

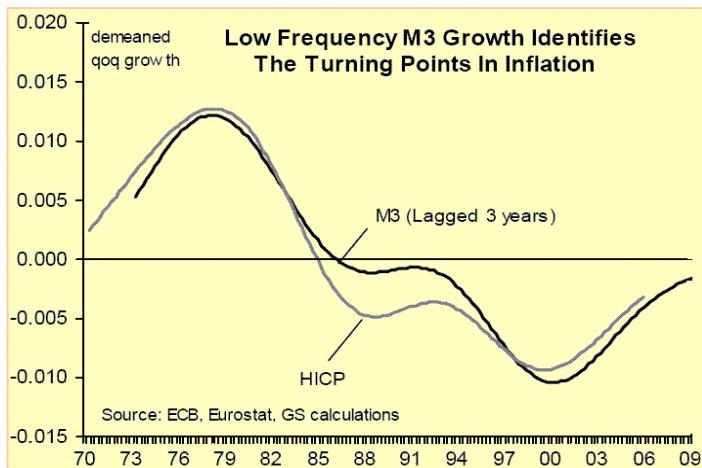
Is the Hedge Fund Crisis over ?

The fundamental Analysis Your Banker won't disclose.

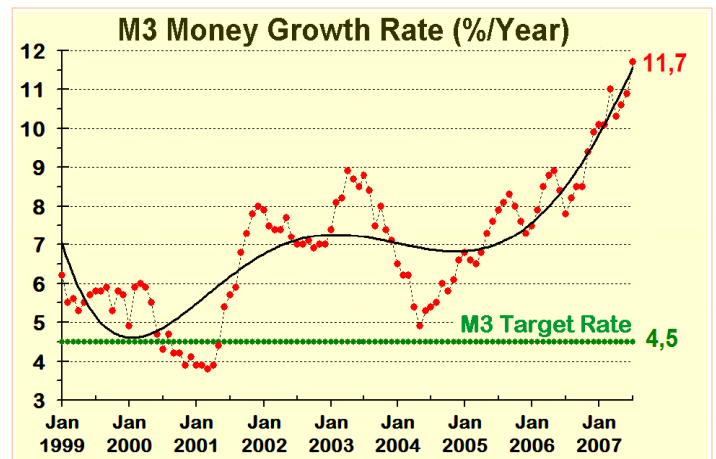
The hedge funds crisis remained confined to a mini-crash so far. To find out whether the risk of a full blown recession is now foreclosed or whether more turmoil is still to come, we investigate whether the deeper causes leading to the crisis have been remedied. The credit mania leading to present hedge funds crisis is a school model of malinvestment resulting from run away credit expansion, false information, pep talk and grossly underrated inflation and credit risks. The European central bank (ECB) played a central role in the credit mania. For the sake of the lagging countries in the European Monetary Union (EMU) the ECB maintained interest rates too low for too long, causing run away money supply in Europe⁽¹⁾ still adding to the worldwide credit bubble initiated by the FED.

Runaway money growth.

To guarantee financial stability of the EMU, the founding nations agreed a double a monetary objective. An inflation target of 2%, and a growth rate of the total money supply (M3) of approximately 4.5% Scientific research had indeed shown that the money supply rate provides an excellent forecast for the inflation rate some three years later, and that restricting the money supply to 4.5% would limit future inflation to 2%.



Over the first eight years the average money supply in the Euro area in reality reached 6.9% or more than half above the target. Eight years after its founding, the latest ECB money growth rate reached a provisional peak of 11.7%, or roughly 10% above the growth rate of the real economy.⁽²⁾ In every day words this means that for the moment an 11.7% larger amount of money is chasing a quantity goods and services that is hardly 1.7% larger than twelve months ago. The consequent inflationary pressures on prices can be guessed even without econometric models.



The 11.7% figure dates from July. That is the month preceding the hedge funds crisis, and before the ECB decided to massively inject liquidities into the financial system in an effort to keep the acute liquidity shortage under control. This new injection will have steeply accelerated the money supply and will most probably bring the August growth rate close to 14%. That is three times the agreed and repeatedly confirmed target of 4.5%, thereby continuing the accelerating exponential trend the new ECB president Trichet initiated.

