The G20 Agenda

1. Facing fundamental decisions

There can be no doubt that the world is now in profound economic crisis. And if we do not get on the right track soon, the result will be crises within nations, which in turn, as history teaches us with ruthless consistency, will result in crises between nations. The phase of faulty or inadequate analysis, vaguely defined rescue packages, wishful thinking and populist strong-arm tactics will have to give way to concentration on what really matters. Not that we have any illusions about this. But we hope at least to do two things with this Investment Commentary. Firstly, to clarify our own thinking, and secondly perhaps, just possibly, to make some small contribution to the political process that will take place in London at the beginning of April.

Faulty or inadequate analysis: for far too long the crisis in the banking system was regarded as a problem of liquidity. The observation that, within a short space of time, one market segment after another dried up, misled people into seeing a symptom of the problem as its cause. Let's think back: the first tensions in the area of low-grade securitized American mortgages appeared in the first half of 2007. Then, this supposedly liquidity-related problem ate its way into more and more securitized credit derivatives and products. At that time, we used sausages and rotten meat as a metaphor to explain this phenomenon: the vast number of financial products that had emerged in recent years consisted of nothing other than sausage meat of less than impeccable quality, packaged in the skin of the various structures and products. The suspicion that these might contain genuinely rotten matter explained their rejection by purchasers.

But by the end of 2007, the banks' financing potential had also dried up. The market in so-called "commercial paper" in particular, hitherto the epitome of liquidity, became enormously stressed, almost overnight. By then at the latest, the central banks, the regulatory authorities and the market players should have realized that anxieties about rotten meat were no longer confined to individual financial products or the sub-prime problem in the USA, but had now spread to certain very big, and mostly system-relevant, banks as a whole. Throughout the entire crisis – and still today – there has been a lack of the honesty needed to call the problem by its real economic name: insolvency, failure, bankruptcy. The over-90-year-old Anna Schwartz was the only eminent economist bold enough to use these terms, and to draw the attention of the Fed's Ben Bernanke to the fact that he – an expert in the economic history of the 1930s – was fighting the wrong crisis with the wrong methods. The interview with Anna Schwartz in the *Wall Street Journal* of 20 October 2008 is well worth a close re-reading.

The ineffectiveness of the measures taken so far is striking. Since the middle of 2007, governments and central banks have poured out thousands of billions of dollars, euros and Swiss francs. The effect has been, to put it mildly, minimal. Or, to speak more plainly, catastrophic. Not only has it failed to enable the global banking sector to recover: rather, it has radically reduced businesses' ability to obtain credit from the banks. Furthermore, the countries have increased their levels of debt to an unprecedented degree, and thus decisively reduced their financial freedom of action.

It is important to understand the distinction between a liquidity shortage and insolvency. The former affects a basically sound balance sheet – sound, in that there is no concern about the intrinsic value of the assets. The problem affects "only" the financing side: too many liabilities fall due simultaneously, and cannot be met for certain reasons. In insolvency, by contrast, there is a mismatch between the asset and liability sides of the balance sheet. Debt is typically fixed, whereas assets are exposed to changes in value. The buffer is the equity. If loss of value reduces it, insolvency, overindebtedness, lies ahead. Liquidity problems are temporary; insolvency is existential. Lack of liquidity may, but need not, lead to insolvency; an insolvent balance sheet, though, does usually result in illiquidity, as no-one any longer believes in it. Insolvency inevitably results in radical restructuring, or the winding up of the business, with the remaining assets being divided among the creditors. Continuation as a going concern will be the option of choice if it makes sense in economic terms, and agreement on it can be reached during the bankruptcy proceedings. Closure of the business will be preferred if the outlook is poor and the transaction costs involved in continuing are too high. So much for the definitions.

In her interview with the Wall Street Journal, Anna Schwartz claimed that the banks affected by the crisis, and, because of their size and importance, the system as a whole, were insolvent. Or, in our less elegant terminology, the banks were not only selling, but had themselves become, sausages containing rotten meat. Whereas the many facilities made available by the central banks would have made sense in a liquidity shortage, in a situation of genuine insolvency, quite different, and much more radical measures are required. There is no alternative to either radical restructuring or the cessation of business activity. A reduction of capacity in the whole sector is unavoidable: our estimates indicate one of between 30 and 50 percent. Instead of this, so far, state support has been used to preserve the existing structures at any price. The financial crisis continues because the unattractive task of creative destruction and restructuring is still being tackled only very hesitantly, if at all.

