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In this issue:

UK casts light on ECB policies and considers its future association

by Gordon Kerr and John Butler, with Enrico Colombatto

CENTRAL BANKS

As the US vs European recovery story swings our way, what lessons can Europe learn from the strong swing to the centre right in Britain's elections? Is there a possibility of Brexit?

Despite accepting that events in Greece may soon result in a shock to the European economy, mainstream media have continued the line that the worst of the crisis is over and that the US has led the way. In recent years, because of the broadly similar monetary policies of the Federal Reserve Board and the ECB, the media have accepted the US recovery story and merely lobbied for policy changes at ECB level that might enable European economic data to more closely track the US. The loudest calls at the end of 2014 were for the ECB to implement QE on a grand scale.

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Criminal convictions in banking. Is deregulation really to blame?

by Gordon Kerr and John Butler, with Enrico Colombatto

FINANCIAL MARKETS

Banks have been hit with more fines, but more importantly, also with Criminal Convictions. Is this banking out of control because it has been deregulated? Is it fair to call the regulatory changes "deregulation"?

Criminal Convictions

Five banks pled guilty in May to criminal charges. They agreed to pay $5.6 billion in fines for rigging the foreign exchange (Forex) markets. Most of these banks had actually admitted culpability in November and agreed to slightly smaller fines, but in the intervening months US law enforcement officials from the Federal Reserve and Department of Justice extrapolated enough evidence from chat room data to mount criminal charges of antitrust violation – abuse of market power.

There is little evidence of any strong objections from the banks, even though arguably the admission to corporate criminal guilt crosses a Rubicon. As is now standard practice, senior managers of all banks issued statements of contrition and regret, and Barclays even stated that its latest internal review will also cover similar rigging activities in

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(cont'd) UK, ECB policies and future...

CENTRAL BANKS

Europe's Economy improves cyclically as America's stalls

It is therefore rather ironic that the outlook for the US economy has recently worsened. As we have reported in our Newsletters of April'15 and February'14, previous US optimism was not soundly based and leading indicators clearly now show an economy verging on recession. Initial optimism at the US employment number published June 5th (+280,000 jobs), quickly faded; only 2% of new jobs (6,000) are in the productive side of the economy: construction, manufacturing, mining and energy. Employment in the productive economy continues to fall and is now 11% below pre-crisis levels, but admittedly much stronger than in many parts of Europe.

How does this data square with several recent years of optimism? As previously explained, monetary stimulus provides only a short term boost to jobs and GDP at the expense of longer term problems, which are now irrefutably visible. Given its influence over ECB policy, it is unfortunate for Europeans that the media have not made this connection. The economic data in Europe are looking a little better of late, an overdue cyclical bounce helped by lower oil prices and a weaker euro. This bounce has been a blessing for the ECB, who have used this relief to strengthen their calls for structural reforms among European countries.

...media have accepted the US recovery story and merely lobbied for policy changes at ECB level that might enable European economic data to more closely track the US.

In the UK, Cameron's Centre-Right Party wins power, but is Brexit now more likely?

ECB President Draghi has led European policymakers in hailing Britain's recovery, perhaps because it allows them quietly to laud austerity. Even Britain's recent price deflation has been presented as good news, with no dissent from Continental policymakers who foretold economic Armageddon should deflation take hold in Europe. Britain is increasingly viewed as part of Europe, despite not joining the Eurozone. But is it likely to

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(cont'd) Criminal convictions, deregulation

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metal priced benchmarks and Libor. The media, as usual, called for individuals to be jailed, and one or two extremely junior scapegoats have already been identified. This is wonderful news for senior management; the fines sound large but have been calculated so as to have no significant impact on compliance with minimum standards for Basel and Leverage Ratio purposes. Further, the markets are now so accustomed to such announcements that they are treated as routine costs of doing business, and management are usually rewarded and enriched (through personal equity incentives) as share prices rise upon the news.

Are Deregulation and Monetary Policy to Blame?

Of course, monetary policy has played its part in this decline in banking ethics. Since the early 1990's, the US has driven down global interest rates whenever banks were perceived to be in trouble; this effect becoming known as the "Greenspan Put" after Fed chief Alan Greenspan.


FINANCIAL

'Greenspan put' may be encouraging complacency

'Moral hazard' may be created by the interventions of the Fed, says Peronet Despeignes

But has banking really become deregulated? To some it may appear so. We have explained how banks' discretion over accounting and regulatory capital reporting is so wide that, with taxpayers providing most of bank funding via QE, bailouts and zero interest policies (savers foregoing interest), financial reporting has been gamed by mangers incentivised to enhance their personal emoluments.

