3 September 2012

Renaissance Capital

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Thoughts from a Renaissance Man

Merkel, Draghi and 1837

- **This was one of those rare summers when trading desks behaved themselves** and left most asset prices largely unchanged, allowing us time to discover and finish Alasdair Roberts' book, *America's First Great Depression: Economic Crisis and Political Disorder after the panic of 1837*. As financial markets re-engage, attention is focused on the decisions by the European Central Bank (ECB) and the Fed that have been left hanging since late July. But what the *First Great Depression* tells us is that, at least in Europe, the ECB's actions are now less and less relevant. It is no longer important whether Spanish yields are 7%, 5% or even 3%. They need to be negative for the ECB to make a substantial dent in Spanish unemployment. The benchmark of ECB success is how many millions of Spanish jobs it can create. Unless the Spanish unemployed are convinced that the euro offers them the best prospect of future employment, the eurozone will prove as vulnerable to dissolution as the US was in the 19th century.
- **While many rely for their historical comparisons** on the past 20 years, for which Bloomberg provides reliable data, we believe it is the mega-shocks that only occur every 40 years or so that deserve close analysis. In reverse order, these are the 1970s, the Great Depression of the 1930s, the Long Depression (which broadly covers 1873 to the 1890s) and what Roberts' refers to as the First Great Depression of 1837-1845. Real estate and asset-price bubbles, combined with over-investment, precede a collapse of confidence, severe economic dislocations, sovereign or sub-sovereign debt defaults and political turbulence. What proves particularly interesting about 1837-1845 is the comparisons that can be made between the political, economic and market thinking in a US that was roughly 60 years old, and the roughly 60-year old EU.
- **As we highlight in subsequent pages,** the economic fallout from the 1837 crash led to one-third of the states in the US failing to meet their debt obligations. Charles Dickens talked of US state debt paper in disparaging terms that investors in Greek bonds in 2011 would clearly sympathise with. Investment banks declared that the US federal government should back-stop US state debt, a move rejected by increasing numbers of populist and mainstream US politicians, who argued that this would only reward speculators and foreign bankers. Today, markets look for eurozone debt mutualisation as their preferred solution to the debt problems of eurozone member states.
- **What US states did do in the 1840s was start collecting taxes more effectively,** embark on deep spending cuts and – perhaps most importantly – introduce constitutional amendments forcing them to balance budgets. Eurozone member states are doing the same today. The positive lesson to draw from the First Great Depression is that eight years after the crash (i.e. 2015 on our timeline), the economy was recovering. Indeed, economies always recover from depressions. In addition, the changes made by US states did encourage investors to start buying their debt again. If the ECB can buy a few years via the long-term refinancing operations (LTRO) that expire in 2014-2015, and by new measures in the approaching weeks and months, we are confident that recovery will come.
- **However, the negative lesson to draw from the First Great Depression is more compelling.** The recession exposed deep divisions between the North and the South that contributed to the Civil War that broke out 15-20 years later. The US might have foundered sooner, were it not for the perceived threat from a powerful enemy (the UK). The EU lost its powerful enemy (the Soviet Union) in 1991, and while we believe a European civil war will never happen, a currency break-up is plausible. The US helped to pull itself out of recession in 1846 by embarking on a war with Mexico that united the nation. We doubt Mexico will provide such support to the eurozone today. Crucially, the US was a more united nation in the 1840s – while eurozone unity is now fragile and depends primarily on whether the region can be an economic success story again. The key benchmark we see for ECB success in the coming weeks is whether new measures will help increase employment in the periphery – and especially Spanish employment, from its current 68% rate, the lowest in the eurozone. Failure will increase political tension over 2013-2014. Emerging markets would be wise to still prepare for medium-term instability, while hoping the ECB can deliver solutions.