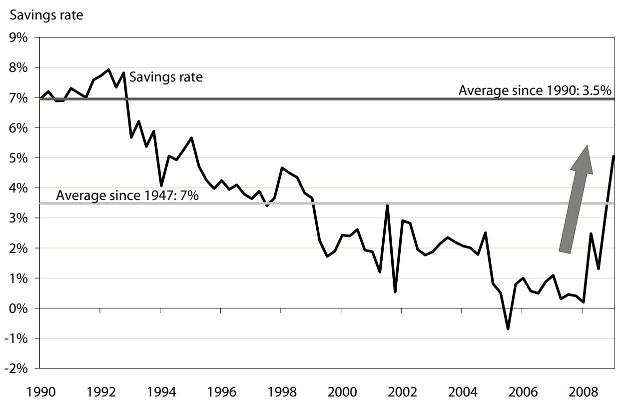
According to Anna Schwartz, the Great Depression of the 1930s was triggered by a genuine liquidity crisis among the banks. This could have been dealt with successfully by a generous injection of funds by the Fed. However, faulty analysis and a lack of understanding of monetary theory led to disaster. Bernanke knows all this backwards. Unlike the 1930s, however, the financial crisis of 2007ff. is a solvency crisis for the banks, because the financial system has, for decades, made too much credit available. The real problem is the asset side, and its intrinsic value. The difficulties in financing the liability side are not sufficient as an explanation of the situation. Put differently, the expensive approach adopted by the central banks and the authorities to the banks involved can be understood in terms of a logical problem of a lack of differentiation between necessary and sufficient conditions.

It has taken a grand old lady, who at her age has little to lose and, given her importance in her field, owes no-one any favors, to give us this highly unwelcome news. If the G20 group meets without an understanding of the questionable analytical basis underlying the crisis, it is highly likely that there will be more fiddling around with the previous remedies, and that vast sums will continue to be poured out with little effect.

2. At least three crises at once

Over the past 18 months, this problem of insolvent banks has triggered three further crisis-like developments, which characterize the current situation. The first of these is undoubtedly the shift among Americans from consumption to saving. This has been long overdue; the imbalance in the balance of trade between China and the USA, and the continuing rise in America's foreign debt have long indicated a pattern of behavior that was not sustainable: "vendor financing" by the Chinese, overconsumption on credit by the Americans. Despite all the efforts at stimulation, and presidential attempts at encouragement, Americans now seem unwilling to be dissuaded from their determination to get their finances in order on an individual basis, and thus to reduce their risk. What figures are so far available send a clear message.

American savings rate: a paradigm shift



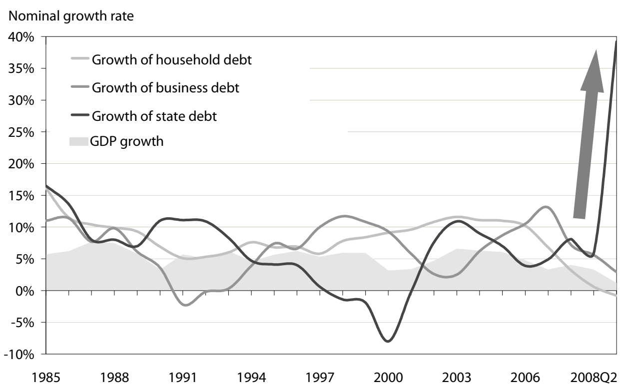
Source: FED St. Louis

The world as a whole is now adapting to the new circumstances. The Chinese suddenly find themselves confronted with sales problems and, given this uncertainty, are no longer investing in production sites. As their suppliers, the Europeans are facing disaster for their much-vaunted capital goods industry: exports to the Far East have literally collapsed. There is great uncertainty as to how long this sad state of affairs will last. If it is only short, given the mostly sound balance sheets of industrial enterprises, and applying remedial approaches such as short-time working, then companies will pull through. But if it goes on for longer, the result will be mass shut-downs. For the European business model is ultimately fairly dependent on demand from the Far East. Sadly, there is a multiplier effect between the inevitable, and lasting correction of American overconsumption and the collapse in the demand for capital goods now affecting Europe. A one-percent reduction in American consumption results in a reduction of several percent in European exports.

