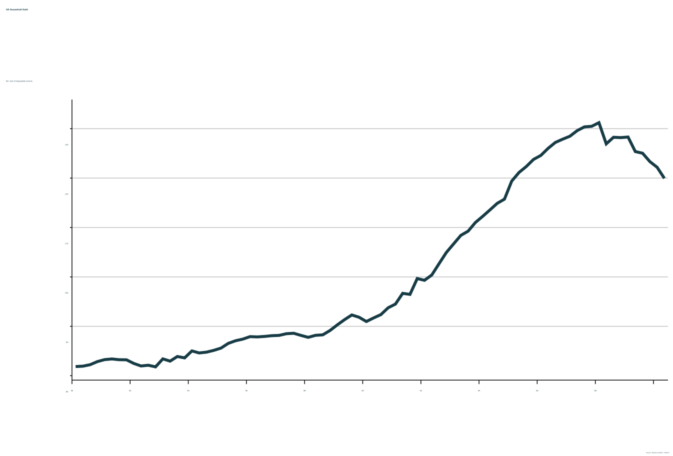
fathom

Crisis of Confidence
November 2010

Debt crisis is not over

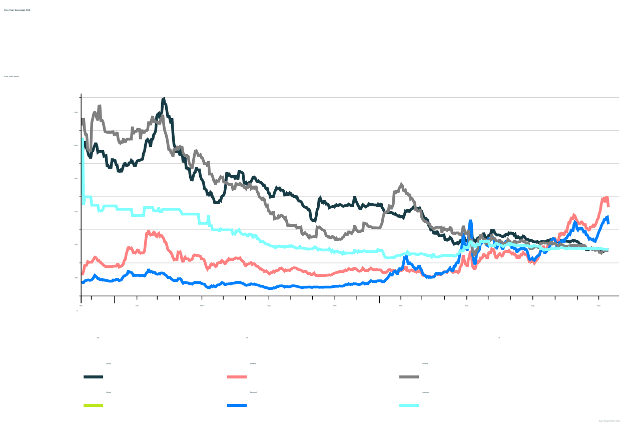


- Inflation was the issue of the last few decades; debt will be the issue for the next few
- BIS analysis suggests the average decline in debt/GDP after a debt crisis is 38 pp.
- We are about one-third of the way through this process, in the US and elsewhere

Overview

- Debt crisis: first the banks, now the sovereigns – two sides of the same coin
- Immediate stress is on the PIIGS, and especially Ireland, who are trapped in the single currency
- One option would be to leave the euro. The precedent is the Gold Standard – case studies:
  - UK
  - France
- Staying in the euro will be hard, but not impossible. US case studies show how to cope with excessive debt in a fixed currency:
  - Orange County
  - New York City
- But many economies, including the UK, are stressed – and eventually the spotlight will fall on us too. The best defence is:
  - Fiscal consolidation
  - QE – once more, with feeling

Ireland approaching crisis



- CDS spreads in Portugal and Ireland are at distress levels – markets see a high risk of default
- What happens next?
  - Bail out, default, quit the euro, or pay it back

Celtic paper tiger

"In appearance it is very powerful but in reality it is nothing to be afraid of: it is a paper tiger. Outwardly a tiger, it is made of paper, unable to withstand the wind and the rain."

Mao Zedong, describing the US

- In the decade through 2006 the Irish economy grew at an average annual rate of 7%
- Unemployment was 3.9% in 2001
- But, since the financial crisis, GDP has fallen 17%, and the unemployment rate now stands at 13.6%.
- House prices have fallen 36%
- In the crisis the household savings ratio has doubled to 11%

Public finances: serious but not hopeless

- Budget deficit of 32% of GDP (including bank bailouts) or 12% without
- Government aiming to reduce deficit to 3% of GDP by 2014
- On Dec 7 the gov't will announce plans to find a further €15bn in savings – of which €6bn in 2011 - having already made €14.5bn in cost savings since 2008
- But some €3.5bn in savings identified in last year's spending review have not yet been made
- Public sector pay was cut by 14% in 2008 – more cuts in pay and jobs to come

