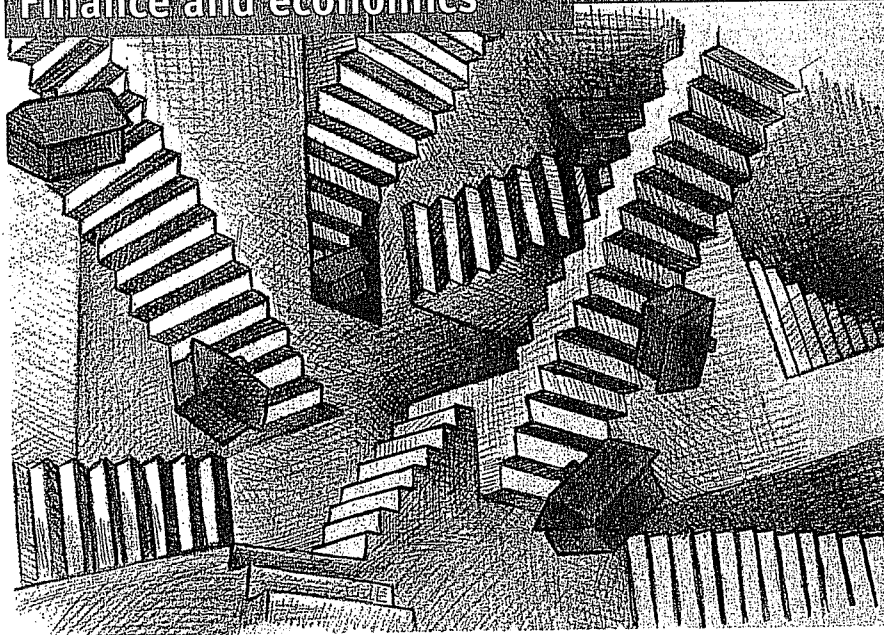


Finance and economics



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Fannie Mae and Freddie Mac  
**End of illusions**

An eight-page section on the crisis gripping the world economy and global markets starts where it all began—with America's deeply flawed system of housing finance

THERE is a story about a science professor giving a public lecture on the solar system. An elderly lady interrupts to claim that, contrary to his assertions about gravity, the world travels through the universe on the back of a giant turtle. "But what supports the turtle?" retorts the professor. "You can't trick me," says the woman. "It's turtles all the way down."

The American financial system has started to look as logical as "turtles all the way down" this week. Only six months ago, politicians were counting on Fannie Mae and Freddie Mac, the country's mortgage giants, to bolster the housing market by buying more mortgages. Now the rescuers themselves have needed rescuing.

After a headlong plunge in the two

firms' share prices (see chart 1), Hank Paulson, the treasury secretary, felt obliged to make an emergency announcement on July 13th. He will seek Congress's approval for extending the Treasury's credit lines to the pair and even buying their shares if necessary. Separately, the Federal Reserve said Fannie and Freddie could get financing at its discount window, a privilege previously available only to banks.

The absurdity of this situation was highlighted by the way the discount window works. The Fed does not just accept any old assets as collateral; it wants assets that are "safe". As well as Treasury bonds, it is willing to accept paper issued by "government-sponsored enterprises" (GSEs). But the two most prominent GSEs are Fannie Mae and Freddie Mac. In theory, therefore, the two companies could issue their own debt and exchange it for loans from the government—the equivalent of having access to the printing press.

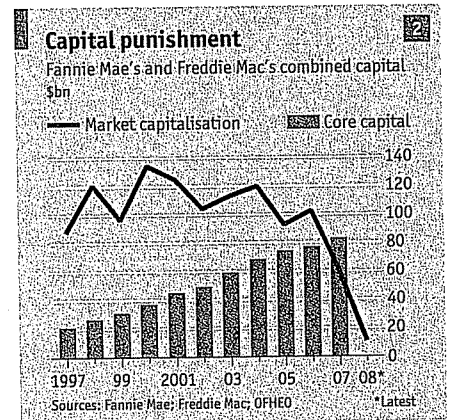
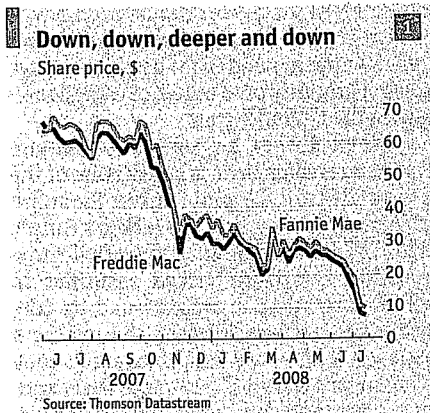
Absurd or not, the rescue package notched up one immediate success. Freddie Mac was able to raise \$3 billion in short-term finance on July 14th. But the deal did little to help the share price of either company or indeed of banks, where sentiment was dented by the collapse of IndyMac, a mortgage lender (see page 82). The next day Moody's, a rating agency, downgraded both the financial strength and the preferred stock of Fannie and Freddie, making a capital-raising exercise look

even more difficult. As a sign of its concern, the Securities and Exchange Commission, America's leading financial regulator, weighed in with rules restricting the short-selling of shares in Fannie and Freddie.

The whole affair has raised questions about the giant twins. They were set up (see box on the next page) to provide liquidity for the housing market by buying mortgages from the banks. They repackaged these loans and used them as collateral for bonds called mortgage-backed securities; they guaranteed buyers of those securities against default.

This model was based on the ability of investors to see through one illusion and boosted by their willingness to believe in another. The illusion that investors saw through was the official line that debt issued by Fannie and Freddie was not backed by the government. No one believed this. Investors felt that the government would not let Fannie and Freddie fail; they have just been proved right.

The belief in the implicit government guarantee allowed the pair to borrow cheaply. This made their model work. They could earn more on the mortgages ▶▶



▶ they bought than they paid to raise money in the markets. Had Fannie and Freddie been hedge funds, this strategy would have been known as a “carry trade”.

It also allowed Fannie and Freddie to operate with tiny amounts of capital. The two groups had core capital (as defined by their regulator) of \$83.2 billion at the end of 2007 (see chart 2 on the previous page); this supported around \$5.2 trillion of debt and guarantees, a gearing ratio of 65 to one. According to CreditSights, a research group, Fannie and Freddie were counterparties in

\$2.3 trillion-worth of derivative transactions, related to their hedging activities.

