Energy, currency reserves, credit: does disaster threaten?

1. What Royal Dutch Shell thinks

It doesn't often happen that one returns from a conference with high-quality speakers in a genuine state of intellectual enrichment. Mostly, it's more a case of reviving old acquaintances – "let's meet more often" – and making new contacts, so that when one gets home it's no longer quite so clear which face belongs to which visiting card. But no matter, the main thing is the network has been expanded. One's seen one's own name, spelled correctly, fortunately, among all the other prominent names on the participants list, and so feels a part of the informal community of important contemporaries. In short, the almost liturgical sequence of speakers on such important topics has once again served as an alibi for the much more significant satisfaction of the need for human interaction to flatter the ego and, just conceivably, as an excuse for escaping from the often somewhat stifling confines of one's daily working environment.

But the exception proves the rule. At this year's St. Gallen Symposium, a meeting of business leaders, academics and students from all over the world, the CEO of Royal Dutch Shell, Jeroen van der Veer, set out his company's strategic considerations. A star performance, intellectually and practically, particularly because Van der Veer made no secret of the difficulties Shell's top management had long had in grappling with the question of a long-term perspective. The first approach was to focus the thinking on two relatively extreme scenarios, based on a thorough and analytically impeccable assessment of the situation. However, it soon appeared that this resulted too quickly in a compromise solution somewhere in the much more probable middle ground between the two extremes. This would produce mediocre solutions – undoubtedly well-founded, but in no way suited for distinctiveness compared to the competition or to provide answers for genuinely threatening developments. In view of this unsatisfactory situation, they then decided to go over to a variety of scenarios, developed by hordes of experts and presented at lengthy meetings. This too turned out to be unsatisfactory, because a collective debating society is simply unable to focus on more than four or five different scenarios. In the end the discussions mainly focused on which of the many scenarios was currently under discussion – they never got as far as practical strategic proposals.

On the basis of these experiences, Shell forced itself to adopt a strategy process limited to three, ideally mutually self-exclusive scenarios. Its advantage, according to Van der Veer, is that there is much less danger of a feeble compromise, and, more importantly, it is possible over time to review the probability of the individual scenarios occurring without entirely losing sight of the other scenarios. This way, the link between short-term business policy and the longer-term strategic objectives was less likely to be lost sight of, easing the burden on the management process. This seems convincing enough, but even more so are the three specific scenarios selected by Shell for the subsequent development of global oil and gas supply.

The starting point was the insight that, given the significantly more broadly based growth of the global economy – China and India are entering the commodity-intensive phase of their development – an accelerated (and not just more or less linear) rise in the demand for fossil fuels must be expected. It is also clear that there will be fewer and fewer accessible sources of "easy oil" – or, in economic terms, disproportionately higher (long-term) investments will be required for each additional unit of fossil fuel. Further, the accelerated use of fossil fuels will further increase CO_2 emissions, possibly to an extent that will be widely regarded as unacceptable.

Before we describe and discuss Shell's three scenarios, let us pause for a moment to be clear about the following. In the previous two Investment Commentaries, No. 248 and No. 249, we painted a generally very positive picture of the global economy and the financial markets. Ever more broadly based growth coupled with low inflation, a continuing dramatic drop in informa-

tion and transaction costs, with very positive impact on consumers, high levels of liquidity, not only for money but also for goods and services; all in all a virtually unconstrained global availability of almost anything for which there is a demand – so absolutely no reason to take a pessimistic view of the world. We could of course set against this admittedly rosy-spectacled view a negative counter-scenario, giving all the reasons why we should not take an optimistic view of the future. We know them well, these reasons: international terrorism, the evil state of Iran, the central banks apparently printing money flat out – all reasons why stock markets prices, which have anyway been rising for far too long, must take a sharp and dramatic dive.

There is of course always a market for prophesies of potential disaster: they can never be wholly dismissed, but are ultimately trivial. For it is precisely such two-scenario perspectives that rapidly result in mediocre solutions. As such, they are never entirely wrong, but also never entirely satisfactory. If we intend to deal below with the risks to be encountered (perhaps more than ever) in the "New Economy" of unconstrained availability, then we, like Royal Dutch Shell, must force ourselves to think more rigorously, and also adopt the technique of three scenarios that are, as far as possible, mutually self-exclusive. After energy, we shall address the piling up of currency reserves, and lastly the extremely low risk premiums on the capital markets.