The second crisis-like development concerns the financing of business. We have already referred to the difficulties banks are having with one another: who wants to deal with counterparties that are probably insolvent? But with no interbank business there is also no credit for trade and industry, for all three of the banks' economic functions – risk transfer, term transfer and batch transfer – only function if banks can balance their risks and balance sheets among themselves. The recessionary development in the real economy is now further accentuating the banking sector's credit provision problem. Bad debts are rising on the asset side, and on the liability side the need for contingency reserves is growing. However attractive loan interest looks with much higher risk premiums, from a position of financial weakness the banks will be in no hurry to increase their exposure. Uncertainty about the intrinsic value of banks' balance sheets combined with uncertainty about recessionary developments in the real economy: this is a sure-fire recipe for aggravating and increasing the extensive credit problems already being experienced.

Furthermore, the "credit crunch" is hitting an economy, – already weakened by the recession described above – that had, in the wake of globalization, organized itself as if there were no longer any such things as bottlenecks, whether real ones related to the availability of materials and components, or financial ones related to the uninterrupted availability of capital and credit. However solid the equity position of many businesses appears, some of the financial requirements that will have to be met this year are worrying. According to our calculations, for example, General Electric, the multi-dimensional technology conglomerate, with a pseudo-bank attached, will have to hit the capital market for USD 193.7 billion in 2009.

A tidal wave of debt



Note: Growth figures relate to the USA

Source: FED

The third crisis-like development concerns the state. We have already mentioned the loss of financial freedom of action resulting from the stupendously generous rescue and stimulation packages. The unparalleled increase in state debt levels (see figure above) must give pause for thought in every respect. No less serious in our view is the increase in complexity that will result from very far-reaching state involvement in the concerns of the private sector. Why should we have an excessive level of complexity (which in future will have to be regulated) in the big banks and insurers, and why should it be supposed that the state, with its generally weak leadership structures, will be able to avoid the pitfalls of complexity? Politics involves, among other things, an attempt to satisfy the wishes of every conceivable sector of the electorate and every imaginable interest group. The farther the state moves away from its real task of advancing general prosperity (creating *common wealth*), the more partially or thoroughly disappointed citizens it will leave behind. Uncertainty as to what benefits may be expected some day, coupled with uncertainty as to who on earth should fund all the additional state activities: this is a poisonous combination from the perspective of a rapid recovery from recession. For uncertainty generates anxiety, hopelessness, and in the worst case, rage. Rage at promises broken because they could never have been kept. Promises of the sort that are currently very popular.

3. Chaos

The prevailing theme of the crisis in finance, business and the state is, then, uncertainty. The multidimensional crisis and the resulting interventions in the financial sector have resulted in complete chaos. The remains of almost-bankruptcies lie around all over the place: toxic investments here, SPVs and CDOs there; everywhere, on both sides of the Atlantic, big banks and big insurers continue to struggle for survival. Citigroup has just had to exchange the state's preference shares for ordinary shares, to save some 1.25 billion dollars in fixed dividends. A few days ago AIG, the giant insurance company, had to beg the US government for a further 30 billion dollars, in addition to the 140 billion already granted. And also a few days ago, Lloyds Bank was definitively nationalized, leaving British taxpayers to shoulder guarantees for "assets at risk" to the tune of 215 billion pounds. Banking today is characterized by banks that are fully nationalized, part-nationalized, or operate with explicit or implicit state guarantees, as well as those that still believe themselves to be free of such state-provided crutches. Who has what competitive advantage? And at what price? How, if at all, will the risk taken on by the state be compensated? We hear of the need to nationalize infrastructure-related providers such as stock exchanges and clearing houses – and this despite the fact that they in particular have remained utterly stable despite the crisis. By contrast, Fannie Mae and Freddie Mac, the two vast, intransparent American mortgage financers largely responsible for the crisis, not only remain untouched, but are getting a plentiful supply of fresh capital (a further USD 46 billion as of 12 March 2009).