Grossly underestimated inflation threat

Very remarkably and against all economic logic major price hikes have not materialised so far. However not without raising widespread doubts over the representativeness of the ECB's official inflation rate. The figure of about 2% is indeed believed to systematically and grossly underestimate real price hikes.

Keeping the Consumer Price Index (CPI) representative for the actual cost of living has always been a point of dispute in Europe, where authorities always found good reasons to strike the fastest rising items such as oil or cigarettes from the CPI list. This adds to the ECB's impossible task of weighing rising shares of services in family budgets of differentially aging populations, and makes the weighing of changing consumption patterns in very different economies even more awkward. In fact the ECB inflation rate is a highly obscure average of most dissimilar inflation rates of still very disparate EMU economies, and as an average it is by definition concealing much larger inflation rates in some of the major countries.

More importantly the ECB's inflation rate does also rather systematically underestimate real inflation because it does not ponder the lowering quality of goods as it compares today's low quality import stuff with the top quality domestic produce Europeans were used to a few years ago.

¹ See: The Euro: the Gamble with People's Prosperity that went terribly wrong http://workforall.net/the_Euro-gamble.html.

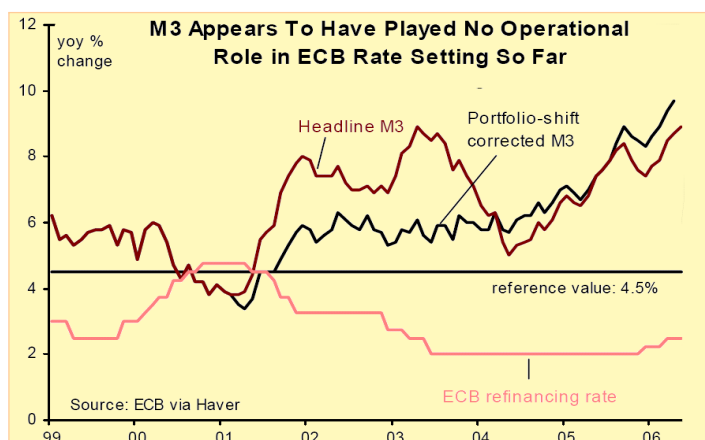
² Source: <http://www.ecb.int/press/pr/stats/md/html/index.en.html>

However the most weighty criticism on the ECB's Consumer Price Index (CPI) is that by definition it covers consumption items only, and that the rapidly rising house prices (and asset prices in general) are unaccounted for. The resulting underestimation is most important as the monthly mortgage payments for an average family dwelling now account for one third of the European family budget.

Besides Inflationary pressures have also been delayed by the increasing use in industry of futures and option contracts to cover future raw material needs. All these financial constructions have indeed the common feature of creating a virtual offer (of raw materials) that in reality does not (yet) exist and whose effective delivery is secured by non existent material. Guarantees often are supplied by dubious market participants not seldom operating from some obscure attic. This virtual offer has long kept prices low, dissimulating the looming shortage of foodstuffs, metals and energy. These constructions have temporarily retarded inflation but certainly did not eradicate it in the long run.

Redundant M3 target ?

In spite of the obvious underestimation of the inflation threat, the bank sector has seized the ECB's suspiciously low CPI to dispute the value of the M3 money supply target. In a recent analysis⁽³⁾ the generally well respected Goldman Sachs research department asks the question most openly why the bank sector should be limited by M3 targets as inflation remains low anyway. Why not allow the sector to print money as much they feel necessary, and yes, why not accelerating the printing machines? The economy most probably even would benefit some Keynesian economist continue to make us believe. Even top economist and once Belgian candidate for the ECB presidency Prof. De Grauwe, has questioned the value of the M3 target⁽⁴⁾. The old universal relation between prices and money supply obviously is under serious attack in banking circles. As a matter of fact the ECB has despite all its solemn declarations in practice not worried in the least about the money supply. For deciding its interest policy, the ECB has in practice ignored M3 just as much as the FED always did.



