



www.itulip.com

June 8, 2010 (transcription date)

Eric Janszen (EJ) Interview with Alex Jurshevski (AJ)

We've spent years talking to academic or industry economists who've given us a good understanding of the myriad ways governments drag economies into a state of over-indebtedness and how, theoretically, they might get out of it. It's far easier to pontificate and speculate about debt and money going on in Greece, Iceland and ex-Soviet countries, and speculate about euro zone countries leaving the euro than it is to work through a debt crisis with the relevant parties, with representatives of government and of international financial institutions (IFI) such as the IMF, within the operational constraints of the real world.

After all of the newspaper editorials are written someone still has to sit down with private and public lenders and borrowers to work out a deal and execute on it, even as the accusations fly in the press and angry citizens take to the streets. Such a person has the experience to offer informed opinions on risks, options, and outcomes for the sovereign debt crisis that has followed, with gruesome predictability, the global financial crisis before it. That's where our guest, Founder and Managing Partner of Recovery Partners, Alex Jurshevski comes in.

Alex Jurshevski has more than 20 years of experience in investment management, M&A and advisory work. His firm offers Principal Investment and Risk Advisory Services in the area of distressed assets and turnaround management. During his career, Mr. Jurshevski has been involved in over US\$40 billion of financial restructurings and over US\$20 billion of primary transactions. He has been a managing director of the Bankers Trust and has also worked with the Investment Banking Division at Nomura. He was on the European Management Committee at NIplc and was also the Chair of the Emerging Markets Trading Committee, head of portfolio management operations for the New Zealand government in the New Zealand Debt Management Office (NZDMO), and a member of the Advisory Panel on Government Debt Management and the World Bank's Government Borrowers Forum

EJ: Alex, we very much appreciate having the opportunity to talk to you today.

AJ: It's a pleasure to be here.

EJ: Give us the full rundown on your background.

AJ: Well, my background is actually as a professional economist, monetary economics and econometrics. I did my graduate work at McMaster and my undergrad at McGill up here in Canada following which I joined the Bank of Montreal as a financial economist. Apart from watching the Bank of Canada and the Fed this also involved bankruptcy research, assessment of fiscal policy and also projecting what we call up here "the all-bank balance sheet" which was part of the planning processes for the various production areas in the bank. So I cut my teeth early on by understanding financial flows and policymaking in the Canadian economy and the US economy,

EJ: That was in the early 1980s?

AJ: Yes. That set the base for moving over to the trading side in the mid 1980's with the Bank of Montreal. Within a couple of years I was running all of the short-dated businesses in the trading room. I had about ten people working for me dealing FRAs, Futures, Over-the-Counter Options, Caps, Floors, Collars, that sort of thing. A few years after that, subsequent to the 1987 crash, my boss and I were looped into the Brady Commission, an investigation into the causes of the crash. We provided the submission on behalf of the Canadian banks through the CBA (Canadian Bankers Association) to the Brady Commission in response to their questionnaire and survey. So I got into sort of larger scale financial issues at around that time.

Then I moved over to CIBC where I was running a multi-currency derivatives book, long-dated fixed interest swaps and cross currency structures primarily. They sent me to Tokyo to run Capital markets and so with that background I was recruited by the government of New Zealand in the early 1990s to clean up the debt problem in New Zealand. They had a portfolio that was completely miss-specified. They had under-developed capital markets. It was a complicated collection of problems but the main one being that they had too much debt. They were in a very slow growth type of mode because they were coming out of the end of a long period of austerity following the currency crises in the mid 1980s. And also the composition of the debt was inappropriate for their risk-appetite. It had a very small concentration of domestic debt and a very large concentration of foreign currency debt that was denominated in a number of different currencies. Long story short, it took about three to four years to clean that mess up.

Following that I went to London and worked in private equity for about seven years and that got me into a number of different economies in central and eastern Europe, on top of the developed economies in Europe and North America, where we were doing acquisitions of financial services companies, pubs, manufacturers and other private-equity situations.

Following that experience I founded *Recovery Partners* around 2000 in London, England after the tech wreck. *Recovery Partners* was initially established as a turnaround practice where we would go into distressed businesses, look to see what the problems were, whether it's a financing issue, an operational issue, a personnel type issue requiring an interim management stopgap--what have you. We'd supply appropriate advisory to those companies to try to get them back on their feet again—get them refinanced and off to the races.

Around about 2002 my old employer CIBC called and hired *Recovery Partners* to help manage their Basel II compliance program. And we took over half of the compliance activity for CIBC, working inside CIBC, helping them build credit-risk models, operational-risk models and bringing them generally into compliance with the requirements of Basel II. In that process I moved back to Canada from London along with my family and the bulk of the *Recovery Partners* business over here. Following the CIBC contract we repositioned the business slightly. While we are continuing to offer turnaround and restructuring advisory services and we have also tacked on an ability to invest in distressed loans that banks or near-banks were looking to divest from their portfolios because of the increased capital or just simple distress; or because they weren't equipped or prepared to deal with a specific non-performing loan situation.

EJ: According to a recent story, you have \$500 million burning a hole in your pocket for that purpose. How many countries have you worked in recently?

AJ: It is more accurate to say that we have solid investment relationships that back deals that we source. We've been doing that business for about three-and-a-half years now on top of the advisory business and *Recovery Partners* has worked I guess in about five or six different economies. Most recently we were in Iceland speaking to the Government about the need for a comprehensive debt management strategy and offering advice on their relationship with the IMF going forward.. Earlier we were on a retainer from one of the main IFIs to clean up a big debt problem in Tajikistan. We've done acquisitions in the US and Canada. So it's been a variety of engagements.

EJ: Has the Global Financial Crisis (GFC) been as good for you business as one might expect?

AJ: The GFC has brought with it expectations of a huge flood of business but we have not seen that as yet up here in Canada. The amount of distress we're seeing up here in Canada is actually less than it was two years ago before the crash. That said, there's quite a bit of activity in Europe and there's a growing sovereign debt problem worldwide. If we look from east to west I don't think there are too many economies that are not affected by pressures on credit ratings and country finances. I guess the two islands of prosperity in this whole thing are Australia and Canada. But generally speaking, we have a world that is sinking deeper in debt. There are more problems and we think that the bulk of the opportunities we have been expecting to emerge for the last four or five years ago still lie ahead of us,.

