



JEAN-PIERRE PATAT'S MONTHLY CHRONICLE

A former central banker looks at the news

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Figure of the month: **8.65**, the ten-year rate on the Greek debt, over 500 base points above that of France.

When there is again talk of a bond market crash.

Are we at the eve of a situation of deep investors' defiance against sovereign debt, causing a strong increase in interest rates and/or a large crowding-out effect for other issuers?

The question may seem over alarmist; certainly there is the established case of Greece and, possibly in the future, that of other peripheral European countries. Even so, the media's catastrophic outpourings on the debt topic seem not to have worried investors who so far continue to fund the major countries at modest rates.

However, to a great extent the situation stems from factors not necessarily lasting: banks' reluctance to lend to the private sector, the lack of alternative lucrative investment opportunities (the short term returns almost nothing) or safe ones (equity markets are out of the woods but do not yet seem sound enough to justify massive shifts towards them).

Yet, banks' cold feet could be overcome and the other assets for investment might well regain their colours (not forgetting commodities, rising in a lively way over the past few weeks).

In reality, an increase in long-term rates is inevitable, and monetary policies will need to be implemented with finesse at the "exit from the crisis" so that the required rates rises which will occur appear as the logical end to exceptional times rather than as the real threat of a return to inflation; this because such a perception by the markets might jeopardise the rebalancing of portfolios and substantially enhance shows of defiance against bonds.

The worst is by no means certain though. The credibility of States' commitments to return to better controlled deficits within reasonable time frames will obviously be of great importance. And, "stabilisers" favouring bonds do exist (e.g. strict rules controlling the placements of institutional investors). Finally, the implementation of the Basel III rules, as they are actually conceived, might alas provoke structural unwillingness by banks to lend to the private sector.

Even if limited, though, any rates rise will hurt, given States' debt levels. Let us not forget that in France debt servicing involves sums equivalent to the total of income tax revenue.

The universal bank: above all let's keep it.

Here are a few figures drawn from the reports of the French Banking Commission. Between 1993 and 2007, the share of revenues from interest alone (that is to say the product of traditional banking activities in managing deposits and offering credits) within the total of profits made by French banks went from 63% to 18%. Over the same period, the share of commissions jumped from 20% to 30%. The share of other operations, mainly income from market transactions and operations for own accounts, moved from 17% to 52%. These major structural changes allowed banks to maintain satisfactory returns whilst still offering advantageous conditions for credit in a strongly competitive context. Thus, the very good French corporate risks are presently benefitting from rates below 2%, whereas in the USA (where, despite the repeal of the Glass Steagale Act, the separation between commercial banks and investment banks remains very present in practice) the prime rate is 3.5%, even though Fed rates are lower by about 1% than those of the ECB. It is understandable that European banks are opposed to attempts to separate them into commercial banks and investment banks when they are drawing only 18% of their income from traditional operations which generate 80% of operational costs (a rough reckoning shows that in 2007 revenues from interest covered barely 40% of operational costs). Clearly, any separation would lead to a substantial increase in the cost of credit.

The tax on banks: a good idea but plenty of questions.

What at first seemed to be a good, simple idea is fast becoming a real headache. Apart from questions relative to tax bases and rates, it is the very nature of these levies which is causing debate. Would this be a) an insurance premium paid by banks to fund future bail-outs (in which case, look out for moral hazard, some say); or b) repayment of advances made by States to troubled institutions - something to refill public coffers; or might it even be (because not everywhere were banks financed from public funds) c) a fair contribution to public finances hit by a crisis for which banks were responsible? In this scenario, completely well founded, are we thinking wishfully in hoping that for once Europe could set the example with a clear doctrine?

Revaluing the Yuan is not a good thing for everyone.

Pressure mounts on China to allow her currency to increase in value, with added reinforcement from two great emerging countries, India and Brazil, breaking up the artificial concept of BRIC. Should Europe, which produces mighty little in the way of goods able to compete with Chinese imports, rejoice in a probable outcome which risks only securing price increases and lowering household purchasing power?

Mastering the inflation responsible for neo-liberalism and financial capitalism.

That is what is being said and written by some economists. According to them, from the moment when monetary policies gained control of inflation, the reign of the creditors began, and with it all the market vagaries and the primacy of share holders over wage earners. Mastering inflation favoured the growth of bond markets, but it is hard to see any relationship to the crazy financial innovations or to the greed of share holders. In these affirmations, there is also the persistent belief that inflation helps growth - a belief passed on by the IMF's chief economist who recommends a substantial lift of the inflation targets for central banks. If only it were that easy!

Words of the month: "a credible economic plan".

That is the requirement of German leaders in respect of Greece if they are to agree to the implementation of an aid mechanism for that country. Obviously the Greeks "cheated". Obviously they lived beyond their means. Nonetheless, the changes agreed by the Greek government and the higher interests of the euro zone make it worthwhile to stop gesturing, even if this posturing stems from internal political considerations. Unless, that is, Germany (fully aware of a continuing slide of her economic weight within the zone and in Europe) is seeking to maintain in this way an appearance of leadership (resting less and less on concrete reality) by adopting an attitude that is systematically moralising and scowling.