³ The ECB and its Monetary Analysis, Goldman Sachs Economic Research, <http://www.nber.org/~wbuiter/m3.pdf>

⁴ Is Inflation Always and Everywhere a Monetary Phenomenon? Paul De Grauwe, Magdalena Polan, (2005) http://www.econ.kuleuven.be/ew/academic/intecon/Degrauwe/PDG-papers/Recently_published_articles/DeGrauwe_Polan_SJE_2005.pdf

Alchemy makes banks rich and citizens poor

The banking sector obviously has very good reasons to have money supply target abolished. After all their virtual alchemy turning paper into gold or at least into real purchasing power is a most lucrative business. For the productive citizen however the results of an abolition of the M3 target would be devastating as all the purchasing power the banking sector acquire by means of printing money is purchasing power which is diluted from the buying power productive citizens have worked so hard for

Therefore If there is anything citizens must by all means fight to conserve, it is the money supply target. In the present monetary system without any gold backing it is the only remaining restraint against wild money printing. Even though the ECB's present target of 4.5% is unarguable much too high, it is our only guarantee against a progressive erosion of our buying power. As long as the gold-backed money standard is not restored only a money supply target near to the growth rhythm of the real economy can indeed prevent inflation and allow purchase power to keep up with productivity gains. Any growth rate above this rhythm is inflationary in the true sense and is endangering the economy..

No, it is not the money supply rate which is flawed, it is the inflation target which is a conceptual economical inconsistency. The detrimental consequence of targeting inflation (at an excessive rate of 2%) is that the average price level can no longer decline. As a result the price mechanism is incapacitated, and the self healing effect of price reductions during economic downturns is lost. Prices can also no longer ease in times of exceptional productivity gains such as we enjoy today.

Counterfeiting

Since over a decade our economy benefits from a most exceptional period of progress. Technical innovations have strongly improved products as well as production processes. Robots, Internet, GPS, mobile communication, digitalisation, bio- and nanotechnology are only a few of the latest innovations. And globalisation was even more beneficial to productivity as it allowed the abolition of trade barriers, liberalisation, privatisations and increasing mass production.

Tanks to this exceptional period of both technological innovation and economic progress we now pay only half the price we paid 20 years ago for products like electric and household equipment, textiles, or picture prints down even to 10% only for items such as computers, mobiles, printers and air travel. Very remarkably the average price level continued tot rise in spite of those massive price reductions. The reason is that the inflation target prevents the average price level from falling and people's buying power from rising. Inflation targeting indeed prevents increased productivity benefiting the average citizens. Maintaining a 2% inflation target means nothing less than institutionalised confiscation of all future prosperity gains resulting from progress.

By targeting a 2% inflation the Central Banks must indeed set its interest rates accordingly low, stirring expansion of credit and the money supply and thereby diddling bit by bit and almost unnoticeably hard-earned purchasing power from the productive citizens. By lending purchasing power which is nowhere borrowed the bank sector does indeed bring unearned money into circulation against which no production of goods and services were produced in the real economy.

With huge quantities of unearned money in circulation not finding new goods and services to buy in the real economy, the excessive money can obviously only find a spending outlet in the available stock of consumer goods and investment opportunities. The excessive money supply has therefore the same inflationary impact as counterfeiting as the new money dilutes a fraction of the purchasing power of money people own.

Real Estate Bubble

This brings our to the second detrimental consequence of the excess money supply, namely that Europe is heading straight on a real estate bubble just like the US did before us. As real estate was widely believed to be the best investment in an inflationary environment, demand estate has exceeded supply for over a decade.