EJ: Great, then with your credentials firmly established, we have many questions. Let's start with the sovereign debt crisis in Europe. The popular press here characterizes it as like a government debt version of the US sub-prime lending crisis, prone to contagion. Is that an accurate analogy?

AJ: Well, yes and no. I think what we saw as a response to the GFC was obviously a resort to what is now widely known as quantitative easing (QE) which, when I was in college studying economics was called "printing money." There are second-order effects of Fed-mandated quantitative easing that are underappreciated. In the initial stages of the crisis governments were expected to widen their fiscal deficits, add more stimulus to the economy on the fiscal side and aggressively expand monetary policy—move to an expansionary policy—to support activity and to prevent a worse crash from occurring. As a stopgap, that policy did succeed in forestalling a much worse crash but what we are now seeing in a number of the weaker economies, especially, whose finances were not as strong going into the crash as other economies, are second order effects that include unsustainably large structural government deficits that need to be addressed. Those government deficits in turn are feeding back into expectations for some of those economies that there may be a real probability of sovereign default.

EJ: Who is on the top of your list?

AJ: That depends. Iceland, for example, is a special case. They would have crashed whether Lehman's had gone down or we had a GFC or not because they were out of control for a whole different set of reasons. If we concentrate on Europe, the economies that seem to be in trouble are those that have taken on too much debt, that have not managed it appropriately and don't have the social contract to be able to address it in a short enough period of time. Fiscal imbalances loom large, and I would include, obviously, among the cast of characters the PIIGS: Portugal, Ireland, Italy, Greece, Spain. Those guys

are definitely out of control but there is a whole other cast of characters behind the curtain that have been having the same sets of troubles.

They would include many of the Eastern European countries—Latvia in the Baltics, the Ukraine, Hungary. These folks are all having the same sets of fiscal issues. You've got the huge fiscal imbalance in Britain as well, which is a very important European economy. The deficit this year is expected to come in somewhere around 12% of GDP. That's unsustainably large. Britain already has a fairly high debt-to-GDP ratio and similarly even the mainstream economies like Germany and France that appear to be in better shape also have very significant financial requirements in terms of their funding gap.

Looking across the entire OECD this year you're looking at a funding gap on the order of \$12 to \$13 trillion that needs to be funded and this is going to create pressures in financial markets—pressures we're already feeling now in the sense that the markets have gotten very balky. There's limited liquidity in a lot of the funding markets. Many deals are being pulled. Even up here in Canada we're seeing a number of IPOs for good issuers being pulled because the investor base has simply retreated and is, I think, waiting for things to shake out. This is, in my opinion, one of the worst crises I have ever seen and it's something I don't believe is going to go away as a consequence of the "reflate-and-wait" strategy which is what I think the authorities were counting on when they implemented the QE to start off with.

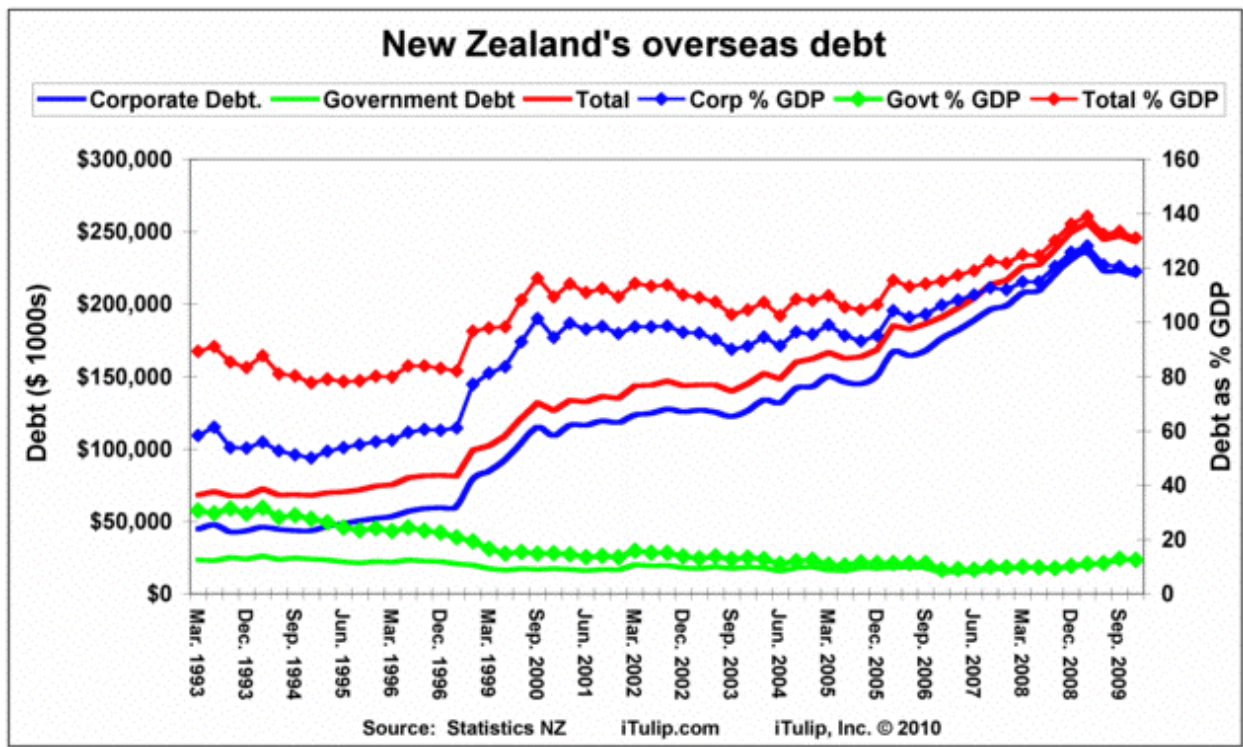
EJ: Given that you've been at this since the early 1980s, that's saying something. If reflate-and-wait isn't going to fly, let's talk about scenarios. The theory behind reflate-and-wait is that once a reflat economy becomes self-sustaining it grows itself out of debt. But public debt levels, at least in places like the UK and the US, were so high before the GFC and unemployment was so high after the crisis that the amount of stimulus required to get the economy moving again left these countries hopelessly indebted relative to income that can be generated to grow tax revenues enough to cover the debt. They are likely to find themselves needing to do a second round of stimulus but won't have the credit to do it.