Debt shifted from banks to govt

- Anglo Irish Bank was nationalised in January 2009
- Gov't has a 36% stake in Bank of Ireland
- Allied Irish Banks were effectively nationalised with €7.2bn of support
- €2.7bn has been given to Irish Nationwide Building Society

- Bank bailout could cost a total of €50bn
- The size of the bailout is equal to €22,500 for every tax payer
- The equivalent of about a third of the Irish economy has gone into supporting the banks – compared with 6% in the UK for RBS, Lloyds and Northern Rock put together

Anglo Irish Bank

- From 1998 to 2008 Anglo Irish Bank's loan book swelled from €3bn to €73bn
- Toxic property loans have been bought by the National Asset Management Agency (NAMA) at discounts ranging from 55% to 67%

- Credit-default swaps on subordinated debt of Allied Irish Banks are 57% upfront and 5% a year, meaning it costs €5.7m in advance and €500k annually to insure €10m of the bank's debt for five years.

Good news – fiscal impact can be positive

	Change in cyclically adjusted net lending, 1994-99 (percentage points)	Change in number of jobs, 1994-99[a] (thousands)			Contributions to GDP growth 1994-99 (percentage points)		
Country		Public	Private	Total	X-M	I	GDP
Canada	7.0	-48	1761	1713	2.75	5.30	19.62
Sweden	7.0	-47	237	190	3.32	5.60	18.30
UK	6.9	-294	2288	1994	-2.15	5.05	17.42
Memo- June 2010 Budget (2010-2016)	7.9	-610	1950	1340			

(a) Comparison is from 1993 Q4 to 1999 Q4

Source: Fathom calculations

	Change in cyclically adjusted net lending 1979-86 (percentage points)	Change in number of jobs, 1979-86 (thousands)			Contributions to GDP growth 1979-86 (percentage points)		
Country		Public	Private	Total	X-M	I	GDP
UK	2.34	-633	424	-209	-0.45	1.72	13.51

Source: Fathom calculations

Bad news – not so easy in a fixed currency

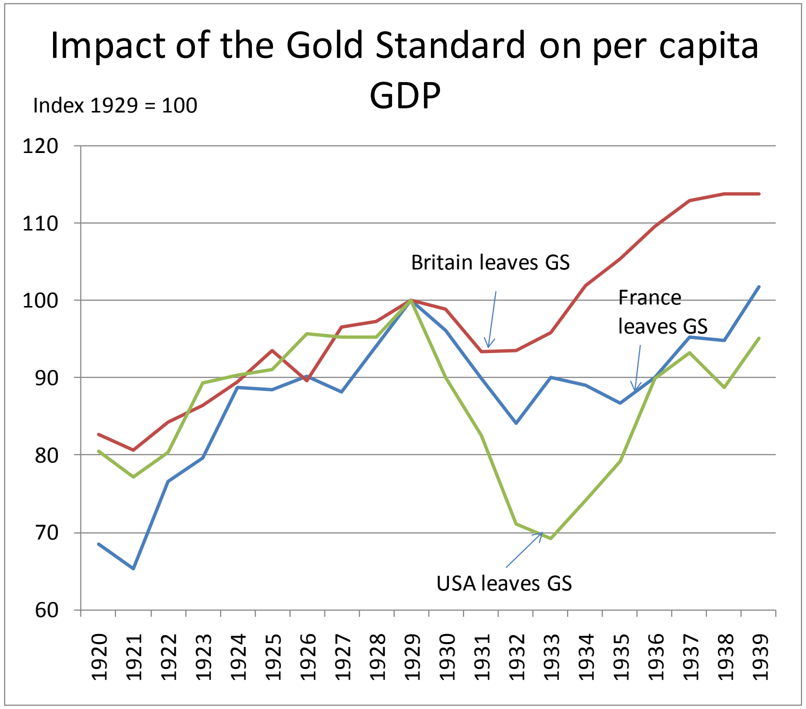
- Previous experience of debt cycles suggests that recovery is much faster in countries which can inflate their currency

