States under stress

1. Thoughts on game theory

Some two months ago, staff at our bank in St. Gallen had the opportunity of an extensive discussion with the Nobel Prize winner and mathematician Robert Aumann. Aumann fled Nazi Germany in the 1930s and, after studying in the USA, has worked at the Hebrew University in Jerusalem since 1956, researching into game theory. Our discussions with him focused on the application of game-theory concepts to the structures and processes in the financial system. And they provided ample confirmation of the theory that the given incentive situation, created by implicit and ultimately explicit state guarantees for the big banks, combined with modern, commission-driven distribution practices and compensation systems oriented to the short term, was bound to result in a high level of debt. Aumann demonstrated parallels between the “rules of the game” and insurance fraud. The most recent statements from the central banks (for example, from Philipp Hildebrand, chairman designate of the Swiss National Bank, in Peking on 12 June 2009) indicate that the organizations that will play a decisive role in the future structure of the financial system are beginning to think along similar lines.

More important for what follows here, however, was Professor Aumann’s distinction, based on concrete examples, between “cooperative” and “uncooperative” rules of the game. The background to this topic was our concern about the future of Swiss banking secrecy, and thus Switzerland as a financial centre, or rather the patently evident aggression towards so-called “tax havens” shown by foreign governments in the run-up to the G20 summit in London in early April. The insights from the workshop left nothing to be desired in terms of clarity. The difference between cooperative and uncooperative games is that agreements are legally enforceable in the former, but not in the latter. In cooperative games, players benefit from the “rule of law”, whereas in uncooperative games the “law of the jungle” applies. For a strategy to be successful, it is essential to know which set of rules applies to the game in question. Success in an uncooperative game depends on a demonstration of the will to win. The precondition for this will to win being taken seriously is possession of the potential to prevail, if need be. When backed up by serious preparations, this will is usually sufficient to avoid a “need be” situation.

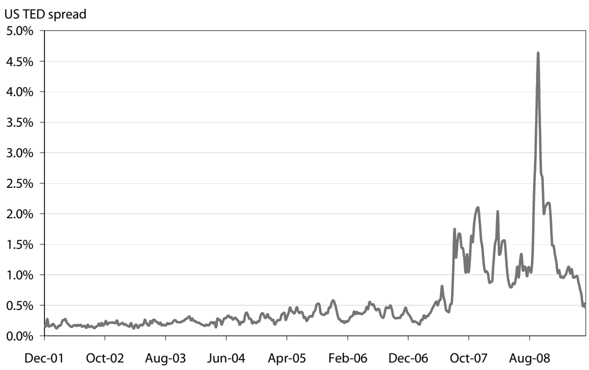
Game theory has the advantage that such insights can be applied universally, regardless of the stakes being played for. Aumann used Neville Chamberlain’s trip to Munich in 1938 to illustrate “Si vis pacem, para bellum” (If you wish for peace, prepare for war). He strongly believes that history would have taken a far more positive course if we had been spared “peace in our time”. This gave rise to two thoughts. Firstly, it was a reminder of the real reason why Swiss banking secrecy was introduced in the 1930s; the efforts to protect funds from Nazi Germany played a significant part. Secondly, it raised the question of whether the kowtow by the so-called tax havens, orchestrated by the OECD before the G20 summit, may not also have been in some way a “trip to Munich”. This would imply that, in the wake of the financial crisis, we are no longer in cooperative mode with regard to international taxation issues – and probably other matters as well – but rather in uncooperative mode. In this Investment Commentary, we shall pursue this question, and look at the potential consequences.

2. Over or not; that is the question

According to Aumann, we need to know what sort of game we are playing. We may not have been (and perhaps are still not) aware that extreme events like the financial crisis always end, one way or another, in an uncooperative game. Normally, in the financial system, and indeed in the economy as a whole, it can be assumed that agreements negotiated in a cooperative game are legally enforceable and will be fulfilled as a matter of course. This ceased to be the case at the latest with the arbitrarily effected bankruptcy of Lehman Brothers, and the freezing of interbank business that we subsequently had to endure for more than six months was a typical example of such a “game” played under different, and entirely unfamiliar rules: i.e. without any assurance that agreements will be honoured, as the counterparty is no longer in a position to do so, or no longer even exists. As far as interbank business is concerned, we have in the meanwhile returned to cooperative mode. The reason for this is that governments all over the world have made it quite clear that they were prepared to bail out any bank, and for that matter, all sorts of other debtors, at almost any price. So, we can again rely on our own agreements being honoured, until further notice.