There is no way a private bank would be allowed to have such a highly geared balance sheet, nor would it qualify for the highest AAA credit rating. In a speech to Congress in 2004, Alan Greenspan, then the chairman of the Fed, said: “Without the expectation of government support in a crisis, such leverage would not be possible without a significantly higher cost of debt.” The likelihood of “extraordinary support” from the government is cited by

Standard & Poor's (S&P), a rating agency, in explaining its rating of the firms' debt.

The illusion investors fell for was the idea that American house prices would not fall across the country. This bolstered the twins' creditworthiness. Although the two organisations have suffered from regional busts in the past, house prices have not fallen nationally on an annual basis since Fannie was founded in 1938.

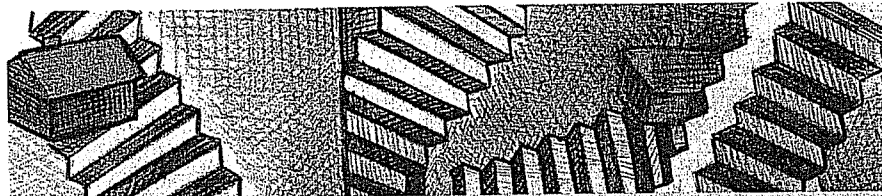
Investors have got quite a bit of protection against a housing bust because of the type of deals that Fannie and Freddie guaranteed. The duo focused on mortgages to borrowers with good credit scores and the wherewithal to put down a deposit. This was not subprime lending. Howard Shapiro, an analyst at Fox-Pitt, an investment bank, says the pair's average loan-to-value ratio at the end of 2007 was 68%; in other words, they could survive a 30% fall in house prices. So far, declared losses on their core portfolios have indeed been small by the standards of many others; in 2008, they are likely to be between 0.1% and 0.2% of assets, according to S&P.

Of course, this strategy only raises another question. Why does America need government-sponsored bodies to back the type of mortgages that were most likely to be repaid? It looks as if their core business is a solution to a non-existent problem.

However, Fannie and Freddie did not stick to their knitting. In the late 1990s they moved heavily into another area: buying mortgage-backed securities issued by others (see chart 3 on the next page). Again, this was a version of the carry trade: they used their cheap financing to buy higher-yielding assets. In 1998 Freddie owned \$25 billion of other securities, according to a report by its regulator, the Office of Federal Housing Enterprise Oversight (OFHEO); by the end of 2007 it had \$267 billion. Fannie's outside portfolio grew from \$18.5 billion in 1997 to \$127.8 billion at the end of 2007. Although they tended to buy AAA-rated paper, that designation is not as reliable as it used to be, as the credit crunch has shown.

Sometimes the mortgage companies were buying each other's debt: turtles propping each other up. Although this boosted short-term profits, it did not seem to be part of the duo's original mission. As Mr Greenspan remarked, these purchases “do not appear needed to supply mortgage market liquidity or to enhance capital markets in the United States”.

Joshua Rosner, an analyst at Graham Fisher, a research firm, who was one of the first to identify the problems in the mortgage market in early 2007, reckons Fannie and Freddie were buying 50% of all “private-label” mortgage-backed securities in some years—that is, those issued by conventional mortgage lenders. This left them exposed to the very subprime assets they were meant to avoid. Although that exposure was small compared with their port-



A brief family history

## Toxic fudge

Chartered by Congress; out for themselves

ADAM SMITH thought that private companies chartered to fulfil government tasks had “in the long run proved, universally, either burdensome or useless”. That has not stopped them thriving. America has five government-sponsored enterprises (GSEs), set up to subsidise loans to homeowners or farmers. (Sallie Mae, which deals with students, gave up GSE status in 2004.) Because they count as privately owned, GSEs are kept off the government's books. For politicians that has made them irresistible ever since the Farm Credit System's creation in 1916.

Fannie Mae and Freddie Mac dominate the GSE system, accounting for four-fifths of its total credit portfolio. Fannie was created in 1938 as a government corporation. In 1968 the Johnson administration decided to list its shares to reduce the budgetary pressures created by the Vietnam war, according to Thomas Stanton, of Johns Hopkins University. Freddie was born in 1970 and listed in 1989. Both companies aim to support the secondary mortgage market. They have succeeded all too well: they own or guarantee about half of all mortgages.

Their supremacy reflects their privileges. As well as an implicit state guarantee, which allows them to fund themselves cheaply, they enjoy exemption from some taxes. They run with far less capital than banks and have more latitude to include as capital dubious items such as preference shares and tax assets. The capitalised value of these privileges is huge: between \$122 billion and \$182 billion, according to a 2005 study by the Federal Reserve.

It gets worse. The same analysis concluded that shareholders, who enjoy turbocharged gearing without higher borrowing costs, siphoned off about half of the subsidy. Managers trousered an unseemly sum too: between 1998 and 2003, Fannie's top five executives received \$199m.

With so much at stake, no wonder the companies built a formidable lobbying machine. Ex-politicians were given jobs. Critics could expect a rough ride. The companies were not afraid to bite the hands that fed them: in 2004, the day before a congressional committee discussed the regulation of Fannie, the company ran a television advertisement attacking the committee. Their regulator, the Office of Federal Housing Enterprise Oversight, says its powers were weakened during its creation in 1992: for example, its budget must be approved annually by Congress and thus depends on political goodwill.

Accounting scandals in 2003-04 (the two firms restated earnings by a total of \$1.3 billion) led to a change of management, and supporters argue, of culture. The pace of balance-sheet expansion and accumulation of risky private-label securities has slowed. Yet neither company can be accused of anticipating the housing crash. An end to GSE status looks unlikely: as truly private companies Fannie and Freddie would require unrealistically large injections of equity. The government wants to avoid nationalisation. That leaves the status quo, the public subsidy of private profit: a combination as toxic as it was in Smith's day.

folios, it could have a big impact because they have so little equity as a cushion.

Both companies make a distinction between losses on trading assets (which they take as a hit against profits) and on "available-for-sale" securities which they hold for the longer term and disregard, if they think the losses are temporary. At the end of 2007, according to OFHEO, Fannie had pre-tax losses of this type of \$4.8 billion; Freddie's amounted to \$15 billion.