But chaos and uncertainty have also spread to the real economy. There are now automobile manufacturers with and without state support. In parallel with the subsidization of automobile manufacturers, who find themselves in a particularly delicate economic situation, the new US government is making every effort to achieve better protection for the issue of securities. Consumers hold back because (in their own delicate economic situations), they are unwilling to risk a bad buy. Chaos also reigns among the millions of home-owners with sub-prime mortgages. Will they have to leave their property or not? Who will profit from the promised relief, and who won't? Uncertainty too among the middle class who continue to pay their dues. Political promises of remortgaging are clearly not directed at them, but they are the principal victims of the recession, who will, if they are still earning money, make up the taxpayers who are highly likely to be called upon to foot the bill. Uncertainty is now also rife in the real economy this side of the Atlantic too. Hardest hit so far has been the export-oriented capital goods industry. But the stimulation packages, particularly generous in Germany in the run-up to the autumn elections, are aimed mainly at the construction industry. Who gets what, and who doesn't? Who has to pay for it and who doesn't have to pay for it? Question after question.

Chaos and uncertainty in the state as well. Roles and responsibilities in the regulation of the financial system have become thoroughly muddled. What, after all the failures, has the Securities and Exchange Commission (SEC) in the USA still got to say for itself? What to do about the growth in the regulatory power of the Fed? A previous Governor of the Fed, Paul Volcker, warns against it, while the current Governor, Ben Bernanke, is looking for greater regulatory and supervisory authority for the Fed, and demanding a "super-regulator" from Congress. In England, what in future will the FSA regulate, and what the Bank of England? What influence should the state exercise over its newly acquired holdings? Of the bank of America, we hear that, as a result of the TARP rescue package, it has ceased applying for H-1 B visas for highly gifted immigrants, in favor of employing Americans. In Germany, directors' remuneration is now frozen more or less at general manager level. In Switzerland, efforts have been made to oblige the financial supervisory authorities to express an opinion about the UBS's bonuses. How conservatively or aggressively should the state deal with the toxic assets it has acquired? Should it wait before realizing them – perhaps for ever? Or should it accept the losses involved in a more rapid approach? If the question of the creditworthiness of states, and whole groups of states, becomes more acute, how should the resulting differences in confidence be managed? How is Italy, still, after all, a member of the eurozone, to be refinanced this year? Will the other EU member states help out? What governance system will apply to this help?

Given this accumulation of unanswered questions, it should come as no surprise that the most delicate sensors in such situations, the stock markets, are in an extremely nervous state. Volatility remains extremely high, reflecting market players' widely varying expectations concerning future developments. It may be objected that the stock markets are "irrational" – driven, indeed, by the partially deranged. But it may also be claimed that they are among the most honest indicators. For, unlike most opinion polls, prices on the stock exchange are prices actually paid, and the payment of a price has a direct impact on the wallet. Accordingly, it is generally well considered; better considered, at all events, than the superficial response to some trivial opinion poll. From this perspective, the new American president has got off to a catastrophic start, regardless of the opinion polls. In his first few months in office, the chaos has got worse; the stock market's response could hardly have been plainer.

4. G20: what now?

At the G20 summit in April, the heads of state and prime ministers of the leading industrial nations will have to decide whether they want to contribute to a further increase in chaos, or to a clarification of the situation. That may sound a bit (too) trivial, but it isn't. For the preconditions for ensuring that political and economic disorder does not simply increase are drastic, and politically fairly unattractive. They include:

- An uncompromising and analytically impeccable definition of the real economic problem; it consists not in a lack of demand, but in the illusory value of a bubble of debt.
- The clear communication of an allocation of the damage caused by the crisis; this is a matter of correcting the illusory value and allocating this correction within society.
- A farewell to the beautification of banks' and insurers' balance sheets, and a commitment to an uncompromising restructuring, including capacity reduction where required.
- A clear determination to integrate China into the full economic responsibilities of a nation, which include a currency policy oriented on the market economy.

- Indications of how states will handle the complex economic tasks and structures that they have acquired; information on reprivatization plans.
- Clear ideas on how the battered national budgets can be restored.

From a short-term perspective it is, of course, easier, and perhaps politically more attractive, to give priority to combating the symptoms of the recession, and to give undue importance to side-issues such as dealing with actual or supposed tax havens. The strategic decision facing the G20 members is whether to give preference to what is apparently necessary and attractive in the short term, or to be prepared to tackle the roots of the crisis, and put the focus on the post-recessionary order.