So far, so good. And this "good" can be seen in the TED spread – the difference between LIBOR, the average interbank interest rate, and the "risk-free" interest rate for short-term Treasury bonds. After a phase of wild fluctuation, with peak rates that would previously never have been thought possible, we have now returned to normal ranges – albeit with the additional knowledge that such fluctuations are possible. This knowledge will have its impact on the players in the financial system for some time to come.

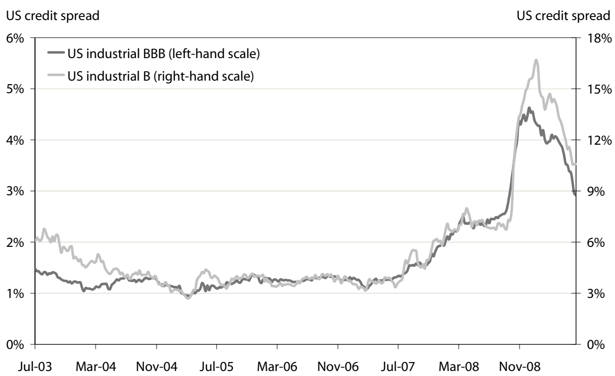
Normality – with reservations



Source: Bloomberg; analysis

In fact: so far, not really so good, for two reasons. Firstly, other more important interest rates, such as that for loans to industrial companies, have not yet returned to normal, as the figure below clearly shows. It depicts these risk premiums against "risk-free" loans.

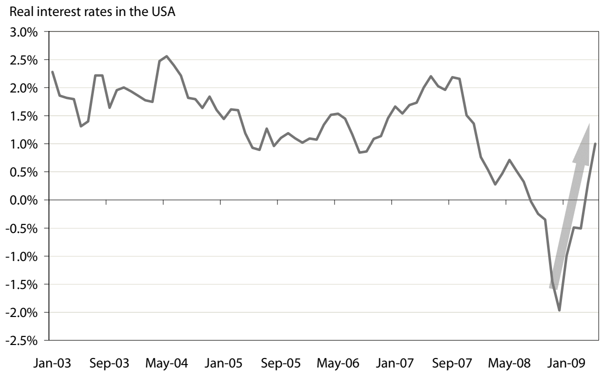
Recessionary levels



Source: Bloomberg; analysis

Secondly, there is something far more fundamental that we very much dislike the look of: the rise in long-term interest rates for "risk-free" Treasury bonds. There are three possible reasons for such a rise: one that is pleasing and two that are a great deal less pleasing. Higher long-term interest rates might indicate a general assumption that the recession will soon be over, which would mean, among other things, that investment would pick up again. And because investment is by definition medium or long-term, the demand for medium or long-term financing must rise; rising interest rates would represent a reasonable discounting of this increased demand. However, practically all the available data from the real economy argue against this view. At best, the only improvements to be detected are stabilization at a new, low-level base, or a deceleration in the rate of descent.

What is the significance of the recent rise in interest rates?



Source: Bloomberg; analysis

Note: The real interest rate shown corresponds to the difference between the 10-year nominal return on Treasury bonds and the 12-month rolling average rate of inflation.

The rise in interest rates might mean that there is a general assumption of higher interest rates in the future. Such an assumption is by no means unreasonable, in view of the enormous amount of liquidity that the central banks have pumped into the system over the past 18 months. It is, however, countered by the overcapacity that is now evident in almost all sectors of the economy, whose reduction has been seriously delayed by all the state stabilization programmes. It is difficult to imagine the rapid occurrence of a scarcity of resources. What remains is a general unease with regard to the ability, or the will, of the central banks to really go over to "quantitative tightening". Many politically motivated incentives tend in the opposite direction.