The US in the 1830s was in a very different position than it is in today – then, it was the recipient of external monetary policy decisions. It was low UK interest rates and high UK demand in the 1830s that helped to fuel a US real estate boom so intense that "everyone was sure his fortune was made," according to Roberts – in the 2000s loose global monetary policy helped produce a similar effect in Spain. When monetary policy tightened due to surging commodity prices, the crash of 1837 saw property assets "knocked down…at one-fifth of their real value." We are very far from such clearing prices in Spain today. During the First Great Depression, trade turnover plummeted by 50% in some categories, the capital of US banks fell by 40% from 1839 to 1843 and loans by New York banks were cut by one-third. A banking crisis obviously resulted, in part because in states such as Florida "appraisals of the value of mortgage property were vastly inflated." Attempts to bail out local banks in Mississippi then fed into default by the state itself.

The defaults and political mess that resulted from this will not surprise those following events in Greece and the rest of peripheral Europe. Loose policy in the 1830s had seen money flood the US, with American states amassing a debt equal to that of a combined Russia, Prussia (Germany) and the Netherlands. But with the crash came default, and by 1842, "one-third of the Union was refusing to meet obligations to overseas lenders" – today, if Spain accepts EFSF/ESM support, a large minority of the eurozone will also be dependent on others to help meet their obligations. As in the eurozone, it was smaller states that ran into trouble first; the largest defaults, by Pennsylvania and Louisiana, came in 1842, five years after the crash began (equivalent to 2012 now). To deal with the problem, Barings Bank suggested the US federal government should guarantee US states' debt, an idea that was "savaged by Democrats as a scheme to cover the losses of foreign bankers." Today we have the same mix of suggestions that the eurozone should guarantee member state debt, and complaints from Greek politicians over 2010-2011 that foreigners have been out to protect the interests of German bankers. In comparison with US debtors, creditors felt rather differently – the poet William Wordsworth was among those critical of US defaulting states. Dickens had one of his most famous characters, Ebenezer Scrooge, talk of the worthlessness of a "mere United States' security."

US politics got ugly. Turnout rose as voters were determined to throw out incumbents in favour of the opposition or populists. The populists of 1837-1844 included Indiana's governor, who claimed the state's debt problems were partly caused by investors who made credit so easily available. The governor of Arkansas was elected on the promise to break the "heartless tyranny" of the banking establishment, and spoke in terms that we think Alexis Tsipras of Greece's hard-left Syriza party would heartily agree with. New parties emerged, such as the American Republican Party (no connection to the present-day Republican Party), which was formed in Philadelphia on an anti-immigrant platform and found startling electoral success – we have seen the same in various eurozone countries.

The 1840s saw the rise of populist politicians haranguing banks and investors, while orthodox political leaders were defeated whenever voters got the opportunity – a trend seen with US President Martin Van Buren's defeat in 1840, and of course in subsequent depressions such as President Herbert Hoover's defeat of 1932, and President Jimmy Carter's defeat of 1980. Today, incumbent governments have been defeated in every peripheral European state where elections have been recently held. Indeed, even democracy itself was seen as under threat. In 1842, five years after the crash of 1837 (i.e. similar to 2012 on our timeline), the Navy secretary said he "should not be surprised to hear of popular outbreaks in all the large cities, and of desperate measures calculated to overthrow all law and all order." Rhode Island was on the verge of its own civil war.

Yet by the late 1840s, the US and most of its states were largely stable, growing and able to borrow again. What changed? First, the global economy recovered, and the US economy with it, helped by a successful war against Mexico begun in 1846 that both reduced unemployment as the army expanded, and improved national self-esteem. We are confident that we will see economic recovery again. The 1837 crash had largely run its course after eight years. The US was in some sort of recovery mode six years after the 1973 crash, until the oil shock of 1979 created a double-dip recession (before the Reagan boom in 1983). The famous Great Depression that began in 1929 double-dipped after eight years due to monetary and fiscal tightening, but again the economy was in recovery mode after 10 years. While we do fear the 2013 fiscal cliff, we are confident the Fed will act in the coming months to ease policy to help offset it. The implication is that even the eurozone will be showing evidence of good growth by 2015-2017.