- The Gold Standard meant the quantity of currency in circulation was tied to the amount of gold held in reserve

- The '30s started with all major currencies in the GS – but Britain left during 1931, followed by the US in 1933 and France (and others) in 1935

- Leaving GS was the trigger for a sustained recovery in all cases – but it was opposed at the time by those who feared inflation

- Today, the equivalent is the euro



Options within a currency union

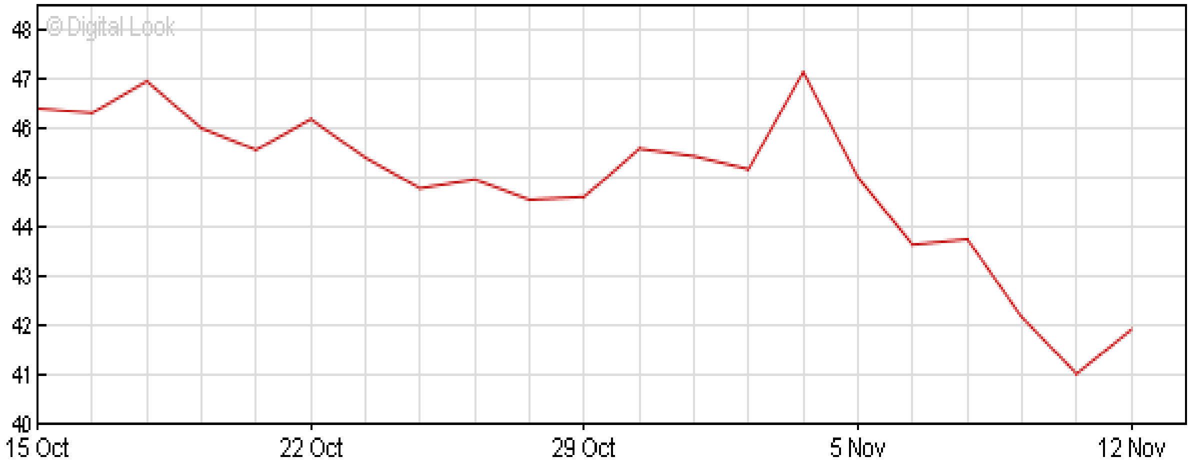
- **Bail out**. Involves some mechanism for fiscal transfers within the currency, such as exist within the dollar. The EFSF (May 10) introduced such a mechanism for the EA.
- **Default**. The dollar allows individual states or municipalities to default, and Merkel proposes something similar in EA. But those arrangements are not yet in place.
- **Inflate**. If the debt crisis affects the whole of the currency union, then it can print money and inflate away the debt burden. Not the case in the EA though.
- **Repay**. The worst option in the short term, implying a major and long-lasting recession. This is what the Irish government is currently planning to do. But it may be forced into one or other of the first two options within the next few days.
- Neither option is great, but there have been examples of both within the dollar, and the governments concerned have continued to function throughout
- Case studies - Orange County; New York City. Both municipalities defaulted on their debt. NYC was ultimately bailed out by the Federal government, unlike OC

Defaults inside the dollar

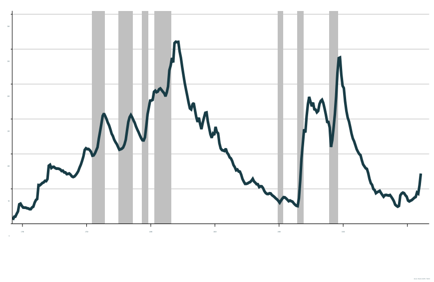
Orange County	New York City
Borrowed large amounts of money ($7.6 billion) to place bets on risky assets, which did not come through. Total loss estimated at $1.5 billion	Made welfare spending commitments that could not be funded with weak financial markets of early '70s. Defaulted on its debt in November '75
The State (California) did not agree to bail OC out, and markets stopped buying OC bonds	Federal government initially refused to bail NYC out, but then agreed to a $2.3 billion loan in December
OC declared bankrupt Dec 94, going into a "Chapter 9" process	Bankruptcy was avoided by means of a fiscal transfer – a bail out
Bankruptcy plan A (tax increases) was rejected by voters. Plan B (41% spending cuts) was passed	The price was a huge fiscal tightening which ensued, with 35000 job losses
OC is still bankrupt today, but it regained its AA status in 09. And it still functions, as it has throughout	NYC has subsequently regained Aa2 status, and the city government continued to function throughout
All the debt will eventually be repaid	