The third reason for the rise in interest rates might lie in a phenomenon that we are not yet aware of. This may sound somewhat trivial, but it isn't really. The unknown can also be dangerous. And because the probability of something unknown, and possibly dangerous, occurring rises with the duration of an investment, longer-term investments have higher risk premiums. Put the other way round: an otherwise inexplicable premium on long-term interest rates is an indication of unspecified risk. We are therefore well advised to consider where this risk might lie…

Let's cut to the chase: we believe that it lies in the danger that the state, that risk-free debtor on whose shoulders much of the burden of the banking system now rests, may itself become a threat to the system in the medium term – or, to put it another way, may become uncooperative. For the banks, the stress is to some extent past, at least for the moment. In fact, this stress has changed sides. We shall consider below what the nature of this stress is, what impact it may have on the economy, and lastly, what this may mean for investors.

3. More and worse than we thought

First, though, a further theoretical perspective on crises, or "extreme events". In 2005, the mathematician Benoit Mandelbrot, whose theories we shall also refer to in this Investment Commentary, demonstrated that situations that inevitably end in uncooperative games occur more frequently than is generally thought. In his book, *Fractals and Scaling in Finance: Discontinuity, Scaling and Risk*, he demonstrates the existence of the phenomenon of "leptokurtosis", or "fat tails". Events on the financial markets do not have a normal Gaussian distribution; rather, there are proportionally too many extreme events, in both the negative and the positive sense. He further stipulates the presence of "regimes"; that is, continuous periods, either with high volatility or with little fluctuation in prices. This is contrary to the principle of chance, on which most risk models are based. Lastly, he points to the phenomenon of serial correlation; that is, the development of market trends that also run counter to pure chance.

The inadequate attention that has been paid to Mandelbrot's work seems particularly exasperating today. It is somehow reminiscent of the dismissal in England of warnings about Hitler's re-arming of Germany in the 1930s. The professional Cassandras are, of course, always with us, but Mandelbrot is not merely some simple financial guru speculating that he might one day be proved right with a specific forecast. He is, in fact, a respected scientist. He is also a highly inventive researcher and a pioneer of chaos theory (which has very little to do with "chaos" in the proper sense). Lastly, his publications are not associated with any obvious interests, such as links to fund managers or other comparable financial services.

Had we listened to Churchill in 1934, or Mandelbrot in 2005, we would have been able to re-arm in good time. What means are there to counter (excessively frequent) outbreaks of volatility or serial correlations? Or, to put the question somewhat more simply, how can serious risk be prevented in financial transactions? Very easily: less debt, or conversely, more equity, combined with a provision of liquidity that will continue to function if the game becomes uncooperative. Unavoidable dependence on others in the face of serious risk can prove fatal. A sufficient degree of autonomous freedom of action is the appropriate response to the challenge that Aumann's uncooperative games do exist, and to Mandelbrot's insight that they occur more frequently than we think. And to the fact, borne out by our experiences in the financial crisis, that the shift from one set of rules of the game to the other is almost impossible to forecast, and occurs very abruptly.

That the banks need to do some re-thinking, or, more generally, that the whole financial sector needs to revise its structures, is generally acknowledged by now. The demand for more equity, more "provisions", is no longer treated as an example of lateral thinking, but has increasingly evolved into the generally accepted view of things. Nor is it now just an outsider's view that over-large and over-complex banking entities with out-of-control incentive structures should be broken up, to reduce the risk of serial correlation. The technical term in shipbuilding is "bulkheads"; the word for the process is "containment", and the intention is always the same: either to prevent disaster occurring, or, if, as Mandelbrot has shown, that is hardly possible, to at least minimize the damage. The loss of a destroyer is less serious than the loss of an aircraft carrier.

But now we need to think further. As already mentioned, we suspect – indeed, observe – that the stress has shifted from the financial system to the political system. We need to go into this in greater depth.

4. Debt: stress or not?

A visible external sign of significant change within the political system is undoubtedly the increase in the state debt of key Western nations over the last 18 months. It is not so much the naked percentages that give pause for thought, nor the unimaginably large sums involved, represented by enormous numbers of noughts. Far more significant in our view is the way this increase in state debt has been accepted as a matter of course. The crisis really seems to have justified everything and anything, and to have opened all the floodgates.