The companies have also been unwilling to accept the pain of market prices in acknowledging delinquent loans. When borrowers fail to keep up payments on mortgages in the pool that supports asset-backed loans, Fannie and Freddie must buy back the loan. But that requires an immediate write-off at a time when the market prices of asset-backed loans are depressed. Instead, the twins sometimes pay the interest into the pool to keep the loans afloat. In Mr Rosner's view, this merely pushes the losses into the future.

Adding to the complexity is the need for both Fannie and Freddie to insure their portfolios against interest-rate risk—in particular, the danger that borrowers may pay back their loans early, if interest rates fall, leaving the companies with money to reinvest at a lower rate. This risk caused the duo to take huge positions in the derivatives market, and was at the centre of an accounting scandal earlier this decade.

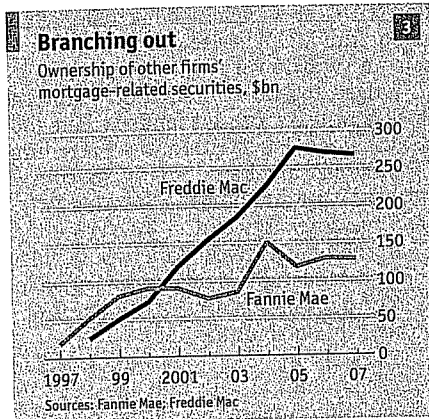
In addition, Fannie and Freddie have bought insurance against borrower defaults when the homebuyer lacks a 20% deposit. But the finances of the mortgage insurers do not look that healthy, which may mean the risk ends up back with the siblings. Just as the rescuers need rescuing, so the insurers may need insuring.

None of these practices seemed to dent the confidence of OFHEO in its charges. The regulator said as recently as July 10th that both Fannie and Freddie had enough capital. Indeed, their capital-adequacy requirement was reduced earlier this year so that they could make more of an effort to bolster the housing market.

### Capital offence

By its own measure, OFHEO was right. At the end of the first quarter, the two companies exceeded their minimum capital requirements by \$11 billion apiece, according to CreditSights. To fall to the "critical level", which would require OFHEO to take the agencies into "conservatorship" (a fancy word for nationalisation), CreditSights says Fannie would have to lose \$16 billion of capital and Freddie \$14 billion. And because neither Fannie nor Freddie has depositors, there is no danger of their suffering a run, as Northern Rock, a British bank, did last year.

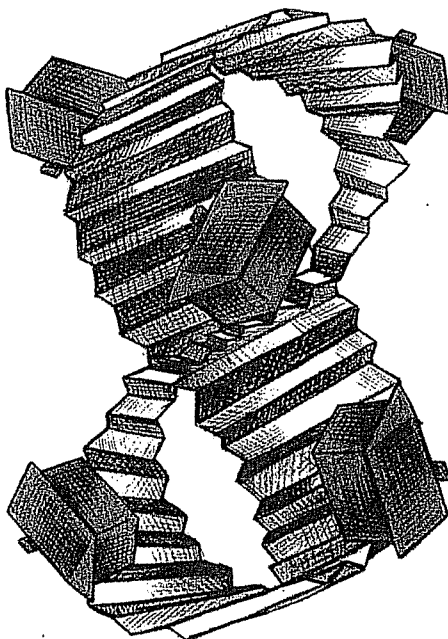
So why the crisis? Given the gearing in the businesses, things only need to go slightly wrong for there to be a big pro-



blem. Freddie lost \$3.5 billion in 2007; Fannie reported a \$2.2 billion loss in the first quarter, having lost \$2.05 billion last year. Each had credit-related write-downs of between \$5 billion and \$6 billion last year. On a fair-value basis, which assumes that all assets and liabilities are realised immediately, Freddie had negative net worth of \$5.2 billion at the end of the first quarter.

Clearly, if the pair continue to lose money for much longer, their capital base will be eroded. And, of course, Congress wanted their businesses to expand—meaning that more, not less, capital would be needed. That would require shareholders to stump up more money. But investors tend to anticipate a big equity-raising by selling the shares, and a falling share price makes an equity issue less likely. The fall was sufficiently speedy in mid-July to prompt Mr Paulson to step in. The stockmarket had called the government's bluff.

The rescue package may have reassured the creditors but it did not stop the share price of either Fannie or Freddie from falling. After all, the government is likely to extract a heavy penalty from shareholders in



return for its support (creditors are another matter, especially as a lot of GSE paper is held by foreign central banks).

Nevertheless the hope is that, if confidence can be restored, Fannie and Freddie can survive without raising capital until market conditions improve. In the short term, as the success of the debt issue on July 14th showed, they should be able to go about their business.

The authorities are keen to avoid nationalisation, which would bring the whole of Fannie's and Freddie's debt onto the federal government's balance sheet. In terms of book-keeping this would almost double the public debt, but that is rather misleading. It would hardly be like issuing \$5.2 trillion of new Treasury bonds, because Fannie's and Freddie's debt is backed by real assets. Nevertheless, the fear that the taxpayer may have to absorb the GSEs' debt pushed Treasury bond yields higher. That suggests yet another irony; the debt of the GSEs has been trading as if it were guaranteed by the American government, but the debt of the government was not trading as if Uncle Sam had guaranteed that of the GSEs.

If Congress approves this package, the Fed will have more authority over the agencies. But that will give the central bank another headache. If an institution is struggling, the normal answer is to shrink its activities and wind it down slowly. But that is the last thing that the housing market needs right now.

With the credit crunch, Fannie and Freddie have become more important than ever, financing some 80% of mortgages in January. So they will need to keep lending. Nor is there scope to offload their portfolios of mortgage-backed securities, given that there are scarcely any buyers of such debt. And if the Fed has to worry about safeguarding Fannie and Freddie, can it afford to raise interest rates to combat inflation? American monetary policy may be constrained.

The GSEs are not the only liability for the government. IndyMac's recent collapse is the latest call on the Federal Deposit Insurance Corporation (FDIC). The FDIC has some \$53 billion of assets, so it is better funded than most deposit-insurance schemes. But if enough banks got into trouble, the government would be on the hook for any shortfall. The same is true of the Pension Benefit Guaranty Corporation, which insures private sector benefits, but is already \$14 billion in deficit.