AJ: Well, exactly. Going back to first principles, there really is no evidence of a "Keynesian Multiplier." I mean this idea that if the government steps in and fills an output gap it's going to lead to additional activity down the road. There is absolutely no evidence of that historically to ever have worked so what you end up with is the government applying a short-term patch. In previous cycles there was enough underlying momentum in the economy to propel the economy forward to make it "look" like the government stimulus was actually having an effect, but in fact, if you filter out all of the extraneous influences, you typically find that government spending produces slightly less output proportionate to spending, or a lot less. In other words, there is a cost to the activity of reflation and the cost gets passed on to future generations.

EJ: What's the probability of successful fiscal consolidation?

AJ: In the last 20 years I'm only aware of two countries that successfully consolidated their finances and worked themselves out of a debt hole without a default or a restructuring. Here I am talking about countries that lowered their Debt to GDP ratio by 10% or more – which is what is required now pretty much across the board. One of those countries is Canada, which embarked on a process of fiscal consolidation in the mid-1990s. That process was complete about seven or eight years later. Debt-to-GDP stabilized and moved down. The government moved into a primary surplus and things were fine. The other economy is New Zealand where you had, in response to the currency crisis of 1984, a very focused political platform amongst all the parties in New Zealand to concentrate on debt reduction and

fiscal consolidation. Over a period of about ten or eleven years, between 1984 and 1995, they were eventually successful.



NZgovtdebt.gif

The conditions for successful consolidation in places like Greece, Spain, the UK, the US simply don't exist because you don't have the political consensus that's needed as a first order condition for one of these programs to ever take off successfully. In Greece, for example, you have a very large rentier class that has benefited the last couple of decades from government largesse. The fact that they have a debt problem is why there's not going to be any political consensus to solve the debt problem—because you have a large part of the electorate that's benefiting from the current set of arrangements. Therefore, voting in a government that is going to implement a serious program of austerity and get the fiscal house in order is a low probability event. The same is true in Spain and certainly true in the UK and, for that matter, in the US where by many calculations you have over a hundred million electors who are directly tied into federal and state government spending programs in one form or another, whether they're employees of government, collecting unemployment insurance, welfare, social security, or food stamps. If you've got that many people on the "gravy train" it's hard to see how, through an election process, you're going to get support for austerity where those people end up being the losers—especially when the historical evidence shows that this could take a decade or more.

The problem the world faces from a policy-making standpoint is that we are caught in this fiscal trap with no real politically feasible way of generating the consensus needed to implement policies that will get us out quickly enough to avoid a more serious crisis.

EJ: Let's say for the sake or augment that the political will and consensus develops to, for example, get the US fiscal house in order. Wouldn't that necessitate massive cuts in government spending, especially the military?

AJ: Huge. Huge. A lot of it depends on your starting point. Russia, for example, defaulted in 1998 with only about 50% debt-to-GDP ratio. Latvia defaulted I believe in 2008 with only around 30% debt-to-GDP. Those are manageable debt-to-GDP numbers as long as you know what you're doing in terms of debt-management. If, however, your starting point is where Greece is, at around 108% debt-to-GDP, or Iceland at around 104% debt-to-GDP, there the difficulty is quite simply the fact that once you're up around those levels the interest bill as a portion of government spending starts to crowd out other expenditures—such as schooling, housing, welfare, and health. And so you end up with a situation where the government budget simply can't bear up to the strain and the impetus really becomes one of "let's default on this debt" or "let's inflate the debt out of here" because mathematically, once you're at 100% or more, you're on a treadmill.

EJ: What's preventing the treadmill from running out of control?

AJ: Right now what's preventing the treadmill from spinning out of control and throwing most of these countries onto the ground immediately is simply the fact that nominal interest rates are at, or close to, zero. Real interest rates are actually arguably in many economies below zero. If we were to have an interest rate shock most of these folks would end up going into the tank right away and therefore the probability of a fiscal consolidation plan succeeding—a fiscal consolidation plan would typically have a time frame of say five to ten years—the probability is low of something like that succeeding in an environment where you are vulnerable to an interest rate shock. At the same time there's incredible pressure on your finances because of a very large interest bill as a proportion of government expenditures. Under these circumstances, the probability of these fiscal consolidation plans succeeding today is very, very low in the context of the history.

EJ: Now that we've described the crisis-prone environment, let's talk about potential triggers for a sovereign debt crisis among the countries that you've mentioned. There was a very good paper written by Roubini back in 2003, that we went over in some detail on iTulip about a year ago [link], that identifies different thresholds that individually or in combination tend to trigger a sovereign debt crisis. One of those is when foreign currency reserves fall below a level that markets believe is sufficient to cover the interest payments on foreign debt owed in a foreign currency. Is that a likely trigger in any of the countries that you're looking at?

AJ: Well I think that's probably a likely trigger certainly in Iceland. Not so much in the euro zone, obviously, because they owe their debts in euros and the ECB can print euros to pay off the euro debts in these countries. But in a number of the Asian countries such as Kazakhstan one of the triggers might be exchange reserves. Another crisis trigger might be the reset profile of government debt—if they've got a lot of floating rate debt and rates rise and the market sees that they're going to have to roll over and reset at higher rates. Another scenario for countries that have large maturities coming up that need to be refinanced and the markets are unfavorable and possibly the refinancing might fail. That's something that affected New Zealand just prior to my arrival there. There are a number of different triggers that individually or in combination can lead to default.

EJ: Others?