Nor has this happened only within the political system. There is no sector of the economy that does not by now claim to be "system-relevant". Long before the crisis, we had become accustomed to the airlines, and the apparently unquestioned higher-order importance of their operations. Now, in the wake of the billions shovelled into the banking system, they have been joined by the carmakers and the chain stores. They all want to be big and important – aircraft carriers, not destroyers. And only with difficulty can the few remaining voices of reason in the political system prevent the most extreme excesses of state support. Under euphemistic titles such as "bridging support" and the like, its seductive venom is spreading into circles that in other circumstances would be far from well-disposed towards subsidies.

It is worth taking a look at the figures, to get some idea of the dynamics of what is going on. If we wished to make things yet more dramatic, we could also point out that this explicit, known quantity of debt represents at most one-half of the reality. Demographic developments and questionable social security systems mean that within almost all the Western nations lurks a level of implicit debt that can only be guessed at, but which certainly amounts to multiples of GDP. Some years ago the Bundesbank estimated Germany's implicit debt at two and a half times GDP. Although not directly visible, this debt is already making itself felt in the excessive premiums paid by the employed; the economic and purchasing power of the Western nations undoubtedly suffers from the structural problems of their social security systems.

The table below shows the medium-term financial outlook for the budgets of significant countries over the coming years, not including implicit debt. The figures, prepared by economiesuisse, the Swiss national council for the economy, are based on IMF projections for the rise in debt levels and on their own estimates for economic growth. Interest is based on an average rate of the last 20 years.

A crushing burden of debt

	Debt as % of GDP		Interest as % of income	
	2008	2014	2008	2014
UK	51.9%	87.8%	6.5%	13.8%
Germany	67.2%	91.0%	6.1%	11.8%
USA	70.5%	106.7%	8.3%	18.8%
Italy	105.8%	129.4%	11.6%	19.0%
Japan	196.3%	234.2%	7.5%	20.0%

Source: economiesuisse

However much such figures are suited to creating stress, we must nevertheless observe that there are currently no signs of it. Many are doing their best to carry on as if things were normal – by no means an unfamiliar phenomenon, when we recall the run-up to the sub-prime collapse. One thing is clear: the official and officious mainstream continues to believe in the persistence of the convenient and the comfortable. Only a few are capable of thinking differently. For doing so automatically labels one the odd one out: at best a visionary, possibly a lateral thinker, more likely a crank with a taste for the absurd. Every shift from a cooperative to an uncooperative mode of play – for that is what we are talking about when we consider "states under stress" – must a priori be regarded as absurd, because uncooperative games are inherently more expensive than cooperative ones. Conceptually, then, any such shift would have to be rejected as unreasonable, and thus absurd. The problem is that human history contains more such absurd shifts than we might expect. The accumulation stipulated by Mandelbrot is probably not restricted to prices on the stock market. Strategic thinking must incorporate the absurd; otherwise it will overlook what is really important.

The aim here is not to portray the consequences of potential insolvency on the part of countries such as Italy, Greece or other financially challenged members of the eurozone as a "strategic problem". In reality, such an insolvency, if properly handled, would undoubtedly be dramatic, but would not mean ruin. The appropriate bodies in the EU and the European Central Bank would have had enough time to work out what "properly handled" meant. They are perfectly well aware that it would be wrong to infringe the Maastricht Treaty with a rescue operation. For, firstly, it explicitly excludes bail-outs, and secondly, the still reasonably intact EU countries would be dragged into the mess, and the problem thus multiplied. It would be no less wrong to attempt to solve the weaker member-countries' financing problems in advance with a eurobond, as this would represent a gigantic subsidy for the financially weak member-countries from the financially strong ones (unremarkably, this idea came from Signor Tremonti, the finance minister of Italy …). Equally wrong would be the monetization of the problem by the ECB. The only way, should the event occur, would be an insolvency process, conducted in as orderly a fashion as possible, for one or more, admittedly very large, debtors. That this can be done has been shown, with all due reservations, by Argentina in 2005 and Iceland in 2008.

The continuing high risk premiums for the bonds of financially weak EU member countries indicate that the market reckons with the possibility of an insolvency, and is, so to speak, making provisions with a premium, but also that it expects any such insolvency to be an orderly process. For otherwise, the difference in the risk premiums to the rate for Germany, for instance, would make no sense. And from this perspective the existence of these risk premiums is not alarming; rather their elimination would be a serious warning signal. Then it would be time to sell German federal bonds!