However, it is perhaps an oversimplification to describe regulatory changes as "deregulation". Despite the 1999 repeal of the Glass Steagall Act, originally introduced in 1933 to separate commercial banking from investment banking, it would be fairer to describe events of the last 15 or so years as "re-regulation". The government has assumed stringent powers. Under the Sarbanes Oxley Act of 2002, executives faced far stiffer penalties for cooking the books. Under Dodd- Frank, 2010, the US Treasury Secretary has the power to take over a bank at a moment's notice. Under the Volcker Rule government officials more or less decide which activities of a bank are 'hedging' as opposed to 'proprietary trading', and swathes of compliance staff have been hired to implement processes specified by regulators, in order that the desired activity can indeed be classified as hedging.

The bizarre present reality is that the US government now micro-manages a raft of previously stigmatised activities, whilst turning a blind eye to profit exaggeration via accounting abuses such as 'marking to model'.

And that is the real relevance of the recent Forex criminality story. Here is yet another area where banks admit they acted dishonestly. Of course, one should be sceptical of how they treat their official accounts, including risk provisions, when they have been found to be behaving dishonestly basically everywhere else. Against this background, they would be inconsistent if they were not playing fast and loose with accounting practices.

The combination of deregulation and strict post-crisis reregulation under the vigilant eye of the banking lobby itself has clearly done nothing more than offer bankers ever more opportunities for gaming the system, sailing as close to the law as possible and often profitably transgressing it as well.

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(cont'd) Criminal convictions, deregulation...

stay in Europe?

UK Prime Minister Cameron entered the May 7th election campaign facing two opposed but strong forces; firstly a powerful euro-sceptic party and secondly a rising centre-left but pro-Europe party. Cameron won over the media with his message that only his party could be trusted on the economy, citing the halving of Britain's deficit (the rate at which the debt grows annually), and boasting that Britain has created more new jobs in 5 years than the rest of Europe put together. Both points are true, but his centre left opposition were unable to take issue with obvious concerns such as Britain's debt having doubled over the course of the last Parliament because they would have increased it even more. Both opposition movements were trounced.

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The resulting, and largely unexpected, gain in Parliamentary seats now gives Cameron a majority of 12, low by historical standards but almost Putinesque compared with Europe's abundant coalitions.

Equally unexpected is the speed and profile of the new movement demanding Brexit. British europhiles had been expecting a modest renegotiation of terms and a low-key referendum resulting in Britain staying "in". But the first weekend in June saw the launch and rapid growth of a new movement within the ruling Conservative party demanding either substantive EU reform or Brexit; one third of its members either have, or are expected to join, the movement: "Conservatives for Britain" (CfB).

In a paper published in the first week in June, CfB take issue with each of the three concessions that Cameron has stated he will require from Europe in order to lobby to stay in: *(see box)*

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CfB's take on Cameron's 3 requirements from EU:

❶ **Restrictions on Europeans' eligibility for British social welfare payments;** CfB say this is far too weak. Nothing short of restoration of full border controls and sovereignty over national laws will suffice.

❷ **An end to Europe's push for "ever closer union".** CfB dismiss this. Delivering a federalised Single European State is the official policy of the French President, Italian Prime Minister, German Chancellor and the Presidents of the European Commission and European Council, and most other mainstream political figures in Europe.

❸ **A guarantee that the UK will never be forced to adopt the euro.** CfB claim this is a sop. Of course Europe will agree; nobody in Europe cares about this. We believe that by 2020, all but 4 member states of the EU will have joined the Eurozone, leaving only Sweden, Denmark and Bulgaria adrift. The powers of non-euro using member states to veto, for example, new banking regulations, under the principle of double majority voting, are likely to be swept away. CfB claim that the Eurozone will take over the main institutions of the EU and that these 4 countries will be encouraged to join up with the non-EU members of the European Economic Area – Norway, Iceland and Liechtenstein - and form their own institutions. So this is no concession at all.

Already a majority of British newspapers have rallied behind CfB – The Times, The Sun, Daily Mail and The Daily Telegraph. Whether point 3) above will be understood, let alone powerfully influence British voters is less clear. The Sun knows how to connect with Britons; one recent widely read article pictured attractive sunbathing girls on a beach under the caption "Will ISIS ruin your summer holiday in the Mediterranean?" followed by a few lines assessing this risk in Egypt, Turkey, Tunisia, Greece and even Italy.

What this means for the future

What is the likely impact of Brexit fears on money and banking?

The media will push for clarity over the concessions that Cameron hopes to negotiate. We expect these to be slow to emerge and trivial in substance. The pro-EU movement will warn of economic devastation should Brexit occur.

The media will push for clarity over the concessions that Cameron hopes to negotiate. We expect these to be slow to emerge and trivial in substance. The pro- EU movement, namely all the British centre left parties, will warn of economic devastation should Brexit occur. This fragile atmosphere will not be conducive to warm British/ EU co-operation over Greece, over new banking regulations, or over new bailout funds.

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