In the end, the turtle at the bottom of the pile is the American taxpayer. But that suggests that, if Americans are losing money on their houses, pensions or bank accounts, the right answer is to tax them to pay for it. Perhaps it is no surprise that traders in the credit-default swaps market have recently made bets on the unthinkable: that America may default on its debt. ■

American banks

## Fear of failure

The collapse of a big mortgage lender sparks panic about others

**B**Y TRADITION, sequels are pale shadows of their forerunners. In this financial crisis, each episode in the saga seems even more potent than the last. While one arm of the American government tried to allay fears about Fannie Mae and Freddie Mac, another was busily orchestrating the seizure of IndyMac Bancorp, a large mortgage lender which collapsed on July 11th. The Federal Deposit Insurance Corpora-

tion (FDIC) set up a new bank to take control of IndyMac's insured deposits and assets, and will now try to sell what it can.

Judged by the standards of Northern Rock, a British mortgage lender where the death throes lasted for months, the failure of IndyMac has been orderly. Its consequences were anything but. Worried IndyMac customers queued in the sweltering Californian sun to retrieve their money, despite FDIC guarantees on deposits of up to \$100,000 (of the bank's \$19 billion of deposits, \$1 billion is uninsured).

Investors in other banks showed far less decorum. On July 14th the S&P500 banks' index suffered its worst daily fall since its creation in 1989. Regional banks took the brunt of the punishment. Washington Mutual in Seattle and National City in Cleveland were both moved to issue

statements reassuring panicking investors that they were well capitalised and had access to short-term funding. Such tactics can easily backfire. Wachovia, the country's fourth-biggest lender, also sought to soothe markets about its finances on July 15th, and watched its shares sink further. Wachovia, which has achieved infamy for an ill-advised acquisition that swamped it with adjustable-rate mortgages in California, has lost more than 75% of its value since the start of the year.

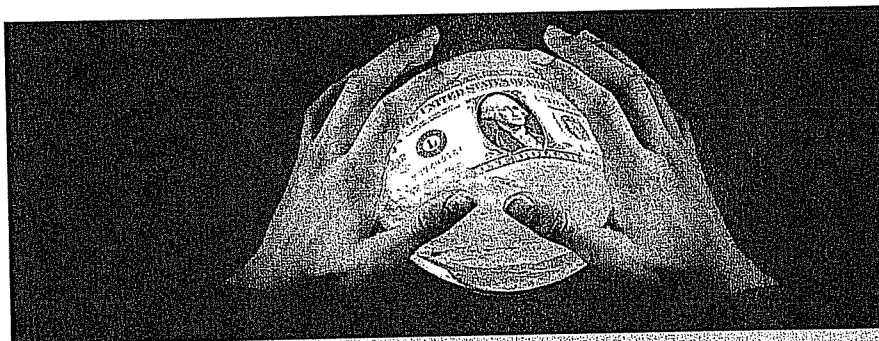
Reasoned analysis is a struggle in such circumstances. "Who is next?", asked a July 13th research note from Dick Bove, a respected industry observer, which ranked banks on the basis of ratios of non-performing assets. His reassuring subheading, "Not as many candidates as one would think", got lost in the stampede as investors shied away from banks anywhere near the top of the list. Mr Bove issued a hasty clarification on July 14th saying that the data had been misinterpreted.

Is the panic justified? IndyMac's fall matters for three reasons. The first is that it forcibly reminds investors and depositors that not every financial institution in America is too big to fail. With \$32 billion of assets, IndyMac is set to be the country's second-biggest bank failure. According to Chip MacDonald of Jones Day, a law firm, it is also likely to be the most expensive. The FDIC reckons that the costs of cleaning it up will be between \$4 billion and \$8 billion, a big chunk of the agency's \$53 billion deposit-insurance fund. Co-incidentally, the ratio of FDIC's fund to the total amount of insured deposits is similar to the capital ratios set aside by Fannie Mae and Freddie Mac. Riskier banks will be asked to pay more in order to top the pot up, another drag on earnings.

### Don't run, run, run

The second lesson of IndyMac is that it underlines the speed with which banks can go under once confidence in them is lost. Plenty of analysts thought the bank was in severe trouble, but the government's hand was forced by massive outflows of deposits that were themselves triggered by a public letter from Chuck Schumer, a spotlight-loving senator, expressing concerns about IndyMac's health. Regulators did not bother to disguise their irritation with Mr Schumer's intervention, but they cannot ignore the broader message: a lack of liquidity kills.

The third message from IndyMac is that the well of capital for ailing banks is not inexhaustible. Before it went under, the lender admitted that its efforts to shore up capital had come to nothing. Small regional banks, less diversified than their larger brethren and more exposed to riskier asset classes such as home-equity lines of credit and commercial real estate, are most at risk of running out of capital-raising options. ▶▶



Prediction markets

## Fortune telling

How to bet on the next bank collapse

**S**URPRISES, in the staid world of banking, tend to be of the unpleasant sort, as customers at IndyMac Bancorp, a California thrift, can attest. Cross a few palms with silver, however, and there is a new way to profit from others' unexpected losses. Punters can now bet on bank failures in America, thanks to 12 new contracts against individually named banks listed on July 16th by Intrade, the largest online prediction market.

Once viewed as grubby gambling dens, prediction markets have sharpened up. Intrade says it has brokered \$76m of bets this year. Its data have been used as a price-discovery tool by America's Commodities Futures Trading Commission, the United States Navy, various Federal Reserve banks, and the European Central Bank. The accuracy of prediction markets makes them hard to ignore: they were better than Gallup polls in predicting the outcome of elections between 1998 and 2004. Using the wisdom of crowds, they do a good job of forecasting the outcome of sporting events.

Exchanges such as Britain's Tradefair and America's HedgeStreet have sought

to apply this predictive power to financial markets, offering contracts on financial instruments, interest rates and commodities. CME Group, a Chicago-based exchange, launched its first economic-event contracts in April. But these markets do not appear to have taken off as successfully as election or sports markets, possibly because they struggle to strike the right balance between experts and laypeople. A bet on the merger that created CME Group received only 82 trades in its 80-day lifespan. When markets are that small, punters should watch carefully for signs of manipulation.