5. A shift to aggressive mode

If at all, "stress" is to be found elsewhere. It probably results from the pincer movement produced by the continuing reduction in financial room for manoeuvre and the rapid growth in the complexity of the tasks to be performed by the state. The latter phenomenon is often overlooked, but may well be more significant than the financial element. In the wake of the financial crisis, and particularly of the economic crisis, many states and their agencies have become involved – or rather, entangled – in economic activities in a wide variety of ways.

There's nothing really new about this. The state's influence on the infrastructure, on supply, on traffic, has always been of decisive importance, often reinforced by the collective ownership of such enterprises. According to a study by Avenir Suisse, the Swiss cantons manage a total of some 1,000 participations, with a book value amounting to CHF 8.3 billion. But the proximity of infrastructure provision to the general public interest means that far fewer conflicts arise than when it is a matter of managing credit institutes and car makers. The optimization of benefits practised in the private sector is not possible with management by decree from on high. The private sector functions by seeking a balance through price. Decrees from on high mean orders, the granting of concessions, rationing and prohibitions. Because of the exponential increase in complexity involved in a growing mountain of orders, concessions, rationing and prohibitions, an expansive approach to economic activity by the state is bound to fail.

In the wake of the crisis, significant parts of the Western economic and financial system now find themselves in the dead-end of the planned economy. The latent awareness of this problem, together with the reduction in financial room for manoeuvre we have described, together comprise the "pincer movement" referred to above. There seems to us little likelihood that the Western industrial nations will be able to get themselves out of this situation without major accidents. For this would require serious savings programmes, reforms to the social security systems and reprivatizations – none of them topics that currently offer the potential for political glory.

In our view, it is a good deal more likely that aggression will be the mode of choice, or, to use the terminology of this Investment Commentary, that the political system will shift from cooperative mode to uncooperative mode, in its dealings with at least part of society. This will be the fairly natural reaction to the foreboding of failure. Examples? First: President Sarkozy. Fair enough, it is often impossible to be sure whether we are dealing with a comic turn à la Louis de Funès or with a serious head of state. The setting for the presidential reception at the palace of Versailles in mid-June tipped over into the ridiculous in grand fashion. But over and above that, and to be taken a good deal more seriously, this monstrous exercise was a clear indication that President Sarkozy is in the process of shifting into uncooperative mode. How so? First, the French parliament, after all one of the three organs of state according to Montesquieu, if not indeed, as the legislative body, the most important one, was ordered *by decree* to attend the president's speech. Just think about it: the legislative must obey the executive's orders! Second: the location – the palace of the Sun King, Louis XIV: it is hardly possible to imagine a greater expression of contempt for democracy. Third: the approach – no discussion allowed. So why choose a *parliament* as an audience?

Another example: the G20 summit in London, referred to above. No objection, of course, to a meeting of the highest representatives of large states. But the way in which the revision of double-taxation treaties, impeccably correct under international law and provided with termination clauses, was blackmailed out of friendly countries is exactly what is meant by a game under uncooperative rules. The exploitation of the OECD, an organization intended to achieve better cooperation (!) between developed, democratic countries, to create "soft law" – by using the threat of grey and black lists to simply impose new law – indicates an increasingly technocratic understanding of law well outside any democratic legitimation. The democratic vacuum at the heart of the European Union is thus being upgraded to a global vacuum. Democracy and the maintenance of the rule of law are the only possibility for preventing the political system from slipping into uncooperative mode – but it is precisely democratic principles and the rule of law that we see being increasingly undermined by nomenklatura-like structures.

Third: the initiative with which President Obama is trying to bring the taxes on American businesses back to the USA. International tax optimization is a significant component of the operations of any internationally active company. It is understandable that the Americans are trying to get a grip upon straightforward island-based letter-box companies. According to a study by the US Accountability Office, of the total of 1,240 foreign branches operated by Citigroup, 427 are located in so-called tax havens. However, the Obama administration's initiative goes well beyond this, and will inevitably collide with the interests of other countries. The uncooperative mode is pre-programmed; the conflict will affect both US and foreign companies, and put a strain on relationships across both the Atlantic and the Pacific.