Second, the weakest US states changed policy. States such as Michigan that cut taxes “to provide relief to voters” in 1839 were forced to reverse the tax reduction in 1841, just as Spain’s loose fiscal policy of 2009 had to be reversed in 2011. Not all tax increases worked at first. In Maryland, “the actual amount of property tax revenue...between 1841 and 1844…was only half of what Maryland legislators had expected, largely because of the state’s inability to enforce the law.” Only strenuous efforts to improve tax collection, in the face of voter resistance, improved the situation. Again Greece today carries echoes of this. Privatisation was attempted but there was little appetite for defaulted state assets – as Greece finds today. State expenditure on infrastructure was cut back significantly.

Balanced budget provisions were approved in various states. Six defaulting states adopted constitutional debt limitations, while eight others that did not default also adopted limitations on borrowing, and two others came close to do doing so. Germany has gotten 25 EU member states (including all eurozone members) to adopt the same provision since 2011.

For optimists then, we can draw a positive scenario for the eurozone from America’s First Great Depression. First, a strong global recovery is likely, even if we have to wait until 2015-2017. The more time the ECB buys us, via the three-year LTROs that expire around 2014-2015, or by fresh action in the next few weeks, the greater the chance that the eurozone will recover before a threatened break-up. Second, European states are making the sort of fiscal changes that US states did in the 1840s, which helped to restore investor trust. Such reforms saw US state debt trade up significantly, from 35 cents on the dollar for Pennsylvania bonds in 1842 to 80 cents by 1849, and from 20 cents for Indiana bonds in 1842 to 52 cents in 1849.

However, we draw a more negative lesson from Roberts’ book, which is that the First Great Depression gravely weakened the US. The economic shocks of that period loosened the strong bonds forged in its war of independence 60 years earlier, and paved the way for the US civil war that came 15-20 years later. Dissolution of the Union may have come earlier were it not for external threats and wars that helped unite the US in the 1840s. The eurozone does not have these ‘advantages’.

“Every day the difference between the North and South is becoming more prominent and apparent...such a Union is one of interest merely, a paper bond, to be torne asunder by a burst of passion or to be deliberately undone whenever interest demands it,” wrote the diarist Sydney George Fisher in 1844. The deep fault-line in the US was over taxes and tariff policy. The South wanted free trade with the UK, to allow it to buy high-quality European-manufactured and luxury goods rather than the shoddier and expensive manufactured goods of the North. Meanwhile the North wanted to maintain import tariffs to help it develop a manufacturing sector to rival Europe’s, while also providing revenue for the federal government to spend on defence and infrastructure (primarily the post office). The economic shock saw the North ‘betray’ the South by reneging on promises to remove the tariff. Arguably, this set the scene for the US Civil War of 1861-1865. The linchpin state in the US was Virginia, probably most like France today. When it swung its support behind the South, the Union broke apart.

Europe's economic problems are not about tariffs, but there is a fundamental divide between Europe's north and south. The core around Germany is a low-debt, high-savings, manufacturing and export powerhouse, with a preference for deflation to protect savings. Much of the south is a low-savings, high-borrowing group of countries with an inherent preference for inflation to resolve their debt burdens. See our Renaissance Man piece, *Who supports inflation/deflation?,* of 20 June 2012 *(click here* to read).

The US was held together by a combination of factors. First, it was surrounded by perceived enemies: primarily the UK. Wars with the UK in 1776-1783 and 1812-1814 and the threat of war in the 1840s over Hawaii and the Canadian-US border show that concern was justified. The EU was established when it too faced a threat, from the Soviet Union, and the eurozone was conceived when that external threat was still considered plausible. This is no longer the case. Second, in 1846 the US could embark on a successful war with neighbouring Mexico, which helped to unite the US after the divisions exposed by the First Great Depression. The eurozone is extremely unlikely to follow such a path. The US's population shared strongly similar cultural roots, an agreed constitution had been in place for 60 years, a common language presumably helped intra-state communication and labour mobility was high. Despite this, war broke out in the 1860s. Europe's electorates rejected a European constitution as recently as 2005, cultural differences remain within Europe, there is no common language and labour mobility can be shockingly poor. Today, roughly 50,000 Spanish citizens are registered as working in Germany, while 5.6mn are unemployed in Spain.