So far, it must be said, there appear to have been no deals on Intrade's bank-failure market. Top of its danger list, based on the bid-offer spread, is Miami-based Bank United Financial, which has featured in news reports as one of several banks with a high ratio of non-performing loans to total assets. On July 16th Bank United's share price more than doubled, however. The stockmarket is a more liquid place to bet on banks—but hedging against failure may be a sensible option if banks continue to go bust.

# Buttonwood | Turning panic into opportunity

## How to tell when markets may have hit bottom

**W**HEN all around are panicking, smart investors should be coolly asking whether it is time to buy. What signals should they be looking for?

One of the first measures is the *VIX*, or volatility index, which measures the variability of the American stockmarket. It is trading around the 30 level, or near its peak in March when Bear Stearns had to be rescued.

The theory is that when volatility is high, markets are usually falling. That is because there is rarely such a thing as a "forced buyer" of shares. But there can be forced sellers, when investors need to dump their holdings to meet margin calls or repay debts. Faced with such selling, marketmakers adjust their prices sharply and that is what creates spikes in the *VIX*.

The *VIX* is well above its post-1990 average, according to the Chicago Board Options Exchange, which trades futures and options on the index. But it has yet to reach the heights seen in 2002, or when Long-Term Capital Management, a hedge fund, was being rescued in 1998. Both incidents, which pushed the *VIX* above 40, proved to be good moments to buy shares on a 12-month view.

A second signal may seem a bit parochial to international readers. It is when the dividend yield on the FTSE All-Share (the broad-based British index) is higher than the yield on ten-year gilts, or government bonds. In other words, investors get paid more to hold equities (with all their growth prospects) than stodgy government bonds. The market passed this threshold on March 12th 2003 for the first time since the late 1950s. To the day, it marked the end of the 2000-2003 global bear market. At the time some commentators said this signal did not matter, since dividends would probably be cut. In fact, the dividend income on the index has al-

most doubled in the five years since.

As of July 16th, the yield on the All-Share was 4.46% and the ten-year gilt yielded 4.95%. That suggests that a further 10% fall in the stockmarket would do the trick. There is, of course, the risk that dividends will be cut if Britain, or indeed the world, goes into recession. But this crossover is a signal of long-term value. It is highly likely that dividend income will increase by 2018. But it is certain, if you buy a ten-year gilt, that you will get the same nominal income in 2018 as you do now.

Another measure that could make shares attractive is a single-digit price/earnings ratio. Higher inflation tends to drive down *p/es*, because it leads to more volatile economic conditions. Investors may also be worried that profits are high, relative to GDP, and are thus due for a fall.

But single-digit *p/es* would compensate investors for those risks. Flip the ratio around and you have the earnings yield, the percentage of the share price that is represented by profits. If the *p/e* is in single digits, the earnings yield is above 10%. On the latest data, a number of European markets, including Belgium, France, Ireland, It-

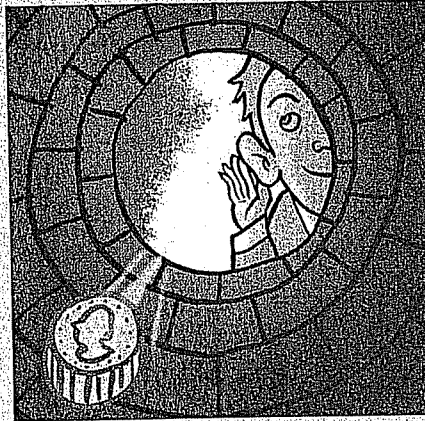
aly, the Netherlands, Spain and Sweden fall into this category; with the DAX on a *p/e* of 10.6, Germany is not that far away. (Wall Street, by contrast, has still a fair amount to fall on this measure.)

On valuation grounds, therefore, investors should at least be thinking about opening their wallets. Of course, valuation is not the only factor that drives markets, as became clear during the dotcom bubble. Just as prices can be driven far above fair value in periods of euphoria, so they can be driven far below it in periods of fear.

And sentiment is pretty depressed. The latest Merrill Lynch survey of global fund managers, released on July 16th, found that a record number were overweight in their holdings of cash and underweight in shares, and most thought that profit forecasts were far too high. That poll suggests investors are already braced for a good deal of bad news.

What is needed to get markets out of their funk is a catalyst. It would help if the uncertainty cleared. In both 1991 and 2003, markets rallied as wars against Iraq began. That was not because the wars were good news, but because investors had been made so uncertain by the pre-war tensions.

The fundamental problem this time is economic and financial, rather than geopolitical. As well as the credit crunch, investors are worried by the combination of higher-than-expected inflation and slower growth, and the fear that central banks will be seduced into setting monetary policies that are too loose or too tight. So the best news of the week, buried under all the headlines about falling bank share prices, was the sharp drop in the price of oil. A belief that oil could soon be in double, not triple, digits really would be the catalyst for a rally.



► That moment may now be arriving.

Estimates of the numbers of bank failures are rising as a result. Gerard Cassidy of RBC Capital Markets reckons that up to 300 banks are likely to fail over the next three years, compared with just three during 2007. This number is less frightening than it sounds. More than 1,000 banks failed at the height of the savings and loans crisis in the late 1980s. "There are 8,000 banks in America and most people haven't heard of 7,950 of them," says Fred Cannon of Keefe, Bruyette & Woods, an investment bank.

IndyMac was sizeable, of course, but its profile was unique. Its deposit-taking pro-

wess rested on alluring interest rates rather than relations with customers. Bigger banks, with deeper branch networks and a broader range of products, are less susceptible to runs on deposits and better placed to use their deposit base to buttress earnings. On the asset side of the balance-sheet, IndyMac's lending zoomed from \$29 billion in 2003 to a peak of \$90 billion in 2006. More than two-thirds of its lending in that year was in Alt-A loans, a class of mortgages for borrowers who cannot document all their income and assets. As well as being riskier than normal mortgages, these loans are also more susceptible to

abuse. IndyMac is reportedly under investigation by the FBI for fraud.