2. Energy: power politics, protectionism or efficient allocation?

First, then, fossil fuels, their extraction, refining and distribution around the world. What intellectual approach shall we adopt towards the future of this sector, decisive as it is for global growth and prosperity? Shell thinks like this:

- Firstly, it is conceivable that the great global power blocs pursue a deliberately planned, activist energy policy, with the primary aim of ensuring supplies, and that this will have a substantial impact on global politics.
- Secondly, it might be that, under the impact of environmental problems and supply bottlenecks, (mainly nationally oriented) controls and regulations will get the upper hand, and protectionism will restrain the development of globalization.
- Thirdly, it is possible that the allocation of energy will be largely left to market forces; that both national and supranational institutions will lose influence, and that ultimately the incentives needed to protect the environment will be provided via the price of fossil fuels.

None of the three scenarios will occur in its absolute form; rather, the world will incline more towards one and then more toward another. What, understandably, Shell does not state explicitly, but must be said bluntly in the Investment Commentary of an independent private bank is that both scenario one and scenario two are highly explosive in terms of power politics and their military implications. To speak plainly, scenario one is currently being implemented by Russia vis-à-vis Europe, and Europe is sticking its head in the sand, in the old familiar fashion, so as not to have to acknowledge what should not be possible: that we have now become dangerously dependent on Russian gas supplies. The USA too is acting in accordance with scenario one: if there were no oil in the Middle East, there would be no American troops there either. Oil-producing countries such as Saudi Arabia, Nigeria and Venezuela are acting rather in accordance with scenario two (an energy policy mainly oriented on internal political considerations). They are optimizing their national revenue streams, often to the benefit not of the nation but of the clan in power, with a far too short-term horizon and without any regard for the rights of future generations. In scenario two, it is only a matter of time till the recipient nations move to domestically motivated interventions. The debate on the climate may well in part be going in the direction of greater protectionism.

In addition to their immense military and power-politics problems, scenarios one and two involve a further serious risk: that despite the likelihood of further rises in the price of fossil fuels, relatively too little will be invested. When expropriation – current practice in Siberia at the moment – or even the exercise of military power threaten at any time in the future, no-one is really going to be ready to undertake the ever greater investments required by the lack of "easy oil". "No-one": well, certainly not investors on the global capital markets who follow the basic rules of sound economics: rather, perhaps state agencies from the countries of origin of the oil and gas. Such "investments" will invariably be accompanied by corruption, the waste of resources and the destruction of capital.

The result is a predictable undersupply of a global economy hungry for energy, and it is also predictable that the remedy will be sought not in a move to scenario three, but rather in the strengthening of energy policies conducted on either a national, or in the worst case a bloc-like basis. Regrettably, the potential for a struggle over fossil fuels, possi-

bly conducted by military means, must be regarded as high.

The question, though, is – and here our thoughts go beyond those of the head of Shell – whether, with the insight that there is a threat that scenarios one or two might materialize, the remedy might still come via scenario three, in that the incentive to substitute fossil fuels would naturally increase significantly if there were politically-caused inefficiencies in the supply of oil and gas. There are certainly limits to substitution, both physically and chemically. The manufacture of polymers without fossil-based raw materials would, for example, be extremely expensive. But perhaps here too (as so often) we systematically underestimate mankind's capacity for invention, because we are focused on those who purport to optimize the well-being of their citizens, but whose hands are actually dripping with the proceeds of the refineries …

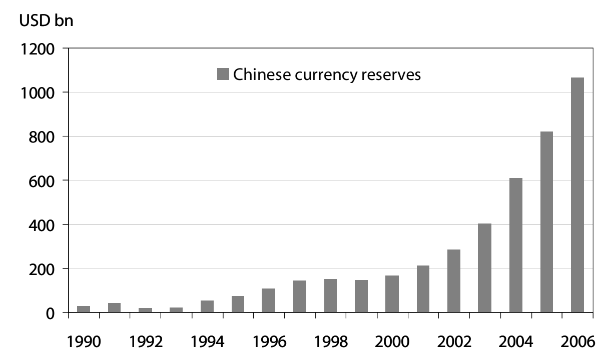
3. How to put an end to global asymmetry?