No time for complacency in UK

- UK banks have the largest exposure of any European country to the Irish economy, in excess of $230bn
- RBS has significant Irish exposure, and has seen its share price fall in the past week
- Its Irish business, Ulster Bank, made a loss of £176m in Q3, hit by £286m of bad loans
- Its Irish impairments this year totalled £785m, more than double last year

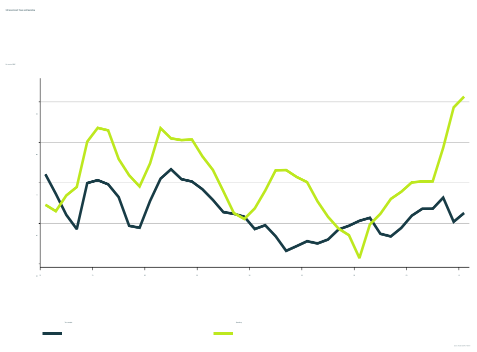


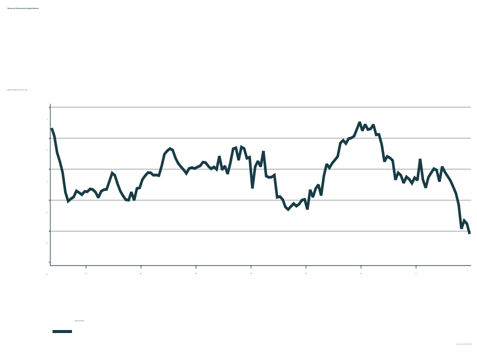
The UK public sector is already stressed

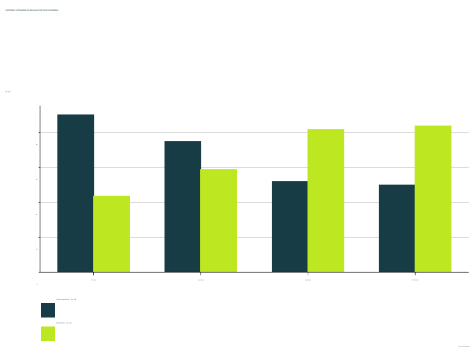


- It is sometimes claimed that Britain's public debt is still historically low. That is only true if you include wartime debts.
- According to the OECD, the UK has the second largest deficit in both headline and structural terms.
- Market patience was not a luxury on which the UK could gamble.

Government is saving...



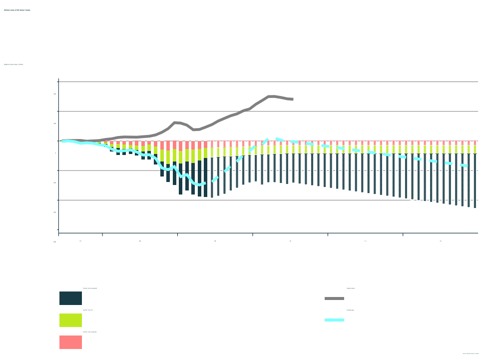


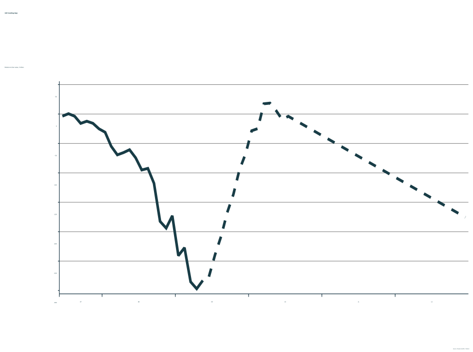


- Lots of talk about tax receipts having collapsed in the recession, but the evidence does not support it. The budget blowout mostly reflects a surge in (non-cyclical) spending.
- Government austerity plans are stacked 73:27 in favour of spending cuts.
- The evidence suggests this is the right track.