The same can be said of the announcement by the Americans of their intention to unilaterally and prematurely annul or modify the agreement concerning "qualified intermediaries". What is the issue here? Qualified intermediaries, or QIs, are non-American securities traders permitted a special status by the American tax authorities that enables them to refund the American withholding taxes to people not liable to US tax (Europeans, for instance) with relatively few formalities. The idea is to facilitate access to the American capital market for non-Americans. Or at least, that was the original idea. Under the impact of the financial squeeze that the US budget is heading for, the Americans are now trying to reinterpret the QI agreement to give the American tax authorities access to any non-US securities held by American taxpayers. At the same time, the definition of an American taxpayer is being expanded far into the indefinable, by rendering liable for tax anyone for whom there is "any indication" that they have spent more time in the USA than "normal holidays currently or in the past or future". It could hardly be less specific; the infringement of the country-of-domicile principle is blatantly obvious, and collisions with other jurisdictions pre-programmed. And who, incidentally, should monitor compliance by the qualified intermediaries with these principles? An American auditor, acting extra-territorially, of course.

Let us be clear about what is going on here. The American Treasury has shifted to uncooperative mode in its dealings with other countries, with companies, and with American and non-American individuals. For the first time since the Wall fell in 1989, the gain in relative power from being the only remaining – and militarily extremely active – superpower is being exploited for economic and fiscal purposes. The irony of this observation lies in the fact that it is only through the financial crisis, at the centre of which, right from the start, we find precisely this superpower, that has made this aggressive approach possible.

From which we can draw a general conclusion. A political system that finds itself in financial distress, disqualified by its own blunders and entangled in ever-greater complexity, does not react with a return to the possible, the reasonable, the appropriate. Rather, it is inclined towards aggressive action. And incidentally, that the aggression is turned on its own citizens is nothing new for America. In 1933 Franklin D. Roosevelt, today celebrated as the inventor of the New Deal, and the model for President Obama, decreed this: "All safe deposit boxes in banks or financial institutions have been sealed and may only be opened in the presence of an agent of the IRS".

6. The aim is control

However threatening it may sound, this may all seem fairly anecdotal. So let us try to take a couple of steps back from daily business, and apply a bit more theory, in order to recognize the really significant strategic pattern. The theory is borrowed, for once, from classic political economy.

This states that benefit optimization in the political system consists in the expansion of discretionary room for manoeuvre. By contrast with the economy – which is fundamentally concerned with money, because money is the lowest common, and exchangeable, denominator for the variety of individual benefits – players in the political system strive for control. Applied to states under stress, this would mean that the current phase of stress is not really one at all. On the contrary, it is more like a gift from heaven, for when other than in a phase of stress would it be possible to trample democracy under foot, break international law, make "soft law" unrestrainedly, and expand taxation claims around the world? From this perspective, the plight of the banks, and the rescue of the financial system by the state represents a unique opportunity for the political system to reinforce its influence, regain lost ground and seize new ground.

Since the start of the financial crisis, capitalism – that is, the organized, liberal system for the free allocation of funds within the economy – has been under pressure to justify itself. It is claimed that the free market has failed. When we look at the Obama administration's ideas about reforming the financial system, it is patently obvious what they are aiming at: a system in which the state will in future be able to grant concessions for the raising of capital. The idea of placing every hedge fund, asset manager and broker under the rigorous supervision of a newly created authority implies that everything outside this controlled area will be illegal. This control, supposedly to increase the stability of the system, goes hand in hand with a tendency towards criminalization. That the boundary between "approved" and "criminal" should be kept as unclear as possible reflects the logic of the political economy model outlined above, by further accentuating the power of the political system.

But the ultimate aim goes further. Ultimately, it must be a thorn in the side of the political system that such a thing as the free allocation of capital exists at all. For the free flow of funds is a contradiction in terms of decrees from on high, and the need of those who can issue such decrees to control the allocation of funds. When President Sarkozy speaks of "good deficits" for "sensible" investments, we know exactly where such "allocations" decreed from on high will go. They will be directed to the pet projects of the ruling political caste. French politicians have an insatiable lust for the *beau geste* of prestige objects, pretty much at any price. But the French practice is equally well matched by the billions the Obama administration has thrown at the car makers.