AJ: Another would be a monetary policy signal event, such as if the market sees, say, in Latvia, that the authorities are starting to expand the money supply very aggressively. Or in Spain or Croatia—these types of places that are also in the “red zone”. If they see rapid monetary expansion they may discount towards the future and say “Jesus, these guys are out of control. We want to pull out.” Then you end up with capital flight, collapse of the currency and—boom, you’ve got a crisis. **It all has to do with capital flight, what the triggers are that will spook foreign or domestic investors to want to get out of government bonds, to want to get out of that currency and want to get into something safer. This is why the United States is in also a very vulnerable position, one that could under certain circumstances see things unravel much more quickly than anyone currently thinks possible.**

The Red Zone

Rank	Country	Debt / GDP	Moody's	Rank	Country	Debt / GDP	Moody's
1	Zimbabwe	304.3%	Not Rated	28	Netherlands	62.3%	Aaa
2	Japan	192.1%	Aaa	29	Norway	60.2%	Aaa
3	St Kitts and Nevis	185.0%	Not Rated	32	Spain	59.5%	Aaa
4	Lebanon	160.1%	B2	43	Cyprus	52.4%	A2
5	Jamaica	131.7%	B3	49	Turkey	48.5%	Ba2
6	Singapore	117.6%	Aaa	51	Croatia	47.7%	Baa3
7	Italy	115.2%	Aa2	52	Poland	47.5%	A2
8	Greece	108.1%	A2	55	Finland	46.6%	Aaa
9	Sudan	104.5%	Not Rated	61	Switzerland	43.5%	Aaa
10	Iceland	100.6%	Baa3	62	Sweden	43.2%	Aaa
11	Belgium	99.0%	Aaa	90	United States	90.0%	Aaa
16	France	79.7%	Aaa	69	Denmark	38.1%	Aaa
17	Germany	77.2%	Aaa	70	Slovakia	34.6%	A1
18	Portugal	75.2%	Aa2	78	Czech Republic	32.8%	A1
19	Hungary	72.4%	Baa1	80	Latvia	32.5%	Baa3
20	Canada	72.3%	Aaa	85	Slovenia	31.4%	A2
22	United Kingdom	68.5%	Aaa	86	Lithuania	31.3%	Baa1
23	Austria	68.2%	Aaa	90	New Zealand	29.3%	Aaa
25	Malta	66.2%	A2	100	Bulgaria	21.4%	Baa3
26	Ireland	63.7%	Aa1	103	Romania	20.0%	Baa3
Average	World	53.6%	N/A	Average	World	53.6%	N/A

Source: CIA World Factbook (<https://www.cia.gov/library/publications/the-world-factbook/>)

Notes: Japan's Public sector debt is very high. However, Japan has a high savings rate which makes it easier for the government to finance the debt. 90% of Japanese debt is owned by Japanese individuals. Nevertheless the National Debt of Japan is a real burden for the economy. The US has a low savings ratio and 25% of US debt is owned by foreigners. The numbers for the US also do not include off-balance sheet obligations. An important factor is not just cumulative national debt, but, the annual budget deficit. This annual deficit determines the rate of deterioration in the public sector debt

EJ: We wrote a piece a couple of years ago [link] on sudden stops as the process might apply to the U.S. Surveying various countries, such as Korea during the currency crisis, the sudden stop process depends on a complex mix of factors. For example, in the second crisis in Argentina in ten years in 2001, the debt and currency crisis was triggered by the US financial markets crisis; the US was its primary creditor standing behind the IMF and the US decided it wasn't going to support Argentina any longer. The US had its own problems. Could the same principle possibly apply to the US and China? What if China were to run into serious economic trouble that made it difficult for them politically to continue to finance the US economy?

AJ: Well, I think that's sort of a medium-term problem. In the short run the US would simply resort to the printing press in order to get its bonds out the door, but certainly in the longer run, China is a very important source of funding for the US. If it were to run into such difficulty that it needed to resort to bond sales in order to maybe fund its own domestic spending programs, or maybe it wanted to sell some of its own US-dollar-denominated currency reserves in order to shift into another currency rapidly—I think that could cause enormous upheaval. But in the short run, because the US is the world's reserve currency you're cushioned from the effect that might have if you were, say, Russia, or if you were a Latvia or a Iceland where you owe debt in another country's currency and you're a much smaller economy and what happens outside means a lot more than what happens inside.

EJ: Nonetheless, even if the US is the world's largest economy and issues the world's reserve currency there must be a threshold someplace.

AJ: The US from a long-term perspective is definitely vulnerable geopolitically and financially by virtue of the fact that a huge chunk of its debt is held offshore now . You have three large creditors: China, Japan and the UK that collectively own up to 50% of the US government debt that is held offshore. All three of those economies have their own problems. If they were to stop purchasing US federal government debt, if they were to slow it down and heaven forbid if they were to go into reverse and pare down some of those holdings, I think it could have a very meaningful impact on the US interest rates. It wouldn't push the country into default, however. As I say you'd likely get a printing press response from the Fed and the bonds would be issued and they'd be put on the Fed's balance sheet and the cash would move from the Fed account into the Treasury account and life would go on for the time being. But the US would not escape without some financial consequence. I think in the short run that financial consequence would be confined to a loss of face from a political standpoint globally and in terms of a financial impact it would be probably reflected in unsettled conditions in financial markets, pressure on equities and higher interest rates in the US.

EJ: Greece demonstrated that another debt crisis trigger is an election. The election in Greece last fall triggered the debt crisis when the new administration arrived and used the regime change as an opportunity to unload the news on the markets that Greece actually had nearly twice as much government debt than the previous administration reported. A similar event just happened in the UK. Do you think we're going to see that throughout the next election cycle across Europe?

AJ: Well, I think the problems are now so obvious that it doesn't matter who is in charge. In Iceland it doesn't matter who is in charge, they're going to have to deal with the problems. Who gets in and how quickly they deal with the problems is going to be the arbiter of whether or not they're going to be successful. One of the issues we have in many of these places is that there is tremendous denial as to what the problems are and as a consequence you don't have a political consensus in those places regarding the appropriate solutions. If we look at Greece, Latvia, Spain, Ireland, all of these countries are pointing fingers at someone else and saying it's someone else's fault and somebody else has to bail them out. In the case of Latvia, they seem to believe that the European Union is going to bail them out. In Iceland, they seem to believe that if they join the European Union everything is going to be resolved. The reality is, until there is political consensus amongst all the parties across the political spectrum and a platform launched by each party in relation to fiscal prudence and debt management, you're not going to see any of these problems dealt with.