No part of the housing market is thriving, but lenders with less exotic portfolios can sleep a little easier. Wells Fargo, the country's second-biggest mortgage lender, briefly lifted the gloom hanging over bank stocks on July 16th after it announced better-than-expected second-quarter results. The relief will probably be temporary. Investors may have been in denial about the depths of the hole banks are in up until now. If the next stage of the grief cycle—despair—is indeed setting in, times will get even more testing. ■

Aftermath of a mega-merger

## Three amigos, only one conquistador

### Mixed fortunes for the buyers of ABN AMRO

TO THE victors, the toils. Less than a year has passed since the bosses of Royal Bank of Scotland (RBS), Fortis, a Belgian-Dutch lender, and Santander of Spain celebrated the biggest deal in banking history, the €72 billion (\$101 billion, at the time) acquisition of ABN AMRO, a Dutch bank. Their divergent fortunes since then reflect the woeful state of European banking.

Start with the casualties. Jean-Paul Votron lost his job as chief executive of Fortis on July 11th, paying the price for his announcement in June that the bank was raising another €8.3 billion of capital by selling assets, placing shares and scrapping its interim dividend. The bank tapped shareholders for €13.4 billion in 2007 to pay for its €24 billion portion of the ABN deal and had denied until recently that it needed more cash. Enraged investors asked the Dutch regulator to investigate whether those assurances amounted to misinformation—the effect was to depress the value of their holdings even further. The bank was even moved to deny rumours that depositors were withdrawing their savings on July 15th. Some think the company may be in play, with ING mooted as a possible buyer.

Mr Votron hoped to make his reputation with the ABN deal. Sir Fred Goodwin, the boss of RBS, has ended up losing his. He too has asked shareholders to stump up, after denying that he would need more capital: the bank's £12 billion (\$24 billion) rights issue closed last month but the pain for RBS continues. Its shares were hammered on July 15th, as investors fretted about its exposure to the transatlantic mortgage meltdown, via its Citizens unit, and the stuttering sale of its insurance arm.

Defenders of the ABN transaction, a lonely band, point out that shares in Barclays, which lost the battle for the Dutch bank, have fallen almost as far as those in RBS and Fortis (see chart). These two banks may well have had to raise capital anyway, given large write-downs in their own businesses. And the deal did give them some useful assets. But both RBS and Fortis picked the wrong time and paid the wrong price for their bits of ABN. Arturo de Frias, an analyst at Dresdner Kleinwort, reckons that RBS paid 17.6 times tangible book value (adjusting for goodwill and subsequent write-downs) for ABN's wholesale business and Asian operations, and that Fortis shelled out 14.2 times book value for its Dutch retail, asset-management and priv-

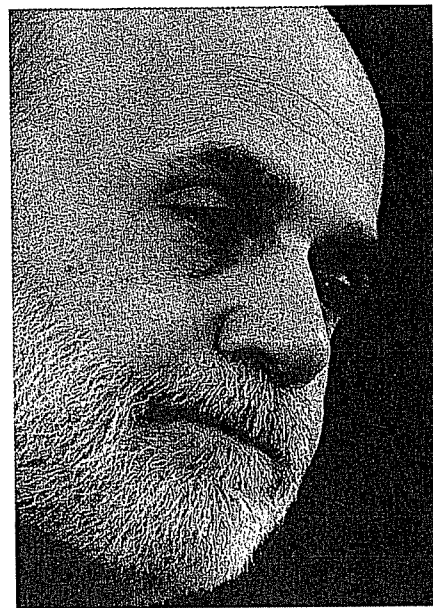
ate-banking arms. European banks today trade at roughly book value.

It does not help that the third member of the consortium, Santander, is one of the very few banks in the region to look sprightly. It cushioned the financial impact of the deal by swiftly flipping ABN's Italian retail network on to another buyer. It kept ABN's Brazilian operations, which still promise buoyant growth. And thanks in large part to Spanish banking regulations, Santander avoided the subprime mess. As a result, it is still able to do deals.

On July 14th Santander announced a £1.26 billion bid for Alliance & Leicester (A&L), a smallish British lender. Shareholders grumbled that the price undervalues A&L, but the A&L board, which backs the bid, has a clearer-eyed view. Small banks with a liking for the moribund wholesale markets as sources of funding are not much in vogue nowadays.

There is muted speculation that other banks may be tempted to make bids but possible contenders are scarce. The fit between Abbey, Santander's existing British subsidiary, and A&L is unusually snug. Lloyds, the likeliest counter-bidder, is under pressure to diversify abroad.

Santander is not without worries. Taking a bet on Britain's crumbling housing market is not for everyone: it will make a £1 billion injection of capital into A&L, some of which is insurance against further write-downs. The Spanish bank's home market is also in trouble. Martinsa-Fadesa, a large property developer, declared itself bankrupt on July 14th. But compared with the storms battering other banks in the region, these are, for the time being, wisps of cloud in an otherwise blue Iberian sky. ■



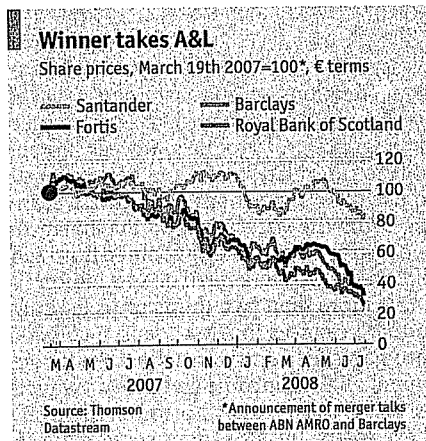
America's economy

## Boxed-in Ben

### For the Federal Reserve chief, even good news turns out to be bad

JITTERY investors and anxious politicians have often relied on Federal Reserve chairmen to conjure up something to steady their nerves. But when Ben Bernanke gave his twice-yearly monetary testimony to Congress on July 15th and 16th, he had little to offer but unvarnished and uncomfortable truths. There were "significant downside risks" to the economy's outlook, he said, and the chances that high inflation would persist had "intensified". Mr Bernanke did not specify which was the bigger threat: recession or inflation. This lack of a clear policy bias invited the conclusion that, for the time being at least, the Fed thinks it cannot safely move interest rates in either direction.