Let us now try to apply the intellectual discipline of three mutually exclusive scenarios to another topic currently causing headaches – the piling up of currency reserves in the vaults of the central banks of the up-and-coming developing economies, China in particular. It is important to be clear about the origins of, or rationale for, such high currency reserves. They are the result of an asymmetry in exchange rates and the flow of goods, sustained over a lengthy period. If exchange rates are held artificially low through compulsory measures, then the central bank must accumulate assets in foreign currencies, to the extent that citizens are prevented from balancing matters via the free movement of capital. In China's case, the compulsory system consists in that firstly, the Chinese are not free to travel outside China, and are thus tied to their place of work, secondly, they are not allowed to exchange foreign currency, and thirdly, they are forced to keep their savings in accounts in Chinese (state) banks. The accumulated currency reserves are equivalent to undistributed national assets, which would have accumulated to a lesser extent with a free foreign exchange mechanism: then, the Chinese would have used up some of these reserves abroad – as tourists in Zermatt or consumers on Fifth Avenue – or they would have found their way into personal assets, in an individual fashion probably involving currency diversification. To the same degree, the deindustrialization in the developed world would have been less dramatic, or would have been compensated for by new demand generated by an influx of hordes of Chinese tourists.

The internal price for the rapid accumulation of foreign currency reserves is an expansion of the Chinese money supply. Reliable data on the inevitable concomitant inflation are sparse, but visible: for instance in the price of pork, or the wages that must now be paid by Western companies for Chinese engineers in Shanghai. The wage gap to the West is getting smaller and smaller.

It is often argued that accumulated currency reserves are a serious problem primarily for countries with a positive balance of capital movements, the USA in particular, in that the result is a dangerous dependency on China as an investor. Of the 2,165 billion US dollars of debt instruments of the American Treasury held by foreign creditors, some 400 billion or just on 20 percent is held by China. It would be particularly dangerous if the Chinese were to sell this debt all at once, or if they decided to embark on major currency regrouping, for example toward the euro. It is undoubtedly true that clusters of creditors are as dangerous as clusters of debtors, but we should not overdramatize the dangers. For even if they wished to, it would not be so easy for the Chinese to get out of their selected investments. Over-hasty sales would have such an impact on the remaining positions that this would not be a rational move to make.

China: the face of asymmetry



Source: State Administration of Foreign Exchange (SAFE); National Bureau of Statistics, People's Republic of China

It is also said that the accompanying US debt is a problem in itself. America's consumption is at the expense of others. The current account deficit represents a sort of aggregated consumer credit. True enough. But is this a problem *per se*? If a debtor's performance is reckoned to be good enough, he can still be lent money, for whatever purpose. And that the American national economy, with an annual GDP of USD 13,600 billion, is in a position to cope with debt of USD 811 billion (current account deficit in 2006) cannot seriously be doubted.

If at all, we rather see a problem in China. We have already mentioned the likely inflation. Be-

yond this, in our view there is a developing politico-economic problem. As mentioned above, the currency reserves are undistributed national assets. They amount to about USD 1,000 per capita for every Chinese. Not an inconsiderable amount, bearing in mind that only very recently, the vast majority of Chinese were below the poverty line of a dollar a day. What if the assets were distributed, or if, say from today onwards, as a result of a less asymmetric currency policy, not the Chinese central bank but individual Chinese were able to enjoy the fruits of their labors? If they became free, responsible and ever richer global citizens? There's the rub: the current, highly asymmetric system is extraordinarily well suited to what is still somehow a Communist regime in China. On the one hand, the industrious citizen can be kept busy, and under control, in what are still very labor-intensive production systems; on the other hand, the banking system, essentially the property of the Party, feeds the *nomenklatura*, and also accumulates reserves that, in the hands of a few technocrats, can be strategically placed, bit by bit, as shown by the engagement in Blackstone.

Which three scenarios are conceivable for coping with Chinese currency reserves in the future?

- Firstly: things will continue more or less the same. The problem will become ever larger, but be put off by the global trading community, with minor upward revaluations on the Chinese side and pin-prick protectionist moves by the USA and Europe in response to pressure from the streets or the financial markets. China will begin to be active as a state investor in all parts of the world (as is already the case in parts of Africa).
- Secondly: There will be some kind of trade war, with all the disadvantages that protectionism brings, particularly for consumers. The pronouncements by American presidential candidates (of both sexes) do not sound encouraging in this regard. China will open up somewhat under the pressure of events, but the opening up will be chaotic and result in dangerous conditions within the country.
- Thirdly: The WTO pulls itself together and finally fulfils its purpose of achieving symmetrical overall conditions for all the member countries. Chinese currency policy is adjusted gradually and appropriately, the banking system is entirely overhauled with the help of foreign banks, and over time the Chinese become net consumers of foreign goods and services. With free floating, the problem of the currency reserves disappears.