This is what we told the folks in Iceland when we visited them about six weeks ago. We said that one thing we don't see in this economy is a consensus on the need to tackle some of these financial issues first and leave off some of the other less important issues from the political agenda to a later date because they really don't matter. But they don't have the consensus. You did have it in New Zealand where all the parties were united from say the mid to late 1980s on, once the enormity of the problem became apparent. Every party, from left to right, had the same view on debt management. We need less debt. We want to get it managed and we want to do it in a cost-effective and low-risk way. That was part of the mandate of the Labor Party that instituted the reforms initially that then became part of the mandate of the National Party that carried on, and those two parties were different ends of the political spectrum. If we look at many economies, there is still not even recognition nor a common understanding of what the problems are. And it would be hard to see, even with changes in government, if you don't make common cause across party lines on common problems, it's hard to see how any change in government is going to result in any better approach to these issues if the importance of the issues and the urgency with which they need to be addressed is not recognized.

EJ: Here in the US there is only one time, in my lifetime, that there has been a political consensus to follow a line of economic policy that was politically unpopular. The Volcker Fed produced a massive recession that went on for nearly three years. The forcing function for broad political alignment was a very high level of inflation in the late 1970s. The prospect of hyperinflation motivated a consensus between both major political parties here to raise interest rates and put the economy through what would be considered some pretty severe austerity measures by today's standards.

AJ: The Volcker recession.

EJ: Yes, the Volcker recession. The inflation crisis was one that everyone across the political spectrum could see and everyone understood the consequences or not addressing it. Today there is no single crisis to point to, but many; we're a dying a death by a thousand cuts. There's no one unifying issue to point to that everyone can rally around and identify as a problem that unites. There is a splintering of perceptions of what the problem is and solutions to the problem. Would you agree with that?

AJ: I totally agree with that. It speaks to what I said in answer to the earlier question. You don't have a consensus view that these financial issues are very, very important and need to be dealt with as the number one priority. It's simply not in the public consciousness and in part that's because governments have spent decades trying to convince the public that other things are more important. For example, Obama's healthcare plan. A visitor from outer space with some knowledge of finance in the 21st century on Planet Earth would have fallen off his chair if he saw that the first thing that Obama spent his political capital on was a bill that nobody understood, that nobody wanted, that took two or three months to ram through Congress in place of taking a leadership role in addressing the very serious ongoing financial crisis we have in the US and elsewhere. I mean, it's just mind-boggling that you end up with a political outcome in the first year-and-a-half of a Presidency that doesn't address any of the fundamental issues that need to be addressed.

EJ: One way this can be understood is that the US is, in the words of [Simon Johnson], now heavily influenced by a financial oligarchy and if you're in a leadership position in this country you can't politically take a very strong position about reining in those industries. We have this heavily subsidized real estate industry here that is largely responsible for the GFC. Obama is happy to complain publicly about the overly cozy relationship between the oil companies and the oil industry regulators contributing to the

catastrophe we have in the Gulf but he would never mention that an overly cozy relationship between the regulators and the financial industry over decades resulted in the financial crisis that we have.

AJ: Well, absolutely. And I mean this whole question of more regulation, or different regulation, or changing the regulatory authorities and consolidating power with the Fed, these are all red herrings. These are all diversions. What the problem was regarding regulation and its relationship to what happened in the crash is the fact that you had all the regulations in place to avert this catastrophe but they weren't enforced! They weren't enforced! And they weren't enforced because it was a wink and a nod the other way. There's good evidence to suggest that the Fed knew and the SEC knew for four or five years before Lehman finally went bust that Lehman was in fact insolvent. Nobody did anything.

EJ: We interviewed Bill Black and got all the detail on that we could ever want. Where does that leave the US banking system? Is it in better or worse shape than reported by the FDIC?

AJ: We've got a situation now where bank regulators, in my view, in the United States are understating the scale of the bad bank problem in the United States and they're understating it in part because it wouldn't be politically expedient to reveal yet "another" large black financial hole. Other reasons could include the fact that they're having difficulty—there's indigestion—they're having difficulty identifying a way in which to deal with the size of the problem. They're having difficulty in finding counterparties for a lot of the failing and failed institutions and they're unwilling to go to an auction or other large-scale disposal framework for dealing with the issue.

The bottom line is that the public is not being told how bad this issue is and its related to the fact that they're keeping a closed book on everything that is going on. I think Ron Paul's bill that he tried to push through—which was eventually defeated on a technicality because they told him it was an appropriations matter rather than a stand-alone bill—Ron Paul's efforts to get the Fed to open up its books are well-intentioned but doomed to fail because no one wants the Fed to open its books. Because at the end of the day the Fed's shareholders are the deposit-taking institutions in the States and they need the Fed around to bail them out if they get into trouble. And who on earth out of any of those folks in that shareholder group would want to reveal how the Fed actually operates? It's very shadowy. We used to joke about it when I was a Fed watcher but I think we're in a situation where the Fed has more than doubled the size of its balance sheet. There have been hundreds of billions of dollars of bailout funds coming from taxpayers that have been thrown at this problem and yet there doesn't seem to be any accountability. The only way you can get to this point is if there is a kind of oligarchy that is working hard to maintain control and a key part of their effort is to keep the books to themselves.

EJ: In your estimation how much worse off is the US banking system than is currently observable by looking at the FDIC's bank data?

AJ: Well, at Recovery Partners we've actually done a bit of work on this recently and what we find is that during the S&L Crisis, the loss-severity, that is, the amount of money the FDIC deposit insurance fund would have to come up with to bail out or to restructure a failed institution usually amounted to about 10% of assets on average. In the current scenario, we did some runs on the failures since 2008 to date and we're finding the loss-severity on average is about 26% of stated assets at the time of failure. So we've got a very significant increase in loss-severities, in fact two-and-a-half times as large.

EJ: So the current banking crisis is two-and-a-half times larger than the S&L Crisis in terms of loss-per-institution?.

AJ: Yes. On a per-bank basis. However the cash cost on a per bank basis is six and half times as large as it was in the previous period, rising from around 45 million per bailout in the late 1980 and early 1990's to about \$300 million per institution currently. In the previous crisis twenty years ago, you were losing ten cents on every dollar, now when the FDIC goes in they're finding they're having to put up 26 cents on every dollar of the process. So both the loss-severity and the dollar costs are far higher. At the same time the published reports from the FDIC suggests that the peak loss experience in terms of the number of banks that are failing is only 100 per year. In the previous cycle, during the late 1980s/early 1990s, the peak loss was 300 banks a year. So we're being told that the number of banks that are failing is one-third as large as before, yet the loss-severity is two-and-a-half times as large.