And the banks are still bust

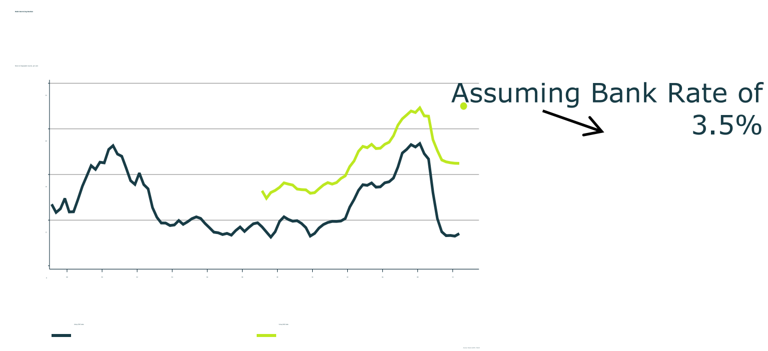
- On the face of it, UK banks appear to have closed their funding gap...
- ...but only if the level of house prices stays where it is
- But prices are already falling:
  - Nationwide index shows 5 falls in past 6 months
  - Halifax 4 out of past 6 months
  - Fathom's API shows that auction discount is widening again
- Assuming a 20% fall in house prices reopens the funding gap to £180bn by 2012, without more capitalisation
- And then there's the removal of the SLS (Jan 2012)...

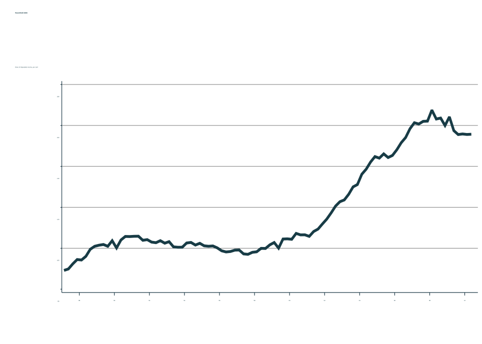




Zombie households on the rise

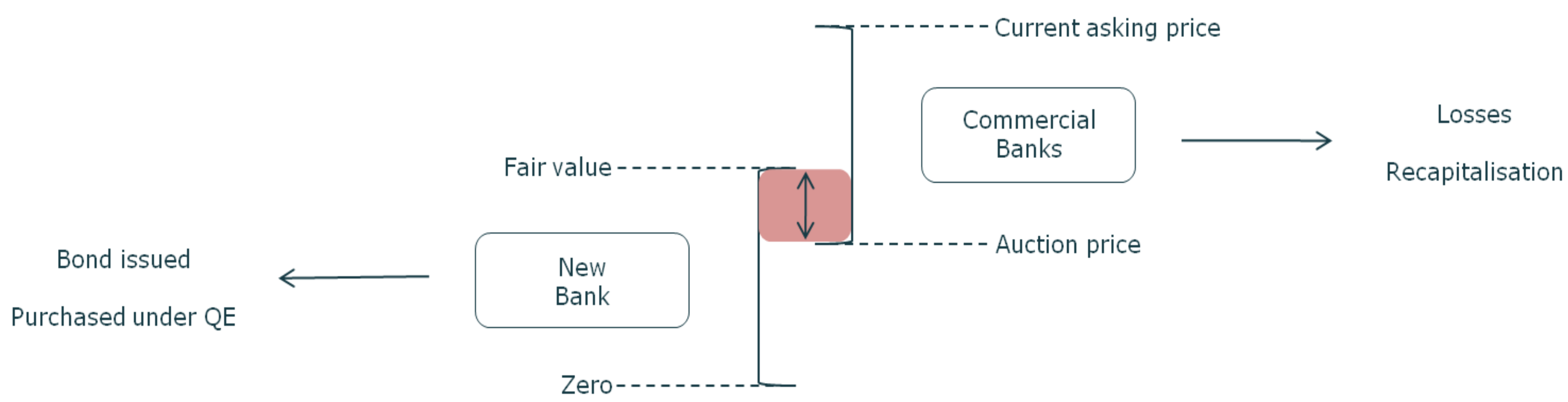
- Comparisons with Japan are usually dismissed, by people outside of Japan. But how different are we?
- Not very, according to the BoJ Governor. And we would agree.
- 15 years of ZIRP has left Japan with a glut of ‘zombie companies’ only kept afloat by the free cash-flow drip.
- In our view, the UK (and the US) are at risk of creating ‘zombie households’.
- Near-zero interest rates may have helped to keep mortgage defaults and housing repossessions much lower than they otherwise would have been, but at what long-term cost?
- UK household deleveraging process stopped when rates hit 0.5% - debt/income ratio has flatlined since. It stands at 155.7%.