Here too, there is not, and never will be, an absolute scenario. At the moment we are fairly well into scenario one, with occasional shifts towards the protectionist scenario two. Both scenarios have within them the stuff for a real crisis on the financial markets and downstream in the global economy. Belief in the need to protect the Chinese regime, on account of the anxiety in Western circles about the internal destabilization of this vast empire, gives the short-term approach the additional boost of "rational", pragmatic policy, and thus make scenarios one and two the more probable, despite the fact that scenario three is the only really rational one, and the toolkit to implement it is available. Investors will probably have to arrange themselves with this suboptimum situation, for better or worse. We will come back to possible responses at the end of this commentary.

It should also be noted that the Swiss have particular experience in dealing with "excessive" currency reserves. The Swiss National Bank began some years ago to talk of "excess reserves", and since then it has been impossible to shut this Pandora's Box again. (Virtually) no-one came up with the idea of simply returning the undistributed national assets to the people. By contrast, there was certainly no lack of ideas within the political system of what else could be done with it. One would not wish the Chinese to get into this situation, for the danger that capital is destroyed in a collective system is infinitely greater than if it is in private hands.

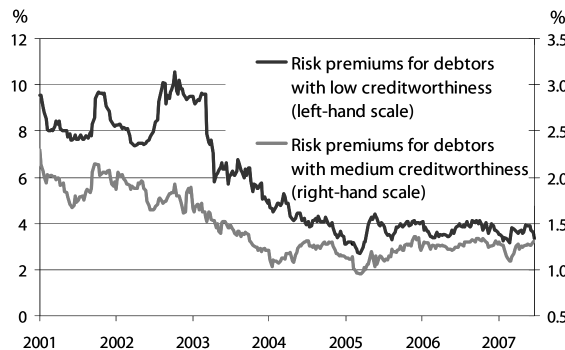
4. Easy money

It is common knowledge that we have in the past opposed with all possible intellectual rigor the notion that there is "too much" liquidity, or that the central banks are making "too much" money available, and the price of assets has reached "excessive" heights. "Too much" suggests excess on the one hand, and knowing better (oneself, obviously) on the other; it presumes failure on the part of the markets. Its use should therefore be strictly controlled. Our interpretation of the financial markets, and further of the whole economy is significantly less judgmental – it is one of higher liquidity at all levels and of all conceivable types: money, capital, goods, services. Everything has become much more available that it used to be. So far, so good; so very good, indeed.

Nevertheless, it is difficult to escape an uneasy feeling in view of the extremely low risk premiums that have been charged for some time now on the financial markets. Has the world really become so much less dangerous? Are risks less serious when they are spread over more shoulders

by means of derivatives and the like? Have the ever greater possibilities to acquire risk – for which one is paid – basically just resulted in a downwards movement in its price, or is there perhaps a mechanism in the system that inherently results in an excessive appetite for acquiring risk?

A completely safe world?



Note: Debtors with low creditworthiness: US industrial debtors with B rating (Standard & Poor's); Debtors with medium creditworthiness: US industrial debtors with BBB rating (Standard & Poor's). Premium differential: to US government bonds.

Source: Bloomberg, analysis

A difficult question, but one that cannot be avoided when considering the condition of the financial markets and future developments. For if there were such a mechanism, then, to the extent of its impact, risk premiums would be too low, or too many too risky transactions engaged in at too low prices. And "too" this time without quotation marks and with all the consequences of a distorted market. Corresponding misgivings always arise when highly speculative constructs, such as the Bear Stearns hedge funds, hit trouble, make the headlines and come under pressure from disenchanted investors. And invariably the debate is not just about the vehicle itself, or even just its managers, but rather about the wider circle, for example, of investment banks providing the credit, and ultimately about the stability of the system as a whole.

