's Catch-22: on the one hand, the structural reforms should make Southern Europe a more interesting place to invest. On the other, the increased odds of a currency devaluation chases private sector capital away. **And unfortunately, no market mechanism exists today to hedge this potential currency risk away**. So today, I may wish to buy a house in Mallorca (where my grandmother is from), but because I cannot walk into HSBC and announce that I would like to sell a million peseta forward against the euro, I stay away. Because most private sector investors like myself cannot countenance an unhedgeable risk of a 50% overnight drop in asset values private sector capital flees, even as asset prices and labor costs collapse.

The ECB's solution to this quandary has been to provide more money to governments. So Southern Europe is like a car that is running out of oil and the ECB's answer is to tie a barrel of motor oil on top of the car, open the spigot, and hope that some oil makes its way to the motor. This is an odd strategy. If the problem is that private sector capital is afraid of a devaluation, then that is the problem that needs to be addressed. The fact that some European governments can no longer fund themselves on the market is a symptom of the problem. **The real European disease is that private sector capital is afraid to invest in Southern Europe for the long term because of the inherent currency risk**. And without private sector capital and long term investment, how can Southern Europe hope to generate growth?

So if Mr Draghi means what he says about doing "whatever it takes," he should consider the following. **Forget about buying government debt**, which at the end of the day, amounts to little else than a "job for the boys" program and which treats the symptoms of the disease rather than the root cause. Instead, start to deal with the fundamental problem at hand, namely "how do we get private sector capital to commit to Southern Europe once again?" And the answer is simple: **start doing what HSBC did for me in 2003.**

Do not buy government debt, sell insurance instead

This is how it could work: let's imagine that I am thinking of investing €10mn in distressed Spanish real estate, but am worried about Spain leaving the euro and a new peseta devaluation. **I could turn to the ECB who would issue a "currency insurance contract" on the proposed €10mn investment for whatever tenor I decided I needed insurance.**

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Here is another idea: if the private sector is afraid of a southern European currency devaluation, the ECB should offer to insure that risk away

How the insurance policies gets priced matters little; what matters is that the private sector could start to invest for the long term in Southern Europe without fear of a currency break-up

The contract could be priced by looking at the difference in annual interest rates between Spanish and German bonds and perhaps taking half of that interest rate difference (after all, the ECB keeps on saying that bond markets are currently pricing an inordinate fear of a euro break-up—it should thus put its balance sheet where its mouth is)!

Thus, if Spanish bonds are today yielding 5.5%, and German bunds are yielding 1.5% for a difference of 4%, the ECB would sell me an insurance contract for 2% a year (or euro 200,000 per year for my euro 10mn of capital invested * the number of years I wanted the contract for). Another option would be to price these contracts by simply taking the difference between the yield of the country I want to buy currency insurance against (in my case, Spain) and the prevailing average yield of EMU government debt… But however the ECB decides to price these insurance policies does not matter much. **What would matter greatly is that their existence as currency-insurance policies would allow me to invest in Spain without having to worry about unpredictable, and massive, currency movements.** In such an environment, Spain would have a chance to re-attract the private sector capital that has fled and, for now, seems highly unlikely to return.

Assuming that bond investors in Spain or Italy are today more worried about a devaluation then a debt restructuring, the existence of such currency-insurance contracts would immediately lead to a convergence of interest rates in Italy and Spain towards Germany. Indeed, if such insurance existed, I could today buy a Spanish bond yielding 5.5%, buy a "currency insurance contract" from the ECB for 2%, and end up with an effective annual yield of 3.5% with the same inherent currency risk that I have with Bunds at 1.5%.

The beauty of such a scheme is that the ECB would actually not be disbursing any money; unless, of course, a country did leave the euro. If such a departure did occur, the ECB would then have to pay up on the insurance policies that it had sold, implying that the ECB would have to print massive amounts of euros to pay off the private sector investors who had essentially sold the peseta, escudo and lira forward.

A way to make everyone smile, even Bundesbankers

But in itself, this then makes a euro departure less likely. Indeed, if today everyone buys insurance against Italy leaving the euro, and if tomorrow Italy does end up leaving, then the Italian lira would likely fall. but so would the euro as the ECB would be forced into massive monetary printing operation (to pay off the insurance). This massive printing by the ECB would prevent the lira from falling too much against the euro, thereby negating the potential attractiveness of a departure for Italy!

Or look at it another way: should Italy or Spain start to leave the euro, does anyone doubt that the ECB would have to print massively anyway in order to support the European financial system? Thus, should countries start to peel away, the end result may not be that different anyway? However, with the insurance contract the massive monetary printing would be hypothetical, and back-ended; a reality which should please the Bundesbankers more than the current promise of massive debt monetization.

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The existence of such contracts may well please Bundesbankers in that they would negate the need for the ECB to print (unless a country left the euro)

With such contracts, German savers may start to pour German savings into Spanish real estate once again?

The Euro crisis has a solution; Draghi has to shed the banker's pinstripes, and become an insurance salesman!

The existence of such insurance contracts should further please Bundesbankers in another way. If, as seems likely, France, Spain, and Italy follow George Soros' (and Anatole's) advice and unite to tell Germany "*give us a lot of money or leave the euro,*" Germany could easily say: "*actually, maybe I will leave.*" At this point all the private sector capital that had come back into Italy on the back of the new lira-euro ECB insurance contracts, would most likely leave again. Indeed, a lira-euro insurance contract issued by a German-less ECB would be close to worthless, for who would be interested in insurance contracts from a Germany-less ECB? In other words, the situation having stabilized, Germany could start playing the greenmail card as well!

So as I look at it, the implementation of such a scheme could well resolve the tensions between North and South that currently risk tearing Europe apart. Bundesbank-types would not be able to complain that the ECB is breaking all the established rules by printing money egregiously. In fact, instead of printing money, the ECB would actually be taking money in (the insurance premium). At the same time, and even with currency insurance, capital would continue to stay away from the countries that did not embrace the path to reform, if only because the debt of such countries would still face the risk of bankruptcy (and because what private sector investor wants to invest in a non-reforming country)? Consequently, Germany would not have to fear governments slipping back into *la dolce vita* on the back of ECB handouts. The threat of the market discipline for non-reforming governments and economies would still be there.

The current market failure in Europe is obvious enough: long-term investors can hedge themselves against government bankruptcies (through the CDS market) but cannot hedge themselves against possible currency devaluations. **It is this market failure that the ECB needs to address**. If it did, the private sector could take care of the rest. So if the ECB really does believe its own rhetoric on how "*the euro is here to stay*", then instead of funding governments with an open check-book, the ECB should simply pledge its balance sheet, and its ability to print euros should the need arise in the future, to a private sector probably willing, but unable, to invest today in Southern Europe. In short, if Draghi means what he says about "*doing whatever it takes to save the euro,*" then he must shed his banker's pinstripe suit, and don the cloak of an insurance salesman.