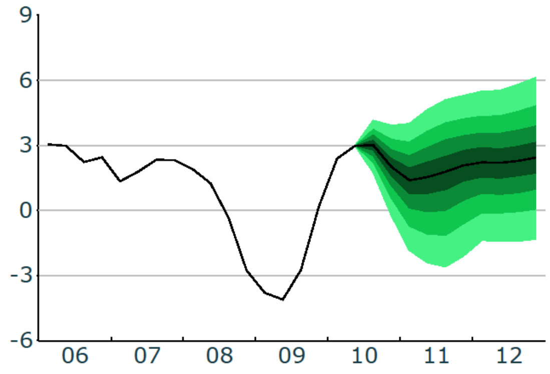
A solution: TARP into the UK

- We have consistently argued that policy measures should be targeted at the source of the problem – the housing market. We recently published a new policy paper along these lines. In short:
  - The Treasury should set up a new bank, to purchase troubled assets from the UK commercial banks, at a substantial discount under current market prices
  - Our Auction Price Index provides the floor for that purchase price, and fair value provides the ceiling
  - The new bank should issue a bond to finance its purchases of troubled assets
  - The Bank of England should purchase that bond using QE



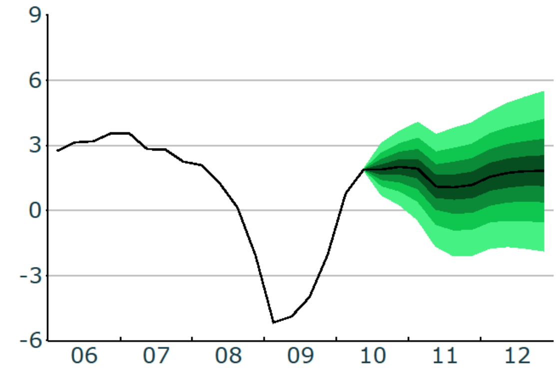
GDP summary

US GDP growth
Annual percentage changes



Source: Fathom / Reuters EcoWin

Euro Area GDP growth
Annual percentage changes