We take the view that there is indeed a mechanism that distorts the markets: one that enables the financial system to allow a much too high level of debt at prices that are significantly too low. This mechanism is known as the "implicit state guarantee". It exists because of the belief that it would be far too dangerous for the financial system if a big bank collapsed. The fear is of a genuine systemic collapse with utterly incalculable consequences reaching far into the real economy. "Too big to fail" is not just lip service on the part of the Fed, but a genuine doctrine, that was applied in practice in the LTCM case in 1998. Ben Bernanke, the new governor of the Fed, denied the existence of any doctrine in an interview, only to declare just such a doctrine in the very next sentence ("… to prevent the failure of a large institution in the interest of systemic stability."). As understandable as the need not to have major accidents in the financial system may be, the prior impact of the knowledge that de facto no big bank can go broke, or, put differently, that no creditor of a big bank can come to harm, is no less alarming. For money is lent to the banks at prices that reflect this state of affairs. The price of the money flowing into the banking system is systematically too low, and the banks' readiness to provide credit, correspondingly too high. The risk is carried by the general public, and this risk is higher overall than it would be if based on individual banks capable of going broke. Put another way: the system generates endogenous risk. Bernanke too sees this endogenous risk, in the same statement about the systemic risk of the collapse of a big bank ("there's a great deal to be done to minimize the moral hazard implications").

So, scrap the implicit state guarantee? Things are not that simple. For the possibility cannot be dismissed that even a bank collapse on a smaller scale could rapidly lead to a crisis whose impact would be significantly more serious than that of, for example, the Swissair grounding. And then, after all, thousands of passengers were stranded around the world, utterly shocked that precisely that embodiment of quality, Swiss precision, friendliness and efficiency was stuck on the ground. A bank collapse would result within minutes in a hopelessly tangled cat's cradle of payment and delivery orders; it would instantly become unclear who owned a commitment, and thus carried its risk, from what point in time and for what duration; this would suck the whole financial system into a dangerous maelstrom. In the place of a relatively small number of airline passengers, we would have millions of frightened bank clients.

What are the conceivable developments in this matter, and where do the risks lie? Let us again try to construct a trio of scenarios.

- Firstly, things can of course continue much as before; then, we will have to accept that there will always be a category of competitors with the special privilege of an implicit state guarantee. The incentive of being "too big to fail" would reinforce the economies of scale already apparent. From time to time the implicit state guarantee would give rise to LTCM-like crises, with serious impact on investors; from time to time the central banks would somehow muddle

through, with a "pragmatic approach" (Bernanke: "We should have a case-by-case-analysis").

- Secondly, it is conceivable that, given the moral hazard problem, and particularly in the event of an accumulation of LTCM-type incidents, the regulatory screw would be tightened on the big banks, and the "one size fits all" approach abandoned. This would mean that smaller banks, that represent no systemic risk in the event of their collapse, would be allowed greater leeway with regard to equity levels, risk management and controlling, whereas the regulator would practically become the constant companion of the bigger banks (a tendency that has already become widespread).
- Thirdly, we could also imagine new approaches to overcome the problem, based perhaps on a distinction between banks' system-relevant functions and their actual business activities. System-relevant are essentially "only" payment transactions and clearing, comparable to a highly complex traffic interchange, which cannot be allowed to be blocked if just a couple of lorries overturn. It must be possible to park broken-down lorries away from the interchange, to repair them or to scrap them, without any impact on overall safety and security. In other words, scenario three goes in the direction of the ability of the regulator to intervene if a collapse threatens, and physically take over the payment and clearing functions. We are of course a long way away from this. The regulatory agencies are full of book-keepers and auditors; units that can intervene effectively require other qualifications.

It is clear that both scenario one and scenario two would be accompanied by serious losses of efficiency. Too low risk premiums are undoubtedly among the most dangerous side-effects of a system of implicit state guarantees. Supposedly risk-free quasi-arbitrage transactions, in the form of so-called carry trades between normally highly correlated financial instruments are a particularly insidious form of such side-effects, for they suggest security where there can be none, and they attract investors who have no idea of the real risks of the deals. Intransparent hedge funds and particularly risky structured products have in recent years attracted far too much money; it is only a matter of time till there are some serious accidents.

Which would favor scenario two. But the idea that smaller banks might be spared additional regulation is really a pipe-dream. For objectively, it is not so easy to determine the boundaries of system-relevance. When the Spar- und Leihkasse Thun collapsed, was Switzerland threatened as a financial center? Hardly. But its reputation suffered severely from the images of queues of anxious clients outside the bank's doors. These images traveled around the world in the same way those of stranded Swissair passengers did ten years later. Banking is based solely and entirely on trust. Loss of trust in even an insignificant player results in serious negative reputational impact, under which whole financial centers can suffer. So the need for regulation is by no means to be taken lightly, which makes it the more likely that scenario two would be characterized by repeated waves of new regulation.

