Trust no-one

"Predictably, there is speculation that Brexit will not happen. If Britain can vote for Brexit, it is being argued, surely anything is possible. But those who think the vote can be overturned or ignored are telling us more about their own state of mind than developments in the real world. Like bedraggled courtiers fleeing Versailles after the French Revolution, they are unable to process the reversal that has occurred. Locked in a psychology of despair, anger and denial, they cannot help believing there will be a restoration of an order they believed was unshakeable."

- John Gray, 'The strange death of liberal politics', The New Statesman, 1 July 2016.

Something rather odd is going on in the mainstream media, when the most insightful commentaries around Brexit are surfacing from publications like The New Statesman as opposed, say, from The Financial Times or The Economist. Perhaps this shouldn't come as much of a surprise, given that the most insightful reportage of the credit crisis came from the likes of Rolling Stone and Vanity Fair, through the good offices of the journalists Matt Taibbi and Michael Lewis respectively. John Gray has form here; again for The New Statesman he forensically examined, last October ('The neo-Georgian Prime Minister'), the weaknesses of a Prime Minister whose sole work experience in the real world consisted of a brief spell in public relations:

"In the world of PR, actions are episodic and discontinuous and their consequences ignored unless they have some immediate effect. All that matters is having a serviceable story, which is constructed to serve the purposes of the day, then discarded and forgotten."

We suggested recently that the EU was a kind of magical mirror, in which observers saw what they wanted to see, as opposed to what was really there. If that was true of the EU in general, it is also true of Brexit in particular: people make of it what they want to make of it; they see their worst fears in their conclusions. The sense of a political and media establishment collectively on the wrong side of history is palpable:

"As it is being used today, "populism" is a term of abuse applied by establishment thinkers to people whose lives they have not troubled to understand. A revolt of the masses is under way, but it is one in which those who have shaped policies over the past twenty years are more remote from reality than the ordinary men and women at whom they like to sneer. The interaction of a dysfunctional single currency and destructive austerity policies with the financial crisis has left most of Europe economically stagnant and parts of it blighted with unemployment on a scale unknown since the Thirties. At the same time European institutions have been paralysed by the migrant crisis. Floundering under the weight of problems it cannot solve or that it has even created, the EU has demonstrated beyond reasonable doubt that it lacks the capacity for effective action and is incapable of reform.. Europe's image as a safe option has given way to the realisation that it is a failed experiment. A majority of British voters grasped this fact, which none of our establishments has yet understood."

One of the consequences predicted of Brexit was that it would lead to economic meltdown in the UK. While the pound has clearly received a good kicking on the foreign exchanges, aiding the fortunes of the export sector and boosting prospects for the inflation that Mark Carney has been desperately trying to stoke since he came to office at the Bank of England, the more visible economic damage has been incurred by the euro zone's banks, whose share and CDS prices appear to be sending distress signals, especially in Italy and Germany.

The rule of thumb during a banking crisis: trust no-one, especially a politician. Peripheral (and now perhaps even core) Europe's banks and its governments are caught like Macbeth's "two spent swimmers that do cling together / And choke their art."

A comparison with a prior banking crisis, with US banks and their Latin American debt adventuring in 1982, is instructive. As Nassim Taleb puts it in 'The Black Swan',

"In the summer of 1982, large American banks lost close to all their past earnings (cumulatively), about everything they ever made in the history of American banking – **everything**."

Richard Koo, the chief economist of the Nomura Research Institute and author of 'The Holy Grail of Macro-economics: lessons from Japan's Great Recession' tells his story with extraordinary candour at the [Centre for Strategic & International Studies website](). The presentation becomes extremely insightful after roughly 31 minutes.

Koo recounts his time as a syndicated loan desk officer at the New York Fed. Late on a Friday afternoon in August 1982, his job, along with those of his colleagues, was to try and convince the rest of the world that the US banking system was solvent when it was not. The following is taken verbatim from his presentation:

"That was about the worst possible banking crisis in modern US history. Our conclusion was that seven out of eight money centre banks were actually underwater.. It was so bad because everyone down from Mexico to the southern tip of Chile went bankrupt.. Paul Volcker, the chairman of the Fed, called central banks and ministries of finance all around the world on that critical Friday in August 1982.."

The Bank of Japan Governor of the time was particularly difficult to locate. A Bank of Japan official who took the call from Volcker recorded Volcker's exact words for posterity. The Fed chairman stated,

"You better give me Governor Maekawa right away. If you don't give me Governor Maekawa there might not be any US banks left on Monday."

As Richard Koo puts it,

"What we at the New York Fed had to do was arrange for all the foreign banks to keep credit lines open to the American banks, knowing fully well that all these American banks were actually bankrupt. And we also could not tell the outside world about the situation because if you go out and say 'American banks are bankrupt' – the next day they ***will*** be bankrupt. And so we had to come up with these stories that 'well, there are some Latin American problems, but they're all good debt, not bad debt', and we had to lengthen the clean-up process; it was a very difficult period for US central bankers and bank regulators in general.. So by keeping this myth going, that everything is fine.. we had to do that for a very long time..”

As the least popular man in Europe once said, when things become serious, you have to lie.

Until Brexit, the Bank of England was encouraging Britain’s banks to rebuild their balance sheets. Since Brexit, Mark Carney has started encouraging them to lend again. They can do one or the other, but they can’t do both.

Russell Napier suggests that there is just one question that now matters for global investors: Wo ist der Hubschrauber ? Where is the helicopter ? Do we end up getting helicopter money, or does Frau Merkel withhold the keys to the cockpit ? The inflation versus deflation tug-of-war just got a lot more intense.

“The decline of European commercial bank share-prices before Brexit made it clear that a monetary reflation of Europe was failing. The collapse in these same share-prices post-Brexit means that even the politicians now realise that the ECB acting alone cannot stabilize the European economy. Indeed, given the evident political strains in the European Union, saving the economy from recession is now key to saving the European political union project itself.”

Helicopter money would plausibly ignite the prices of risk assets (again). A decision by the German authorities to don a hair shirt probably would not.

We were all told to expect bad things from Brexit. But surely not even the most delusional Bremaniac expected that the euro zone’s banks would start to collapse as soon as the UK voted Leave. Given the state of the EU’s crumbling foundations, it is probably best that we left when we did. Now the roof seems to be falling in.

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