Despite the first two advantages, the US was under pressure after the First Great Depression. Today, mutual suspicions in the eurozone between north and south Europe are apparent every day. Support for the EU and the euro is falling in Finland and the Netherlands, while politicians in the south clearly feel countries in the north are being unreasonable in not using their low-yielding debt to help offset the high-cost yields of the south. We cannot see this ever ending in civil war – European states are too rich to lose democracy and democracies do not go to war with each other (the slave-owning American confederacy was no democracy). However, the binds that tie the eurozone together are not nearly so strong. A break-up of the currency union is more plausible, because the key popular support for the eurozone union is not emotional, nationalistic or rooted in fears of external threats. It is primarily economic.

The popularity of the euro in peripheral Europe is no surprise, given the employment boom that it helped foster. The employment rate among Spaniards aged 25-54 rose by 32% to a peak of 76.8% in 2007, from 58.4% in 1994 (a year before the markets began to price in Spanish euro adoption). In 2011, the figure was back to 68.7%, the lowest in the eurozone and well below the 77.2% average for the union.

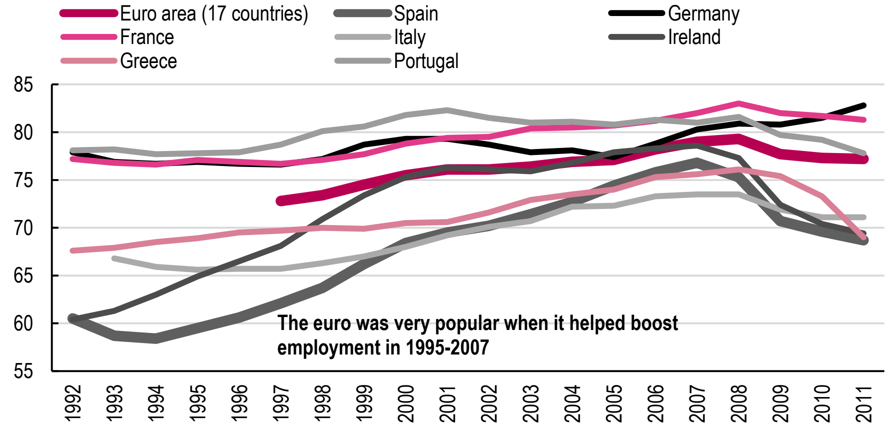
What is crucial for the survival of the eurozone is that this employment rate stops worsening. Whether Spanish yields are 5% or 7% is an irrelevance, because neither will prompt an investment or consumption surge that will create jobs. With nominal GDP growth around zero, Spain needs negative interest rates to offer any hope of reversing the trap in which it now finds itself. The ECB will not provide this, so the prospects for 5.6mn unemployed Spaniards remain bleak. Indeed, more are likely to join them.

The lesson this economist draws from the First Great Depression is that ECB activity in the coming months will reward those buying peripheral European bonds only until political realities again capture investor attention, as they did with the Greek elections in 2Q12. Emerging market governments and central banks would be wise to prepare for a break-up of the eurozone – again see our Renaissance Man piece, *Who supports inflation/deflation?*

However, other readers could draw an alternative conclusion, and one that we hope is right. Some of the measures taken by US states in the 1840s are being taken in the eurozone today, and may well support these countries' eventual recovery, including tax hikes, spending cuts and constitutional provisions for balanced budgets.

In either case, European demand is unlikely to be a significant benefit to any emerging market over 2012-2014. Europe's share of Turkish exports – now just 40%, compared with 50% a few years ago – is falling as Turkey shifts its export focus east and south, and we believe this will be a trend seen in other exporters to the region. Central Europe will struggle the most, in our view, while Russia remains in a stronger position, helped by its large domestic economy, export potential to CIS neighbours and the EU's reliance on Russian energy exports that Europe can neither do without nor replace, yet. Within EEMEA, we believe Africa offers the greatest diversification of export markets, and therefore the best prospects of maintaining growth, irrespective of Europe's problems.

Figure 1: Employment rate among 25-54 year olds in key eurozone countries, 1992-2011 (average %)



Source: Eurostat

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