It is the nature of crises to generate a high level of uncertainty. In this context, economists refer to the inadequate definition of property rights. "Property rights" in economics cover not merely ownership of property or other physical objects, but rights in anything that can in any way be used, multiplied, consumed, or destroyed, in short, anything than is economically utilizable. It is one of the fundamental tasks of states to ensure the determination and implementation of property rights. Clear property rights create greater security, with accompanying reductions in information and transaction costs for business and society. With the information and transaction costs generated by the crisis – reflected in excessive volatility and enormous risk premiums, as well as in the drying up of parts of the financial market – recovery is inconceivable. This is the crux of the obfuscation strategy pursued so far, and of the many stimulation packages: the mountain of debt they generate represents a further, well maintained and still growing (!), but illusory value; knowledge that it is illusory results in anxiety about the inevitable allocation of the damage that will be caused, and uncertainty about the allocation of damage results in exorbitantly high information and transaction costs.

The approach taken so far will not work because it excludes awareness of the illusion. The most important thing now is to do away with the illusion and allocate the damage – that is, the difference between the illusion and the real existing resources – as explicitly as possible. That is the real agenda for the G20 summit.

From a theoretical perspective, it should be added that it is less important *how* property rights are determined than *that* they are defined clearly, reliably and sustainably. In his legendary essay on "The Problem of Social Cost" (1960), Ronald Coase showed that an economic optimum can be achieved regardless of the specific ordering of property rights, provided that ordering remains stable. Coase's theory should be drummed into the G20 politicians. For it will be no bad thing if the (already existing) damage caused by the crisis is now distributed across certain shoulders. What would be a bad thing would be an "ordering" of things that effectively perpetuated this continuous giving and taking away.

The idea that people are better equipped to accept the blows of fate and then rebuild on new foundations than they are to vegetate through long periods of uncertainty seems to us to be plausible, even if it is supported by historical and anthropological observation rather than any particular theory. Pain thresholds and the ability to mourn and move on are generally underestimated – despite the fact that for thousands of years, mankind has known little other than setbacks and the loss of loved ones to violence, disease, famine, fire and flood, and so on and so forth, and has had to be genetically equipped to cope with real shocks. The "phoenix from the ashes" is no mythical chimera, but corresponds to mankind's archetypical ability to always find some means of recovery.

5. Dealing with root causes

We set out below three concrete examples of what such an "allocation of property rights" would mean. The first concerns the trigger for the financial crisis: sub-prime mortgages in the USA. Encouraged – indeed, driven – by the politicians, who had championed home ownership with the "Community Reinvestment Act" (1977/1995), the banks offered loans to households that would never have been regarded as creditworthy by normal standards. The encouragement had a concrete component, in the form of the quasi-state – and now fully nationalized – guarantee agencies, Fannie Mae und Freddie Mac. In terms of property theory, this constellation represented the provision of a subsidy in the form of free guarantees to a certain section of the populace; specifically, support in the financing of particular construction projects. The cost of this subsidy is borne by an indefinite number of citizens and, because guarantees represent contingent liabilities, not only the people who will carry the cost, but also the likely cost itself, are both unknown.

Task number one, then, for the American government consists in clearing up this asymmetrical and ambiguous situation. The ambiguity lies at the heart of the illusion of wealth created in the American real estate market before the crisis. Some believed in the everlasting continuation of the boom on the back of the guarantees; others were (and are) uncertain as to what liabilities the state – that is to say, today's and tomorrow's taxpayers – has taken on.

Task number two would consist in drawing up clear rules for dealing with the disastrous fall-out, now that, despite all the guarantees, the bubble of illusion has finally burst. It is clear that millions of households are facing financial ruin, or have already given up: a collapse in the value of their house, loss of jobs, inability to pay the current mortgage interest, never mind meeting the higher rates that would now be due, or making amortization payments. It is said that the vast majority of insolvent home-owners belong to ethnic minorities. It is understandable that the Obama administration is inclined to take an accommodating approach to these home-owners, and that appropriate financial help is on its way. From a property theory perspective, it would be tempting to consider achieving a brutal form of closure to decades of misallocation. Things would at least be clear: the houses would be free of debt, and could continue to be lived in and maintained; there would be no threat of revolt. The situation would also be clarified for the creditors: "zero" does away with any doubts about possible remaining value.