With financial markets buffeted by renewed fears about the credit drought and a deepening housing slump, Mr Bernanke could hardly boast of the economy's soundness. To make matters worse, figures released as the Fed chairman gave his second day of testimony showed that year-on-year inflation rose in June to 5.0% (see chart on next page), the highest rate since 1991. Paltry pay rises, as well as job losses, mean employment income is probably growing by less than 3%, well below the inflation rate. Falling real income, slumping share and house prices and tighter credit all cast a cloud over consumer spending. Firms worried about future demand will be more cautious too about shelling out for costly capital projects, even if they could ▶▶



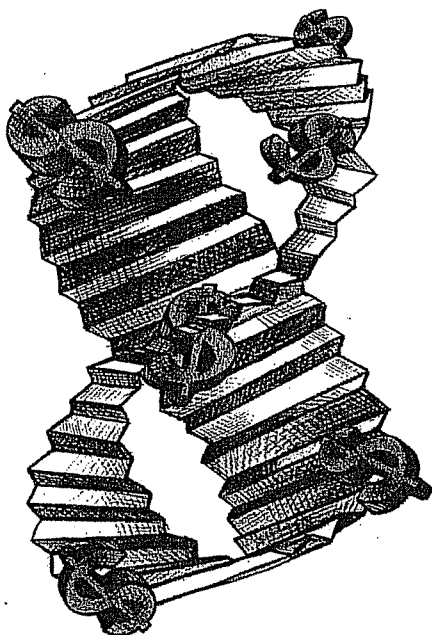
► raise the finance.

Despite these unsettling prospects, the Fed's rate-setters bumped up their forecasts for GDP growth in 2008, to 1.0-1.6%, from the 0.3-1.2% range set out in April. According to the central bank's 48-page report to Congress, the upgrade was prompted by stronger data on consumer and business spending between April and June. Private-sector analysts are revising up their forecasts for this year too. The first estimate of second-quarter GDP, released on July 31st, is likely to show that the economy grew at an annualised rate of around 2%, twice as fast as in the first quarter.

The Fed's trouble is that, though the economy has avoided recession so far, it may not do so for much longer. Indeed Mr Bernanke acknowledged that some of the demand that the Fed had hoped for later this year may have already come and gone. So the economy's first-half resilience may be of more concern than comfort.

The performance of companies and consumers shows why. Businesses received some extra tax relief as part of February's fiscal-stimulus package, which may have helped a little to stave off recession. There was also a spurt in the construction of offices, hotels and other business structures in the spring. However, this burst of activity may have been just the rag-end of the commercial-property boom. "These are projects that were planned when money was cheap," says Kevin Logan, an economist at Dresdner Kleinwort in New York. Now conditions have deteriorated: vacancy rates for offices are rising and retail chains, such as Gap, are closing stores.

Consumer spending seems likely to flag too. A jump in retail sales in April and May owed something to the tax rebates first sent out at the end of April. By July 11th around \$92 billion of the expected \$100 billion of rebates had been disbursed. With household finances under so much pressure, consumers probably leant more heavily on the rebate cheques than had been expected. But a slim rise in retail sales in June is a hint that the effects of this one-off stimulus may already be fading.



Another crutch for consumers has been the home-equity loan. Borrowing from this source rose by 3.8% between March and June, despite a big fall in overall bank credit. This increase came about partly because access is blocked to other forms of borrowing, such as mortgage refinancing. It may also be a sign of distress borrowing, as consumers battle with rising living costs. That battle will become harder if, as anecdotal evidence suggests, banks are cutting pre-arranged credit lines.

The brightest hope for America's economy is its foreign sales. Net trade added more than one percentage point to GDP growth in the year to the first quarter. The weak dollar is still helping American firms take advantage of the strong demand in other parts of the world. Export volumes rose by 10.1% in the first five months of the year, compared with the same period in 2007. But even here, the future is looking bleaker. Rising global inflation, spurred in part by countries with dollar pegs mimicking the Fed's rate cuts, is now prompting central banks in many emerging economies to tighten monetary policy. That will curb demand for imports. America's richer trading partners are struggling too. The euro-area economy may have shrunk in the second quarter. The outlook for Japan and for Britain has worsened too.

There is little that central banks can do to support the economy when inflation is rising dangerously high. The Fed's hands are tied by its concern that today's inflation may lead to higher wages. Mr Bernanke is "in a box", says Michael Feroli, an economist at JPMorgan Chase. The Fed chief has to sound hawkish to show that he has not lost sight of inflation. But equally he cannot set out a plan for interest-rate increases when the financial system is so wobbly.

The good news in the first half may even make the Fed's job harder. If consum-

Financial regulation

# Grasping at shorts

## America's SEC fights dirty

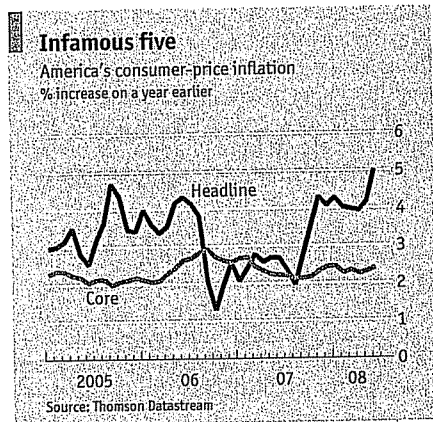
**B**EAR markets often involve bare-knuckle fights, but it is still a shock when the referee starts punching below the belt. The Securities and Exchange Commission (SEC) has intervened in the epic struggle between financial companies and the hedge funds that are short-selling their shares.

Desperate to prevent more collapses, the main stockmarket regulator has slapped a ban for up to one month on "naked shorting" of the shares of 17 investment banks, and of Fannie Mae and Freddie Mac, the two mortgage giants. Some argue that such trades, in which investors sell shares they do not yet possess, make it easier to manipulate prices. The SEC has also reportedly issued over 50 subpoenas to banks and hedge funds as part of its investigation into possibly abusive trading of shares of Bear Stearns and Lehman Brothers.

The SEC's moves deserve scrutiny. Investment banks must have a dizzying influence over the regulator to win special protection from short-selling, particularly as they act as prime brokers for almost all short-sellers. There is as yet no evidence that market abuse has driven down financial firms' share prices—and plenty that their trashed balance-sheets and credibility have. London's financial-services regulator has as yet failed to provide evidence to justify its decision to tighten the disclosure rules on short-selling of some bank shares.