Scenario three would represent a radical u-turn with regard to previous efforts. Perhaps this reflects mankind's innate natural reluctance to think of the end of things. Bankruptcy law is nowhere fashionable, although it is actually of the greatest importance for sound economic development. According to Schumpeter, for new things to be created, what is obsolete must perish and be duly laid to rest. The disposal of mega-dinosaurs, such as the big banks have become, would require suitably equipped undertakers. Their availability and their theoretical readiness to act would probably have greater disciplinary impact that all the previous regulatory attempts by the ever longer arm of the supervisory authorities.

5. What progress really means

What we as investors tend to assume is a matter of course, and indeed often demand more or less vociferously is that our investments generate positive returns. We are perhaps not always fully aware of what this really implies. A positive return by definition represents a future performance, or the potential and opportunity to achieve such. "Performance" cannot simply be equated with the carrying out of a particular task, but must go further and involve the creation of added value. Put another way, the precondition for positive returns is progress. Only the fact that the world is, naturally with all due reservations, generally doing better all the time – that for example the income of ever more of the billions of the global population has risen significantly above the poverty level, that our life expectancy is vastly greater than that of our ancestors, that we have available an unbelievable variety of goods and service – justifies what we as investors find such a matter of course: that year after year, our stock investments grow at an agreeable average of seven percent.

But what is progress exactly? A continuum of slow development, a process of muddling through

human history, an endless tapeworm in the intestines of an indefinable being? We see it differently. Progress is a cascade of larger or smaller, more or less important shocks, mostly set off by a situation that is felt to be unsustainable, and carried through by people's unquenchable desire for improvement, and their innate ability to devise and implement such.

Were we to regard these three areas of risk – the struggle for fossil fuel, the dangerous asymmetry in the People's Republic of China's foreign trade and the financial system's appetite for risk, induced by the implicit state guarantee – as such and exclude the possibility of progress, then we would throw up our arms in despair and immediately abandon all our engagements. All three areas have the potential for catastrophe, and in combination this potential would be exponential. It is not difficult to come up with prophesies of doom.

What is more difficult is to describe progress convincingly, to forecast it, and thus to give reasons for believing in the future and expecting positive returns, despite the obvious and indeed dramatic dangers. We believe that thinking this way, in three scenarios, helps to get away the sort of black-and-white patterns of thought often seen on the stock exchange and among investors (because stocks go either up or down …).

A historical example may help to make this point. Most readers of the Commentary will probably recall the period of the Cold War, from 1945 to 1989. The West then stood in opposition to a heavily armed, apparently ideologically aggressive (the talk then was of "world revolution") and from time to time unpredictable Eastern Bloc. Analysis in the free West was essentially limited to two scenarios: the Kremlin was inhabited either by "hawks", who needed to be dealt with toughly, or by "doves", who should be handled with care, lest they be ousted by the "hawks". The history of Western politics in the Cold War can be seen in terms of the mirror-image activities of adherents of the hawk and dove approaches. If anyone then mentioned a "third way", they meant some type of "soft Communism" – a compromise between hawks and doves, or at best some combination of market economy concepts with the rigors of socialist social systems: something believed to have been identified in Yugoslavia – of all places.

Hardly anyone in the 1970s – or in the 1980s for that matter – thought that something completely different might happen, that would have nothing to do with hawks or doves in the Kremlin – that the Eastern Bloc might simply implode unspectacularly. This "something completely different" was in effect such a third scenario, which, had it been thought of in time, might well have set off political moves by the West quite different from those that occurred. And this third scenario brought progress – both the first and the second would have been disastrous, for with either of them, a vast number of people would still languish in a state of bondage, and vast areas of the world would still be unproductive. And there is something whimsical about this third scenario: among the things that set off the implosion were relatively trivial technical inventions – the fax machine and the photocopier, which proved more than a match for the police state. Apparently small causes, but enormous effect.

If we have this time, perhaps at an interim peak after four years of sustained positive development on the stock exchanges, and with excellent prospects for growth around the world, pointed towards a couple of risks – and there are others too – then this is indeed with the intention of warning against unrestrained euphoria. But it is even more important that we have also pointed to third ways – other ways. Without pressing problems there is no progress; without progress, no returns. Every peak can only ever be an interim one.

KH, 2.7.2007