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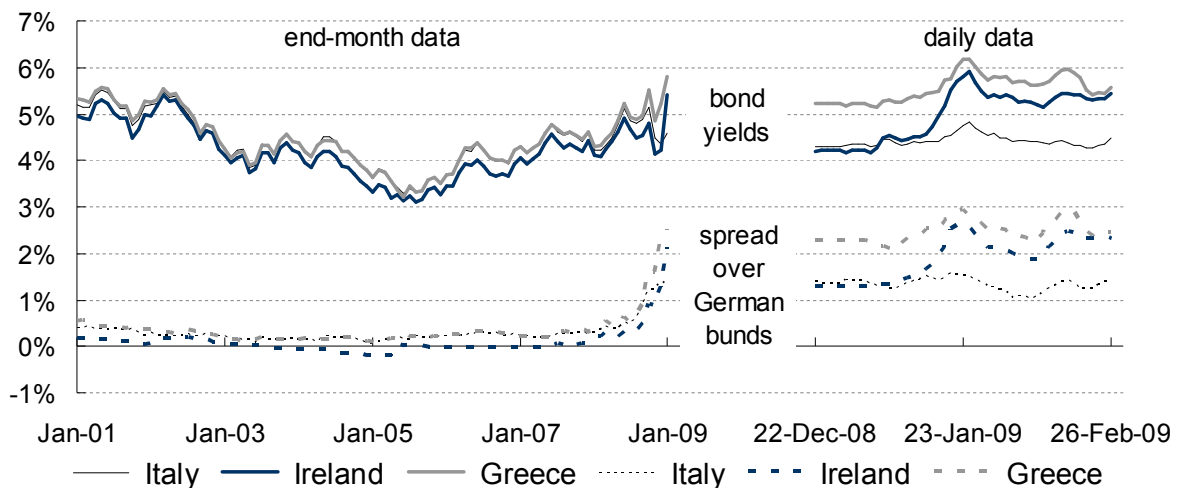
Merkel/Steinbrück destabilising weaker EMU credits

WE SUGGEST: Bunds yields too high, Irish too high vis-à-vis Greek

SUMMARY: There is no danger of crowding-out disrupting world government bond markets, which are doing fine without any co-ordination from Mrs Merkel or any other self-serving politician. The rank ignorance of economics amongst continental commentators is beginning to look like a serious global economic threat.

It is probably not out of malice that high-placed politicians from the stronger Euroland economies keep chattering about an entirely illusory crowding-out threat in world bond markets – what Dutch Finance Minister Bos recently referred to as “free-riders” with large government deficits. Yesterday, we had German Chancellor Merkel of all people adding her ill-educated comments to the clamour with a ridiculous Aunt Sally: “supposing all states were to issue huge bonds on the same day”. As the *Financial Times* debt manager contact observed, “the bond auction calendars ... are known by all of us. We talk to each other regularly ...” But of course the report then went on to mention Ireland – purely coincidentally, the country that European-unity zealots want to cow into voting for the new constitution in a second referendum later this year. (The Irish have already rejected it, of course, but that is not acceptable: they must try again until they give the right answer.)

Weaker EMU credits – 10-yr. gov't. bond yields/spreads



There is a problem, as it happens, but not in Ireland. Ireland has a deficit, to be sure, but its 10-year government bond yield of 5½% is hardly burdensome given its perfect starting-point: net government debt was nil at end-2007 (ie, assets equalled liabilities) and 5% of GDP at end-2008, versus, for example, 33% of GDP in Britain, 43% in Germany, 46% in

the US, and 88% in Japan, where 10-year government bond yields are a hardly crippling 1¼%. Financing 5% of Irish GDP at a 5½% yield is hardly going to make a ripple on global debt markets. Rumours that reached our ears last week of Irish default certainly are pure malice: how can a country with virtually no debt default?

The true EMU problem is Greece and, looming large behind Greece, Italy. These two have large deficits, grossly uncompetitive costs and products, crumbling real incomes from a below-average starting-point, and net debt of 67% and 87% of GDP, respectively. It is probably true, as German Finance Minister Steinbrück said recently, that they will need help from stronger EMU members to stay in the euro. As former Bundesbank President Karl-Otto Pöhl said, at the book-launch this week for David Marsh's "*The Euro*", bail-outs are forbidden under the EMU treaty, so Steinbrück was *ultra vires*. But former Chancellor Helmut Kohl bent the rules almost to breaking point to allow Italy into the euro, so it will be no surprise to see German politicians attempting the same to keep it in. So much the worse for both Germany and Italy – and more on this in my next *Monthly Review*. But Steinbrück's public comments probably aggravated rather than helped the problem – just as British politicians have made the banking crisis far worse by their idiotic alarmism.

The interesting thing about the chart above is “the dog that did not bark in the night” – the missing line: German bund yields themselves, against which the spreads are measured. The reason Irish and Greek financing costs are quite reasonable is that Mrs Merkel, Mr Bos, & Co., have got it precisely wrong: the world is desperate for reasonably sound government paper. The chief reason is that the true “free-riders” in the world are the savings-glut countries that have preyed for the past several years on the domestic demand of deficit countries. Conspicuous amongst these savings gluttons are Germany and Holland. Of the total real increase of the German economy, measured as GDP plus imports, over the latest ten years, an astonishing 78% consists of increases in exports, only 22% being extra domestic demand – and much of that growth of wages and other income, plus cap-ex, in export industries. (Measured against GDP alone, the ten-year gain in exports is actually more than 100% of the gain in real GDP, but this ignores the increased through-put of the economy from a higher import ratio.)

The savings gluttons are now getting well earned punishment for their Scrooge-like habits. Their exports are collapsing, their income and already feeble domestic demand are being correspondingly slashed, and their build-up of overseas assets has crashed in value. It is only fair that they should suffer more in the current crisis, as their excessive saving was the chief economic cause of the 2004-07 debt bubble and financial crisis in the first place. One problem that absolutely does not exist in the current situation is lack of demand for government debt. It is symptomatic of the disastrous misunderstanding of economics on the continent that this is what EMU politicians feel obliged to talk about.

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