The SEC's initiatives are asymmetric. It has not investigated whether bullish investors and executives talked bank share prices up in the good times. Application is also inconsistent. The S&P 500 companies with the biggest rises in short positions relative to their free floats in recent weeks include Sears, a retailer, and General Motors, a carmaker. Like the Treasury and the Federal Reserve, the SEC is improvising in order to try to protect banks. But when the dust settles, the incoherence of taking a wild swing may become clear for all to see.

ers have already used up much of their tax rebates and credit lines, spending is likely to flag soon. A first-half recession followed by a sluggish recovery—the standard forecast until recently—could well have enabled the Fed to raise rates in the autumn. But with the worst news on the economy yet to come, Mr Bernanke can only keep his fingers crossed that inflation does not become ingrained. ■



## Economics focus | Land of the rising price

### Japan has long hoped for a bit of inflation—but not this sort

JAPAN, people like to argue, is one place that should greet the return of inflation with joy. The country, after all, has been in the grip of deflationary forces for over a decade. Even after an economic recovery which began in 2002, the lingering deflationary mindset has meant firms have struggled to raise prices or pay better wages. Lacking animal spirits, a long-predicted virtuous circle—where higher profits would lead to bigger pay packets, leading to more spending in the economy, and so on—has failed to come about, so the recovery has depended too much on exports. A burst of inflation, the Japan bulls say, will provide just the shot in the arm that the economy needs.

Prices are indeed on the rise (see left-hand chart). In the decade to 2007, prices fell on average by 0.2% a year. On July 15th the Bank of Japan (BOJ) raised its forecast for “core” inflation in the fiscal year ending in March 2009 to 1.8%, up from 1.1% three months ago. Goldman Sachs thinks core inflation, which strips out volatile fresh-food prices and is the most widely followed measure, reached 2% in June, up from 1.5% in May. As elsewhere in Asia, higher prices for oil and food are the main cause of the jump in headline inflation. But even Japan’s “core core” inflation rate, which strips out both energy and fresh food, is ticking up, as higher prices for wholesale goods pass on to consumers.

All this, says Christopher Wood of CLSA, a broker, is “unambiguously positive”, because companies will regain their pricing power and because employees will, in time, get wage rises. Mr Wood, who has consistently predicted the unfolding of America’s financial crisis, is as bullish on the Japanese stockmarket as he is bearish on the American one.

### Push v pull

But others question the bulls’ assumptions. John Richards, of the Royal Bank of Scotland in Tokyo, points out that since inflation is almost entirely due to dearer food and energy, both of which Japan imports, rather than because of rising domestic demand, it reflects an unwelcome worsening of the country’s terms of trade.

The prices of Japan’s exports relative to imports have deteriorated for at least four years, but until recently growth in companies’ sales volumes had more than made up for that. Japan’s recovery was underpinned by strong exports, first to China and more recently to Europe and oil-exporting countries. Yet demand

from Asia, which takes half of Japan’s exports, has slowed this year. In value terms, exports to America are shrinking. Now, export growth to Europe looks as if it is wobbling.

Higher prices not only do harm to Japan’s external strength. Contrary to Mr Wood’s assertions, the evidence so far suggests that they are eating into workers’ real earnings, and hurting companies’ profit margins at home (as they have difficulty passing on higher costs). That undermines the willingness of firms to hire or invest. The pressure on companies to cut costs is nothing like it was when Japan was trying to dig itself out of its post-bubble mess. Still, company profits are now falling from record levels. In the first three months of 2008 operating profits were 17.5% lower than a year earlier. Historically, free cashflow is a good predictor in Japan of business investment, which, behind exports, has helped drive Japan’s six-year recovery. Now the BOJ’s latest *Tan-kan* survey of business conditions, published on July 1st, sketches a picture of worsening sentiment. Consumers are also showing signs of belt-tightening.

Not unambiguously good for Japan, in other words, but inflation may not be unambiguously bad either. An unnatural share of Japanese households’ financial assets—51% or ¥785 trillion (\$7 trillion)—are stuffed under the futon or in deep freezes, or held in bank accounts that pay no interest. This risk-averse habit is a legacy of the post-bubble deflation years, when the zero nominal return on cash looked pretty good compared with the alternatives.

No longer, perhaps. This week the BOJ kept its benchmark interest rate on hold, at just 0.5%. Richard Jerram, of Macquarie Capital Securities in Tokyo, points out that real interest rates are now firmly negative, among the lowest of any G8 economy. With the value of savings now trimmed by inflation, he wonders whether households will at last shift savings out of cash and into other assets—shares, property—offering the prospect of higher returns. After all, households’ interest income has fallen by almost nine-tenths since the early 1990s (see right-hand chart).

Predictions of just such a switch have been made countless times over the years. The difference now is that inflation expectations are rising fast. A BOJ survey released on July 4th suggested that ordinary Japanese think inflation has run at 10% over the past year. Historically, it has taken some form of external shock or pressure from overseas, known as *gaiatsu*, to induce rapid and profound change in Japan (as a result of the 1970s oil shock, for example, Japan started liberalising its finance industry). Inflation, argues Mr Wood, even of the bad, cost-push variety, will prove another form of *gaiatsu*. And when Japanese group behaviour changes, he warns, it will change fast.

Will that happen yet? One reason to think not is that the central bank has not been able to raise interest rates anything like as quickly as it would like. It has long wanted to “normalise” monetary policy, raising rates to somewhere near 2.5-3%, but darkening economic clouds abroad and at home keep conspiring to prevent that. As well as keeping rates on hold, at its regular policy-board meeting this week, the BOJ lowered its forecast for growth this fiscal year, from 1.5% to 1.2%.

For as long as money remains cheap, the second element of the optimists’ case—corporate restructuring—is unlikely to take hold. Without the discipline of higher rates, “zombie” companies will continue to eke out a living on a drip of cheap credit, while plenty of unproductive sectors and smaller businesses will escape the kind of consolidation they need. Falling profits and a lack of reform: that hardly makes for a bullish story quite yet. ■