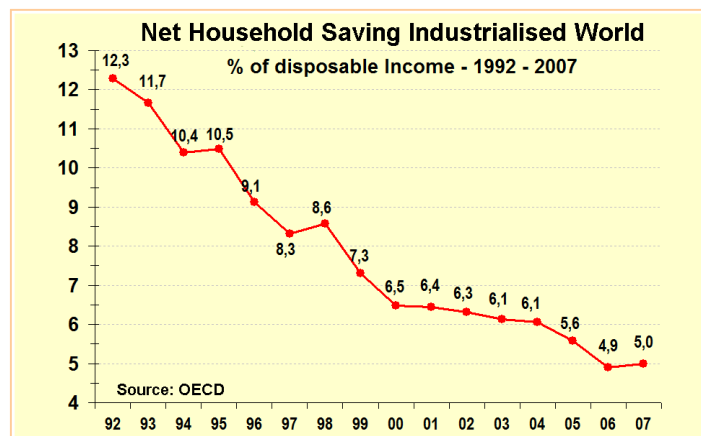
As a result European house prices have soared much more rapidly than salaries, not seldom at rates of over 15% per year. With the help of the easy credit; inflationary low interest rates and the extended the mortgage pay back period up to 40 years, monthly mortgage payments for a property dwelling were kept artificially low and seem close even to rent prices. Certainly so for the inexpert newcomers on the home market who often naively discount never ending price hikes and forever lasting low interest rates in their calculations.

In a vicious circle the easy credit and undersized down payments have boosted demand for houses resulting in the present exorbitant price level Europe knows today. Measured to purchasing power it is now close to 30% (up to 50% even in rural areas) above the American level, which started its implosion already a year ago. Despite massive productivity gains in the construction sector, the purchase of a family dwelling now condemns both family partners to the stingy existence of thirty or forty years debt-forced-labour where previous generations easily acquired their family dwelling with one single salary only.

The European housing bubble also cannot but turn into financial calamity sooner or later. The slightest tightening of the credit market, increase of unemployment or interest rates may cause a domino-effect, beginning with the last buyers, who purchased at the highest level. Many of them have obligations at the limit of their pay back capacity, live just one paycheque away from insolvency or have chosen the risky mortgage with variable interest rates their bankers their bankers so convincingly advised. These will be the first to face foreclosure in a bear market where potential buyers may chose to await further price falls.

Savings shortage.

The worst consequence however of an easy money policy is that inflationary low interest rates discourage saving. In most of Europe the net real interest after costs, taxes and real inflation have now been close to zero or even negative for several years. In the industrial world household savings consequently declined and fell to historical low of 5% of GDP down from 12% a decade ago⁽⁵⁾. Such extreme low saving rates have the factual outcome of citizens now entirely rolling off the costs of the demographic ageing and the pension charges to their children.



Overconsumption and misinvestment.

In the week following the heat of the hedge fund crisis the Belgian National Bank authorities positively welcomed a new low of the savings rate a sign of increased consumer confidence. Such cynic hourah-messages totally lack responsibility and still amplifying the perilous illusion of wealth the easy credit generates. Such politically inspired pep talk as well as banker's get-rich-quick stories and easy credit all generate an overoptimistic climate and hide the instability of the monetary system central banks got us into. It all helps to generate overoptimistic investment expectations and over-consumption.

As long as the lent money is used for financing productive investment, the income generated by such investment is usually satisfactory to finance repayment.

Not so when easy credit is spent on luxuriously consumption. Ever larger cars, boats, holiday villas, Champagne parties, holiday travel, costly spectacles and sport events are so typical for a bubble economy just before the burst...

Neither so when easy credit, -not based on real wages, rents and dividends, but on overoptimistic virtual price hikes of stock and real estate- is invested in speculative manias. As happened so many times before in history, from the tulpomania to the internet bubble, it was again over optimism and easy money generating the present real estate madness and which grossly disturbed risk pricing of the treacherous American CDO's.⁶

⁵ Source: OECD <http://www.oecd.org/dataoecd/5/48/2483858.xls>

⁶ CDO: Collateral Debt Obligation sometimes with dubious underlying collateral

Over-indebtedness: Recipe for monetary Crisis.

Easy credit unavoidably ends in a depression, because even cheap credit sooner or later must be paid back. When overoptimistic expectations have driven citizens to the limit of their refund capacity, time is ripening for the burst. On the slightest tightening of credit conditions, slowdown or rise of unemployment, those debtors cannot but fail on their monthly payments. Over indebted consumers are obviously most vulnerable as during a crisis their transient consumption obviously cannot be undone or marketed against cash.