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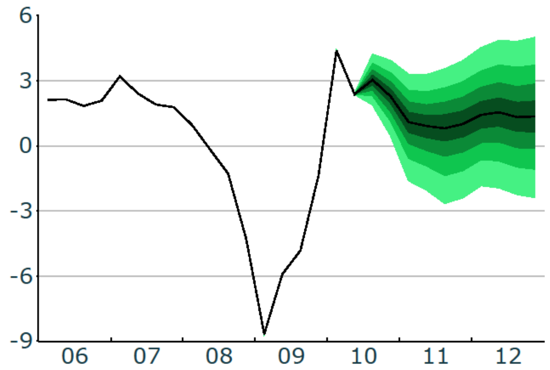
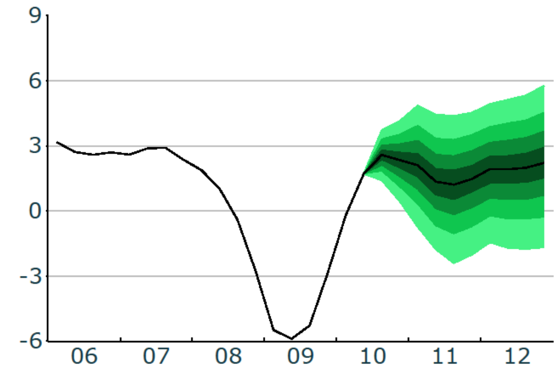
Japan GDP growth
Annual percentage changes



Source: Fathom / Reuters EcoWin

UK GDP growth
Annual percentage changes

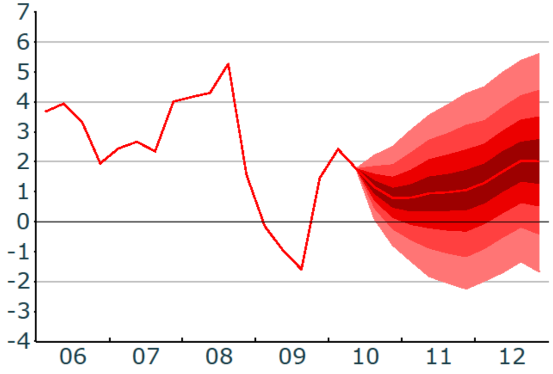


Source: Fathom / Reuters EcoWin

Inflation summary

US inflation

Annual percentage changes



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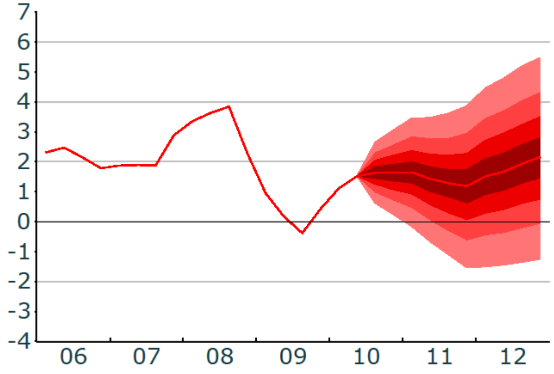
Euro Area inflation

Annual percentage changes



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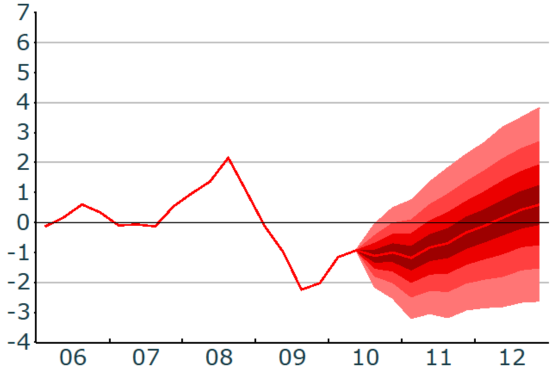
Japan inflation

Annual percentage changes



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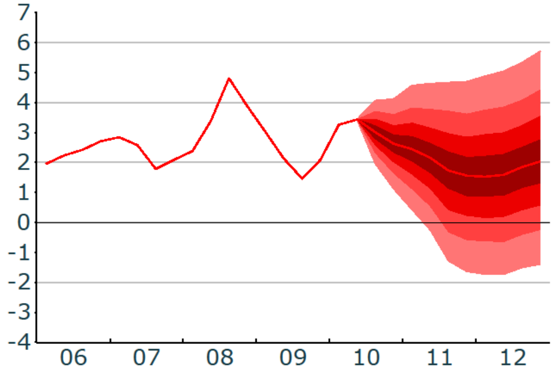
UK inflation

Annual percentage changes



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