EJ: And the answer is...

AJ: **The FDIC is currently reporting just shy of 800 bad banks on the FDIC's watch. We've done some work on this and it suggests to us that the actual number of bad banks on the FDIC's watch list should be around 2,000.** So we think this phenomenon is being vastly understated as far as press awareness and mainstream media awareness of this issue is concerned. The objective numbers that are being reported suggests that it can, in fact, be quite a bit more severe. And that's just on average. We then have to figure is, "Gee... if the loss-severity is *that* bad on average, how safe are the big banks?" Have we actually bottomed out all the issues with the big banks? We know that a number of them have repaid TARP funds. They're out from under the obligation to limit salaries now. Big surprise. But at the end of the day you have to wonder if the increase in loss-severity whether or not some of the bigger banks are still operating on very shaky foundations. So I think whichever way you slice it we're a long way from being out of the woods on the problems in the US banking system as a consequence of the financial crisis.

EJ: Who is keeping these banks afloat?

AJ: Well, we think that the US policy authorities are following a variant of the "extend and pretend" scenario. It's the flip side of what is happening here in Canada. Here in Canada we have five large banks that are responsible for about 60% to 70% of banking activities, depending on which sector you look at, and they've kept a lot of zombie borrowers afloat. In the US we have the other problem: the zombie borrowers are being taken care of through default, restructuring or liquidation but the zombie banks aren't. I think the FDIC knows of additional banks that should be on the watch list and they're monitoring the situation very carefully. There's a reason why the Fed balance sheet has expanded enormously and why it's going to be very difficult for the Fed to shrink its balance sheet and that's because it has taken on a lot of toxic collateral from some of these shaky institutions in order to refloat them with cash. The Fed doesn't want to disclose whom they've dealt with. Chairman Bernanke has said that on numerous occasions. I think that this scenario could certainly drag out. If we look at what happened in the 1980s with the S&L crisis, I mean this could certainly drag out for another few years, particularly if you consider that the implications of a problem as severe as we are estimating it is include the fact that \$500 to \$700 billion funding is required to settle the bad bank issue

AJ: Yes, *Recovery Partners* has direct experience with that in the last two years. A couple of years ago we were called in to a central Asian economy—this is on the public record—by one of the IFI's. There was a question over some agricultural lending that had been taking place in the country for the previous seven or eight years. The roll-up on this liability was about \$500 million. After we investigated the situation and reported back to both the government of that country and the IFI that had hired us, we determined that there had been sovereign guarantees that had been provided to a holding company that was making these agricultural loans, that these loans themselves were worth maybe ten to fifteen cents on the dollar now, and that the ultimate organization on the hook for the loss was the nation's central bank. There was an audit of the central bank performed later that confirmed that finding. We also found that there had been pledges of foreign exchange by the central bank to collateralize the offshore loans. Long story short the central bank had polluted its balance sheet with illiquid assets, assets that were unsaleable and worth far less than the economic value that the central bank had supplied.

EJ: Just like the Federal Reserve Bank in the US. So what happened to the central Asian country's central bank after all of this became known?

AJ: It went bankrupt. That would happen in any other economy where a central bank wrapped up its balance sheet to the extent that the Fed has in old newspapers and dodgy IOUs.

EJ: How does the Fed get away with it? Reserve currency privilege?

AJ: Yes, you've got the world's reserve currency. The US dollar might be a dirty shirt, but it's the cleanest shirt in the closet. That gives the Fed and the US government enormous leeway internationally in getting away with a lot of these financing capers. In the absence of that the Fed would have no leverage whatsoever. The obvious example is what happened to the British in terms of world standing during the Suez crisis in 1956. Once the world went off the gold standard back in the 1930s, and then the Pound Sterling ceased to be a major reserve currency after the Second World War. The UK was bankrupt. It had been refloated by loans from the US. You found that the UK had lost all kinds of political flexibility because when they and their French Allies went into Suez in response to the closing of the canal by the Egyptians, the United States told the Brits and the French: "Get out or we'll call the loans." The Brits and the French had no flexibility, they backed down.

EJ: The equivalent today might be the Chinese telling the US to close down many of its military bases, such as in Japan, so the Chinese don't have to keep lending money to the US so to finance them all.

AJ: Yeah, they could try that but I don't think they'd get too far. There are too many cross currents in that relationship, not the least of which is that the Chinese can't yet project military power much beyond their borders. They do have some financial clout but they need to use it wisely because the US could easily turn around and say, "Okay. Fine. We're going into partial default." That might be one of the solutions that the US eventually selects if they can't get out of this.

EJ: How does a country partially default?

AJ: To invoke partial default, the US simply tells the Chinese, "you guys are off-shore creditors, we're going to stop paying interest on our debt. Your securities are being reclassified. We're going to continue to pay interest on our obligations to our domestic creditors but if you're off-shore, you only get principal payments and guess what we're unilaterally extending the maturity on the debt that you hold." That's a viable option if you've got the reserve currency and you carry a big stick. You simply tell the Chinese either continue to play ball or we'll cause, "your securities to be worth half and carry no coupon."

EJ: There is some precedent for that. The US has in the past reclassified short-term government bonds debt to long-term bonds: "As of today your one year Treasury bonds are 10 year bonds. Have a nice day." There are all sorts of tricks a reserve currency creditor with a powerful global military can play, right? This is the reason the US gets away with paying down foreign debt with stealth currency depreciation the way it has since 2001.

AJ: Absolutely. Absolutely. And that goes for the private sector as well. They are playing around with mark-to-market rules and classification of securities on bank balance sheets, too. It's become very much a shell game. In our opinion this is part of the reason why equity markets are going to have such a very difficult time for the foreseeable future because you have general recognition, I believe, that the quality of bank balance sheets in the US is not what they're reported to be, that the quality of earnings is not what it is reported to be. That would make the equity expansion of bank balance sheets a very difficult to achieve. That's why Citigroup stock is languishing way below ten bucks. It's never really recovered. Folks are still wondering if there's another shoe to drop.

EJ: And you believe there is.