But also industrialists are blinded by easy money as low interest rates cause overoptimistic profit expectations especially in the most indebted and most vulnerable companies. During such an inflationary boom production of capital goods can hardly keep up with easy credit. New machines and factories cannot be delivered fast enough and in an ever accelerating rate managers typically take over other companies at ever higher prices and ever lower returns. Also the liquidity of such high priced and low -productive investments, which during the boom seems inexhaustible, can dry up instantly when the economic prospects turns for the worse or interest rates sooner or later start to rise. Pricey take over's and marginal investments then suddenly become impossible to sell, so that in a chain reaction massive foreclosures and bankruptcies occur.

Excessive credit expansion does indeed at the very start carry the germ of a financial crisis. Depressions should not be mistaken as minor incidents from a far away past. The latest major Japanese financial crisis is scarcely twenty years old and reduced the Japanese stock and property prices down to one quarter..

Crash avoided... temporarily

Few seem to realise the instability of our present financial situation, and how close the excessive money supply brought us to the collapse the monetary house of cards central banks created.

The announcement on August 9th of the renowned French bank BNP that they had to suspend the operations of three of their leverage funds abruptly shocked the faith in the whole European bank system. A few days earlier German banks already had to intervene to save IKB Deutsche Industry Bank and two leverage funds of mortgage specialist Bear Stearns went burst. Suddenly everyone distrusted everyone, and nobody dared to grant credit to nobody. In just a few hours the liquidities on the European money market dried up completely. If central banks had not intervened with a massive injection liquidities at an interest far below the market rate, many banks would impossibly have found the liquidities they needed and would have failed. Even the largest banks face losses for billions on the derivatives based on junkbonds and unreimbursable debt.

Observers feel that the ECB's liquidity injection sends the wrong message to financial markets that she is prepared to rush for aid even to the most reckless speculators. This obviously is not the kind of message which will deter

hedge funds and speculators from engaging in further debt and even larger risks. This way the disequilibrium continues to exist and even to worsen, and the indispensable 'creative destruction' of speculative excesses does not materialise.

Hedge funds have used derivatives, financial engineering and uncontrollable levers to engage in exorbitantly bully exposure. They inflated markets with their speculation and involved ignorant investors in their adventures with deceiving of balance sheet constructions. As long as all went well they cashed huge profits for their funds as well as their administrators. Now that it turns for the worst central bank must not rush to the speculators' aid a second time with even more inflationary interventions. Investors and financial institutions must carry the consequences of their reckless greediness themselves.

Game over

The massive ECB liquidity injection only postponed the unavoidable and larger corrections still to come. The cash injection has not restored any of the fundamental imbalances, nor provided strength to the inflationary house of cards central banks have created. The real estate market remains overpriced and just as inaccessible for hardworking families as before. Millions American houses still have not found a ready buyer. Interest rates and savings rates remain still too low for financing demographic ageing. Europe's social model is still heading with the same speed for an Argentinean style debt crisis.

The remedial effects of the ECB's liquidity injections will indeed be short lived, as new acute liquidity shortages are in the pipeline when ever more unreimbursable debts reach maturity and foreclosures also reach European markets. New liquidity injections would engage in the deadlocked path of an ever accelerating money supply and hyperinflation. The longer the ECB postpones the unavoidable correction and continues its feast of diluting peoples buying power with inflationary low interest rates, the deeper the final crisis will become all the larger and the detrimental effect on our prosperity. It is not for Central banks to save reckless speculators with ever more inflation at the expense of hardworking citizens, nor disturb the correct pricing of risk, nor to intervene at the smallest correction. Mild corrections are beneficial because they clear out speculative excesses and could maybe still help to avoid a 1929 like depression.

Over the coming months savers should be advised to closely monitor the ECB's M3 rate.⁽⁷⁾ Further acceleration would be the unmistakable early warning of worse to come. Bankers can indeed create money from thin air. Real wealth however must still be earned at the expense of people's hard labour

Paul Vreymans
Sept 15th 2007.



⁷ <http://www.ecb.int/press/pr/stats/md/html/index.en.html>