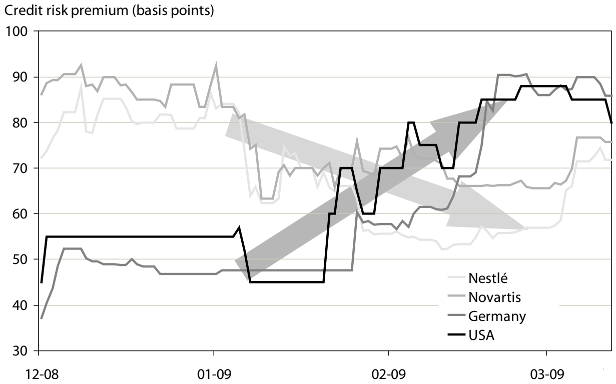
The problem with such a brutal approach, but also with the obfuscatory approach adopted by Obama, with (again) the favoring of particular sections of the populace, lies in the incentive to default it creates for all those who, although under economic pressure, still pay their interest and amortization costs. The righteous are "punished". In our view, the gradual erosion of the solvency of mortgage holders, and so of the American real estate market, is related to this policy of favoritism. Obama has so far left it open who – the creditor banks or the state – will carry the cost of doing away with sub-prime debt. Small wonder, then, that 18 months after the outbreak of the crisis, there is still no market price for American real estate debt.

There is, of course, a superior political approach in this area too. A strict insistence on the validity of signed contracts; the enforcement of rights under current (bankruptcy) law; direct payments to the genuinely distressed to resolve the social problems, with a ceiling, naturally. This could be financed from the funds no longer required to encourage ownership. In this way, property rights on both sides, debtors and creditors, would be far more clearly defined, in that the element of uncertainty due to possible, but still uncertain support by the state would be dispelled, and no further debtors would be exposed to incentives to default. The market could certainly live with this clearer situation, even if at a low level.

6. Support or not?

Second example. In the wake of the financial crisis, significant differences have developed in the assessment of the quality of state debt in Europe. The situation has deteriorated since the beginning of 2009, and states as debtors are now obviously generally regarded significantly more skeptically. The figure below shows the premiums for credit (Credit Default Swaps) for the USA and Germany, two very prominent countries – both for their budgets and their debt – compared to those for two globally based Swiss private companies. The mere fact that the default risk of countries is under discussion, and that premiums exist (and are paid) to insure against it, should give politicians serious pause for thought.

State debt worse that private-sector debt?



Source: Bloomberg

What might appear regrettable for heavyweights like Germany and the USA must be regarded as a catastrophic development for states with weaker budgets, such as Greece, Italy or Austria. For one thing, for these countries financing will now become a real cost issue, and for another, it is unclear whether the sheer size of the amounts to be financed in the near future will not result in disaster, because the capital market simply lacks the necessary capacity. Italy, for example, will still need to "find" some 200 billion euros on the market this year.

From an economic perspective there is also a problem, explicable in terms of property theory. The status of countries such as Italy, Greece and the like as debtors within the eurozone has never really been clarified. There is no explicit obligation on the euro-countries to provide support in the event of the insolvency of a member country. A coherent currency is, however, hardly conceivable without effective (implicit) support, at least for economically or politically important member countries. But the way risk premiums look at present, the market doesn't believe this: if the obligation to provide support were really watertight, and the euro's coherence as a currency thus assured, such differences should not occur, and certainly not for such a long period. In other words, the situation is utterly unclear – a poisonous environment for any recovery of the readiness to invest.

What are lacking are general rules that will give the market sufficient certainty for the specific individual instances that lie ahead. The euro as a construct was designed for fair weather; but a currency and its coherence only really becomes interesting in a crisis. Furthermore, in the meantime, a second, more unpleasant front has opened up for Europe: Eastern Europe. There is hardly a major Austrian, German or Italian bank that has not been deeply involved in financing the Eastern European upswing. How much of the growth there has been real, and how much will now be revealed to be just as illusory as the pseudo-wealth in the American real estate sector, is currently being determined by market forces.