AJ: If you're the Fed, you don't have publicly traded equities. You're a quasi-private organization. You don't have to worry about maintaining your share price. But if you're publicly traded and you're an integral part of the US economy as US commercial banks are, it is concerning that this cloud continues to hang over the banking system. It's going to put a speed limit on any possible acceleration in the pace of expansion in the US. I mean if your financial sector can't keep pace with the potential growth in your real economy, you're going to have very weak real-side activity.

EJ: In your opinion clearly there's another shoe to drop. Let's talk about how that might happen. Many governments are in denial and not confronting their debt issues, so government insolvency continues to worsen. That can always go on a lot longer than one expects but eventually something an event occurs that causes an epiphany and some sort of crisis. As you say the key indicator is capital flight. Do you have an idea of the kinds of events that might trigger a US debt crisis?

AJ: Something could happen anywhere. In terms of a financial event, there's certainly scope to see another large set of failures amongst certain corporates. That would obviously give rise to concerns that their lenders are in trouble. We can obviously see the wheels come off this European Greek rescue package. I mean in the final analysis the EU/ECB/IMF rescue package for Greece is really a bailout for the banks and the countries that lent to Greece. It has nothing to do with Greece per se. We could see a debtor boycott where debtors say simply, "I'm not paying. I'm walking away from this." It wouldn't take much! Because we're working in the world of fractional reserve banking and leveraged corporate balance sheets, if you get just a couple of small events is all it takes to set a major global crisis in motion.

For example: Greece walking away from the table saying, “we’re repudiating our debts...” Spain doing the same thing. You could see that reverberate right through Europe and it comes right back on bank balance sheets through their security positions. That could easily spark a problem. The other issues I see stem from competition for resources that could engender geopolitical tensions. If we end up with oil embargos again, with the Straits of Hormuz blockaded or something similar, you could easily see that causing some sort of sell-off or some kind of melt-down on global stock markets. Of course there are always the black swan events, such as North Korea doing something crazy... well, they do something crazy every month. Another black swan would be the fact that it has been reported that the Israelis have a couple of subs stationed outside the Straits of Hornuz ready to fire nukes on Tehran if the regime crosses some line in the sand. For example, if the Revolutionary Guards make good on their threat to protect the flotillas going into Gaza, this happens and leads to loss of Israeli lives or the discovery of smuggled suitcase nukes... that type of thing. But besides the black swan type events, the high probability risk of a new GFC is countries saying they’re not going to pay down their debts. That feeds back onto bank balance sheets. That feeds back onto stock markets. That feeds back onto real activity, incomes and expectations

EJ: How about new revelations of fraud as a trigger?

AJ: I think there are a couple of fraud shoes to drop as well. Most of the frauds we’ve seen are accounting control type frauds where you have people in positions of authority directing the valuation of assets or directing the way business gets done in order to generate certain outcomes on the P&L. I’m convinced that we haven’t seen the end of those. There are probably a few out there. The other thing that’s concerning is the fact that with the suspension of rules on mark-to-market in the US and the regulators turning a blind eye to valuations that banks are ascribing to assets on their balance sheets, that we end up with a situation where there’s a black hole on one of the big bank’s balance sheets. It could easily happen and probably is already happening. And as I say, there are black holes probably on 1200 more banks that the FDIC isn’t owning up to. So these are all things that are already out there. Now, if they succeed with the “reflate-and-wait” strategy and we get a resurging economy that lifts all the corporate boats and the banks with them, then fine. That’s not our base-line view, however. We think we’re in a slow-growth time for a period of time and that increases the risk of any of these risk factors becoming more prominent and triggering a new slide.

EJ: Getting back to Europe, there has been some speculation that one or more European countries might choose split back off from the euro zone and reestablish national currencies. You were involved in the transition to the euro back in the late 1990s. Do you agree with my thought that it would be very difficult operationally to revert all their systems, everything from to electronic data interchange to the banking systems, to handle exchange rates? Would that be operationally very hard to pull off?

AJ: It’s a huge undertaking. You’ve got everything from deposit agreements to financial contracts between companies. You’ve got the question of central bank operations. It would be an enormous undertaking for any economy to go back down the track to establishing its own currency. That is not to say it couldn’t be done but it is fraught with operational risks, high costs and doubts, I think, about the ultimate probability of success over whatever time frame. Remember the run up to the EMU it took financial institutions four to five years and enormous amounts of money to complete that exercise to move from national currencies to the euro. When I say enormous amounts of money I mean hundreds of millions of dollars per institution, if it’s a large institution.

EJ: And a coordinated effort...

AJ: And that was a coordinated effort with one rule book that all countries went by. Everybody had signed off. Everybody knew what was going to happen and what the end result was going to look like. Don't forget that occurred in a stable environment. It was a predictable event. You've got a situation here where if the Greeks say, "we're out." Well... you've got all the hounds baying at the door, all the creditors wanting their money. They're not going to want to be paid in some new drachma later. They're going to want their money in euros now. You've got the situation right now in Iceland where there has been this very debate about joining the euro and abolishing the krona and the pressure that's being exerted on the Icelandic authorities right now by folks who have krona bonds wanting to be paid out in euros. This is the exact issue. People don't want to get burnt if there is currency conversion and devaluation. There'll be tremendous political pressure put on any country trying to break away and establish its own currency because the expectation among creditor countries will be that they're going to get ripped off. That's entirely separate from the all the operational complexities, which are formidable.

EJ: Whenever the IMF comes in to "rescue" an economy, the first thing they ask an over-indebted economy to do, one that has too much foreign debt, is to enact austerity measures, to cut government spending and raise taxes. I can't think of an instance where that didn't have pretty much the opposite result of the intended result. Rather than help the country repay debt austerity measures shrank their economy and reduced the debtor's ability to repay foreign debt. Austerity almost invariably triggered capital flight. The word "austerity" when it comes from the IMF in connection with a sovereign debt crisis is a starting pistol shot to begin capital flight.

AJ: Well yes. We have at the IMF some very well-meaning people who have never managed a P&L. They've never actually been in front of a trading screen and had a portfolio. They've never run a business. They don't understand second-order effects. For example, if you impose austerity on some of these places, the first people to leave are those with portable skills and portable capital. That zaps the capacity of the economy to produce the outcomes the IMF is looking for. You're correct in saying they typically go the austerity route. They have had this one cookie-cutter approach to restructuring for the last thirty or forty years. I mean they've never changed and I challenge anyone to show me an example of where this has actually worked over the long run.