Capital allocation by permission of state authority would ultimately mean that the link between investor and investment would be made under state supervision, and with state approval. We believe that the efforts to achieve "the automatic exchange of information", as preached by the EU and the OECD, the criminalization of (de facto fairly insignificant) insider trading, the utterly exaggerated presumptions about "the financing of terrorism", and much more besides, all serve as a pretext for the achievement of the real goal – the abolition of the free market for capital.

Do we suppose that this is all the work of evil men? Of a secret society? By no means. All we have done is to apply the political economy model to the issue of the structure of the free market for capital: no more and no less. It is a matter of the inherent forces at work, that (sometimes) seek the good, and often enough create evil.

7. Banking secrecy – an afterword

The political system is striving for capital protectionism; that is, the return of control over funds and the transactions associated with their management to within the area of influence which the system can claim as its own. The Americans are simultaneously trying to expand this area of influence very significantly. We have already mentioned the US tax authorities' intentions with regard to the QI agreement; behind this, though, lurks the yet more expansively conceived inheritance tax. For all those concerned about maintaining their assets across the generations, there are storms ahead.

It is obvious enough that capital protectionism, as described above, is diametrically opposed to cross-border asset management, as conducted in the international financial centres, and in which Switzerland plays a key role. It is a fundamental characteristic of cross-border asset management that both capital and transactions are located outside the control of the countries of domicile. It is on account of this characteristic that the funds, surely of over USD 10 billion, in financial centres like Switzerland, Hong Kong, Singapore, Dubai, London and other locations, belong among the most globalized floats with the greatest efficiency of allocation. Some economists go as far as to say that assets managed internationally have both a global smoothing function in crises, and a potential for upturns.

However unimpeachable – indeed, highly desirable from the perspective of the global economy – cross-border asset management may seem, it has an Achilles' heel. This is the fact that assets managed internationally are often partially or wholly out of reach of the exchequer of the country of domicile. In the wake of the financial crisis and the rescue of the financial system by the political system, significant and enduring damage has been done to the always precarious balance between fiscal interests and the concrete advantages that the global economy derives from the existence of financial centres with cross-border asset management. This is the result of the cartelization of fiscal interests at the G20 summit in London, the blackmailing of financial centres with "black lists", and the threat of the criminalization of individual investors and whole companies, made manifest by current legal proceedings.

It would be burying one's head in the sand to deny that the political system is much more powerful, and the financial centres, because of their lack of concerted effort, but also their relatively puny physical scale, have been driven into a corner. The only question that remains is whether an orderly withdrawal is still possible, or only headlong flight. An orderly withdrawal follows strategic objectives; flight is panic-stricken and frequently fatal.

In recent weeks, representatives of the Swiss financial centre have tried to define strategic objectives for such an orderly withdrawal. The notion of separating the fiscal component from the fundamental component of banking secrecy, by means of definitive compensation through a withholding tax equivalent to the rate in the country of domicile, exactly represents a line of defence with key defining points. Something would be lost, namely foreigners' protection from taxation in their county of domicile, but it would assure the non-criminalization of funds held abroad and completely maintain investors' anonymity. And, if negotiations were conducted on a fairly reasonable basis, also complete freedom to provide services in the countries of domicile.

"Withdrawal" and "line of defence" admittedly have something rather humbling about them. They do, however, belong among the range of options in an uncooperative game. For the line of defence, if skilfully chosen, and defined with intelligent key points (Where can we be flexible? What is on no account acceptable? What do we want in return?), enables precisely what Professor Aumann recommends for those caught up in an uncooperative game – a clear and unmistakable display of the will to prevail. The line of defence makes it possible to recover the ability to win, and it also ensures that the really decisive strategic objectives – in our case undoubtedly the maintenance of a free market for capital, uncontrolled by any state authority – can be achieved.

Churchill was obliged to withdraw from the European continent in 1940. His line of defence was the English Channel. The idea of freedom reconquered Europe five years later. In just the same way, in three to five years at most, the threat of the control of capital allocation by the political system will be over. For the world, and particularly the developing countries, is going to grow. Capital, that flows more freely even than water, will soon find its way again, a way past all the American and European apparatchiks. The evening crowns the day.

KH, 29.06.2009