Bananaland

Decades ago a diplomatic friend was attached to a delegation to the Inter-American Development Bank (IDB), a sort of Western Hemisphere version of the World Bank. The IDB had lent lots of money to a country we will call Bananaland and Bananaland had just gone through one of its periodic political upheavals. In a popular uprising a left-leaning, socially conscious leader (call him Señor Juan) had (with the support of the church and a couple of rural brigades of the army) managed to overthrow Bananaland's dictator for life (call him General Jefe) who had fled to where he had stashed all his loot.

Shortly thereafter the IDB delegation arrives in Ciudad Rico (Bananaland's capital) to discuss past-due interest on some of its loans. Señor Juan checks el Banco Central and finds: nada, nothing. General Jefe has been busy. So Señor Juan tells the IDB delegation that, with mucho regret, Bananaland must repudiate the indebtedness to the IDB because General Jefe took all the money and los pobres of Bananaland didn't benefit from it at all.

Whereupon the IDB delegation huddled, then turned to Señor Juan and said, "We understand. But if you repudiate the loans, we will have to take a write-off and possibly a downgrade and we will never be able to lend you any more money. Whereas, if you acknowledge the loans, our credit rating will remain investment grade and we will be able to lend you enough money to pay past interest and also enough money for the many social programmes that Bananaland so clearly needs." Well, pragmatism won the day. Señor Juan signed up for the new loans and General Jefe kept his ill-gotten gains in a faraway place. Peace in our time.

[A year ago the IDB's loan loss ratio on a $60 billion book was less than a quarter of one per cent so presumably the beat goes on. Now, as then, who knows what the real numbers are?]

We cite the above because it was a precursor to what has followed. Now financial funny stuff is endemic amongst all governments and quasi-government organizations with not only the blessing, but also the complicity, of establishment regulators, banks and so on. And the level of funny stuff has increased dramatically. Today the establishment, as well as fixing things so that bad paper is transformed into good paper, is happy to arrange (for a modest multi-hundred million fee) to have tens of billions evaporate from someone's national debt. Getting stuff off balance sheet has become an art form – just look at Ontario and its public/private stuff. Ontario taxpayers will be burdened with heavy interest charges for decades, but billions stay off the balance sheet.

It's all fantástico. Water into wine. Enron used to do this, with the guidance of Arthur Anderson.

Many investors seem to assume this craziness will go on forever but we don't think so. The solution to Bananaland's little problem was microscopic compared with what is going on with the mightiest powers in the world today. Will the public see through all their charades? Not everybody, but little Iceland provides an example. A few years ago establishment banks, regulators and so on in Iceland, Britain and elsewhere got Iceland hocked up with $5 billion of debt to Britain and the Netherlands ($5 billion they appear unable to pay) and now, in a typical establishment deal, the IMF appears ready to lend the $5 billion to Iceland if Iceland flows the money through to the Anglo-Dutch creditors. By extension this would leave the Icelanders (population 320,000) effectively holding the bag to the IMF (about $50,000 per household) for problems created by a few bankers and regulators. However, in a recent vote, the Icelanders said no thanks to the IMF/British/Dutch proposal. With Sterling under Pressure, the IMF, Britain and the Netherlands appear desperate to paper the situation over and they will try again. But the message is clear; people are developing contempt for big brother.

Now suppose the establishment types from Brussels, Berlin and Paris cook up your standard deal to bail out Greece (for a few months). The usual panacea is a loan from big banks with guarantees from big governments, thereby keeping the liability off balance sheets. Maybe Greece can also raise funds by securitizing receipts from tickets for tours of the Acropolis. Or will the Greeks move way to the left, repudiate the debt, kick out the bureaucrats from Brussels, leave Euroland and live with a heavily devalued Drachma? This is what Argentina did (wisely) in 2002 (over the objections of the US and the IMF). After all, the last thing Greece (or any of the other basket cases) needs is more indebtedness, yet that is the only thing the great white knights talk about.

And will the German electorate see fresh loans to Greece as good money after bad and kick out Frau Merkel? Finally, when Greece (or someone else) does default, the European banking system will receive a huge, maybe even mortal, jolt.

The UK, the US, more than half the states in the union, some key provinces in Canada, the Club Med nations, East Europe, these and more are in the same shape as Greece. The guys who, in theory, should do the bailing out are themselves in need of being bailed out. The whole world is fast becoming a Bananaland.

We are entering a global financial crisis and countries will increasingly be governed by a spirit of *maître chez nous*. It will not be good for anybody's sovereign debt (i.e.: bonds) nor for currencies which, rather like parachutes, will descend, some slowly, some quickly, to ground level.

None of this will help the economy, but a soft economy is still better for investors in good stocks than investment in deteriorating money.

Murray H. Pollitt, P. Eng.
murrayp@pollitt.com

Toronto, Ontario
March 8, 2010