

Don't cry for us Ricardo

First I must start with an apology. I stated in my last newsletter that once the funding budget problems in the U.S. had been resolved, that markets would become less volatile. Well the problem was sorted but in such a way that Obama was seen to be unable to govern as he had to give so much away of his preferred policies to attain the required funding. This then gave credence to the actuality of a weak Government in the U.S. and such uncertainty is likely to create volatility which is what has happened. In Europe the Greek crisis lurches from one suggestion to another, and stability still seems a long way away.

The threat to the viability of the Euro and if to the European Union itself as linked by Angela Merkel, is the most disruptive economic possibility since the Cuba missile crisis of 1962. It is no wonder the markets are volatile. The following are my summary of the thoughts of various economists regarding the various scenarios, and the most likely.

There is a present programme of a Greek austerity programme supervised by a Troika of the European Commission, the European Central bank and the International Monetary Fund. The aim of this is to bring down wage costs in Greece by 30% so that Greece's economy can be competitive with the rest of the Eurozone. How long Greece will be in austerity measures is anybody's guess but it could be 5-10 years. One major problem, with which we in Britain are familiar, is that it needs some growth in order to pay the interest on its loans and the capital repayment of them. Such austerity does not give rise to growth. It is questionable that the Greek people will accept this level of austerity, although their alternatives, certainly in the short term are no better.

The Greek Government could, or may be forced to by civil unrest, unilaterally default and exit the Euro. The new Drachma may be set at perhaps 60% of the Euro, existing Euros in Greece immediately being worth only 60% of their previous day's value. The debts of the Greek Government still remain in Euros, so their debts actually increase. However they will not have the austerity programme and their economy may well grow as they are immediately competitive again as far as trade goes. There are immediate problems for the rest of the EU as Greek Sovereign debt will not be repaid on time and Banks holding those Greek obligations will have to write them down. This is likely to be to a very low level indeed, possibly making the banks insolvent, and certainly reducing their capital base. This would reduce their lending capacity. Not Armageddon, but not great either, and certainly not for growth of economies.

We could have a shift, and it would have to be pretty quick, to full fiscal union. What this means is one central Treasury which issues Tax Rates and distributes revenues. This is giving up economic sovereignty amongst Eurozone countries. This is the whole Eurozone including Greece being one fiscal (tax) union. Politically this is a huge task as all techniques of persuasion would have to be used on the peoples of Europe. We should not think that it is just many of us British who don't wish to lose sovereignty, it is the peoples of most other European countries too.

The worst possibility and one that I don't think will happen is the Euro is abandoned by all states which revert to their own currencies putting back international trade by decades.

Whilst it is probable that of these scenarios, Greece will default and leave the Euro which maybe in January or 2-3 years' time, it is useful to look at the full fiscal union possibility. For this it is helpful to ask the question what is this Euro and European Community all about?

Whilst it is certain that the founders of The European Community wished to ensure forever that war in Europe would be averted, it was also about trade improvement, initially a customs union where there were to be no trade barriers between countries, and then a common currency to make prices easily comparable. This leads to greater specialisation, that is those who are particularly efficient at making one sort of good make it for all of Europe. This has led some to think that perhaps if one country is not actually the most efficient at producing anything, they will be very poor as they cannot produce anything more cheaply than another and cannot therefore sell anything. This is not so.

Ricardo was an English businessman and Economist who died in 1823. He was the first to write and describe the Law of Comparative Advantage. In simple terms, although one country may be more efficient absolutely than another in making say two goods, it is likely that they will be more efficient with one good than the other good. In those circumstances it is in *both* countries' interests that they make the goods they are relatively better at making, even though in absolute terms the latter country is inefficient at so doing. Together all are better off. Thus international trade helps everybody.

All true, but what if prices are manipulated by Governments? A different rate of sales tax (VAT, TVA, Purchase Tax) or subsidy skews the prices so countries may end up making the goods that they are not so efficient at making. Thus Ricardo's theory is not going to work efficiently where there are different rates of sales taxes, and probably even direct taxes (Income Tax, N.I., Corporation Tax). Thus maximum efficiency means harmonisation of Tax rates-that is a total fiscal union. Ricardo might be crying at what Europe is not doing, but he should not because at this stage anyway, most Europeans just don't want it.

Britons should be very wary of feeling smug that we have not joined the Euro. Europe is our biggest trading partner, and any disruption or breakdown of the Euro would dramatically adversely affect our trade. We may be glad we are not in it. However the full fiscal union as described above, which is probably a long way off, when and if it arrives, will be difficult for us NOT to join eventually.

To be acceptable, the running of Europe would have to be more accountable to its populations, but if that came about, then it would be a Brave New World.

I cannot give you a good scenario out of the Greek problem, only the least worst. Stability in markets will only come about when one of these happens. That does not mean selling everything and hiding. It has to be gone through, but sensibly and with diversification, looking for value and avoiding obvious bad buys.

I look forward to meeting you at our November Investment Conferences.

With kind regards

Andrew Roberts