The political and economic dilemma is obvious: however conservatively it is formulated, a European obligation to support the eastern neighbors puts still further pressure on the EU's financial credibility, but failure to do so would represent a setback in the EU's efforts to become a regional state open to the east. But until this issue is clarified, Europe and the euro will find it hard to hold their ground in the global economic crisis.

7. Criminalization or not?

Third example: from a property theory perspective, Swiss banking secrecy as it has so far been understood offered foreign clients two things. Firstly, the (legally complex, but unequivocal) certainty of protection against unauthorized access by authorities and other interested parties (family, acquaintances, criminal organizations, etc.) to information about the existence and extent of assets managed in Switzerland. Hitherto, this certainty has also covered the legal difference between the prevailing domestic legislation, when tax evasion can be prosecuted as a criminal offence, and Swiss law, under which tax evasion can only be prosecuted as a fiscal offence. Put less legalistically, foreign clients have so far enjoyed the benefit offered by Switzerland of non-criminalization for simple tax evasion. In terms of property theory, this is a "property right" that had previously been assured; should one wish (or be obliged) to modify it, this amounts to expropriation in the sensitive area of personal integrity. That is one aspect. The second, more economic component consists in the extensive possibilities for managing assets placed in Switzerland unencumbered by fiscal burdens. It is true that European clients have recently experienced some constraints in this area, with the agreement on interest taxation, but the disparity with their domestic tax rates undoubtedly still remains. This too, in terms of property theory, is a type of assured "property right", and any modification a form of expropriation, although in a less sensitive, purely economic area.

Rightly or wrongly, the crisis has now brought chaos and uncertainty here too. Without wishing to again expand on the whole complex issue of banking secrecy, from a property theory perspective it is clear that a weakening of the first of these previously assured "property rights" would lead to unacceptable results, in that Switzerland would be obliged, so to speak, to betray its clients to the judiciary in their home countries. Anything that goes towards such a betrayal does serious damage to Switzerland's reputation, whereas the second, economic and fiscal, aspect of banking secrecy is significantly less critical. Whatever may happen in this area in the coming weeks, in this side-show of the economic crisis it will be essential that any agreement creates certainty, even if that certainty consists in the knowledge that foreigners will in future have to pay taxes in Switzerland equivalent to those in their own countries. If this is the price of certainty that they will not be delivered up to the gallows of their own fiscal judiciary – then it will probably be worth their while.

8. Postscript on real value

The conclusion from these considerations must be the insight that the crisis is ruthlessly and uncompromisingly dismantling one mountain of illusory wealth after another. These include the illusory real estate prices in America, and in particular the anticipation of their continuing rise. Also, the now meaningless valuations of financial products and bank balance sheets. And, of course, the overoptimistic expectations for the upswing in Eastern Europe. And the absurd idea that an imbalance of trade between two continents could be maintained indefinitely. And the illusion that Americans could consume on credit for ever. And the idea – which has now also become illusory – that Switzerland could indefinitely avoid the demand by a community of states for access to the fiscally sensitive component of cross-border asset management. In crises the cards are dealt anew, and this process is extremely painful. Some try to duck it; others do exactly the wrong thing; others react aggressively, or roll over at the first demand.

Tremendous redistribution processes are in progress. Whatever course they take, there is one thing we need to keep in mind: when an illusion of wealth is destroyed, this is not the same as the destruction of real resources. Raw materials, buildings, machinery, reserves, roads, power lines, communication systems, the environment, including tourist attractions, education levels – indeed, human resources as a whole – knowledge of processes, democracy and the rule of law all remain basically untouched. In Investment Commentary 261, at the beginning of the year, we announced that we were developing an investment strategy that clearly took account of this insight, keeping to a minimum the share of nominal value that must still be accounted for in terms of illusory wealth (hello, state debt!). Our work has achieved concrete results, which are presented in the Financial Markets Overview attached to this Investment Commentary.

With whatever concern we may look to the future, and with whatever lack of illusion we may look forward to the actual agenda for the G20 summit (not the one we would wish for), and all the other conferences that surely lie ahead, we are no less confident that ultimately, victory will go to that which productive forces are in a position to unleash.

KH, 16.03.2009