After the Asian crisis in 1997 and 98 there were a number of economies in that area of the world that wanted to set up an Asian Monetary Fund because they felt that they were ill served by the policies that the IMF had forced them to adopt. They later abandoned the AMF idea as they got out of the crisis themselves using other means.

EJ: Why does the IMF behave this way?

AJ: The IMF is a political organization that's shown itself to be extremely creditor-friendly because it is governed by an executive board that consists of the key IMF member countries. These Executive Directors represent the political interests of the countries they are from first and the smaller countries that they represent also, second.

Let's look at how that's translated into policy decisions for Iceland and Latvia. The Executive Director for the Nordic countries, Iceland and the Baltics, is a Dane called Per Calleson. This means that the Danish ED's office represents Denmark, the Nordics, Iceland and the Baltics at the IMF. There's conflict of interest in the Danish ED's role, because the creditor countries to Iceland and Latvia come in part from Denmark and from the Nordic countries that are the lenders to Iceland and Latvia. In addition Denmark must also pay heed to its political relationships with the bigger economies in Europe, namely Britain and the Netherlands. You begin to get the idea. So you end up with a situation where both those countries have been given the same prescription—austerity—because the IMF and the banks that lent to those countries have a shared interest. "We're going to give you loans but you can't use the loans to support domestic activities." The loans must be used to pay off debts to off-shore creditors. The taxpayers end up having to pay the IMF and donor countries to the IMF. They become tax slaves.

EJ: The "austerity" that the IMF makes a condition of bailouts has nothing to do with improving a country's fiscal position and everything to do with making sure the IMF and its friends get paid back, no matter the consequences for the country and its people?

AJ: Correct, and the citizens on the receiving end of this are catching on. You end up with a situation where as the modus operandi of the IMF becomes more well-known, it becomes politically very difficult to sell these solutions domestically. Because people don't want to end up as tax slaves and paying for somebody else's mistakes. So you find in Latvia and Iceland in the latest crisis that a lot of people simply left and those people are the ones you most want to keep around in helping you out of the crisis because they're your best and the brightest and the folks that typically have portable capital and portable skills.

EJ: A couple of final questions. What's the end game? If we have all these countries, including the US, the UK, all across Europe, and several central Asian countries, with excessive debt but unable for lack of political consensus to cope constructively with their debt issues, how is this all going to work out? Drawing from all of your experience, having traveled to all these countries and been involved in all debt restructurings and negotiations, what do you think is going to happen?

AJ: Well, for that I revert back to my roots as an economist. I think what you have to have is a very large recession. You have to have a clean out. You have to have what you normally have in a forest every few decades. It burns down to the ground and then it renews itself. Until we get rid of the deadwood and get rid of all the zombie companies and zombie banks, we're going to have sub par economic activity. We're not going to have expanding economies for our kids. I'm talking about this globally. Until we get rid of all of the businesses that are unproductive, the banks that are unproductive and that are sucking resources away from the productive sectors of the economy, there can be no dynamic self-reinforcing growth.

There will have to be a reckoning, whether it's a voluntary reckoning or whether it's an involuntary reckoning as a function of some other event, a black swan event like we talked about or some of the other high risk events like another banking crisis. I don't know. It's hard to predict because we live in a complex world but until we have that reckoning and the deadwood is cleared out it will not be possible for the global economy to move ahead on a sustainable and smooth growth path. It just won't be possible because these problems now are too pervasive. They are too wide spread. There are too many institutions that have toxic waste on their balance sheets. Too many institutions are vulnerable to other institutions that have toxic waste on their balance sheets. Too many sets of taxpayers that we now know are not going to be amenable to become the tax slaves of anybody.

Maybe this renewal takes place in an orderly way as a consequence of folks coming to a new social contract. I think that's a low-probability event. I think more likely we're going to in some way lurch into another crisis and in the end that crisis will produce a fairly violent adjustment and the deadwood will get cleaned out over the succeeding five or ten years, setting the scene for renewal. Sure there's going to be businesses that will prosper through all of this because they're businesses that have unique characteristics. During the transition stage, the transformation of the global economy geopolitically, we will see major shifts in terms of how nations use resources, in terms of how we look at the environment. And it's a bit much to ask all of this can happen in a smooth in seamless way. I think the next generation is going to pay. It's not going to pay because we did anything intentionally bad in the Boomer generation but the next generation is going to bear the brunt of what I think is going to be a fairly large adjustment in terms of living standards and ways of doing things.

EJ: If you were to attempt to characterize the way this adjustment might occur, in the more likely event of a chaotic adjustment to alleviate debt versus one that's managed through a new social contract, do you see it more likely to occur as a series of defaults or as attempts to inflate debt away, or some combination of the two?

AJ: I think it will be a mix. I think what we're going to see over the next few years is going to be similar to walking on a crocodile's back, where you have that serrated pattern. We're going to see this massive tension between inflation and deflation, with deflation coming from the pressure of default, the pressure of businesses needing to generate cash at any cost, so they cutting prices and labor is cutting its own wages because it wants to remain employed. So you've got tremendous deflationary pressures globally. There are also deflationary global price pressures due to over-supply because you have huge new suppliers out there, in China and India, that are able to pump goods out into global markets at global quality levels.

Then you've got these massive inflationary forces coming from the stimulus efforts of various governments that are going to push prices the other way. I think it's going to be push-me-pull-you for a while. There will be a lot of volatility. That's not good for anybody. Eventually I think the things have got to tilt in the direction of another crisis for the simple reason that things are uncoordinated and the machine is going to spin off its axle. Just look at what happened 18 months ago. I mean here we are in a situation where the Fed, the IMF, everyone is saying everybody's got to expand their fiscal deficit, expand their structural deficit, massively. Let's pull out of this recession guys. Let's avert a worse crash. Expand your monetary policy. Now, only 18 months later with the onset of the European crisis, it's "Oh, Gee guys, we've got to exercise fiscal restraint. We need austerity. We need to dig ourselves out of this debt problem." You've got a 180-degree policy flip with an economy that is a quarter of the world's GDP—Europe. You've got a 180-degree policy flip within 18 months. This is unprecedented and it's also I don't think an appropriate way to run a very large economy. You don't flip economic policy back and forth like that. It's like trying to turn an oil tanker on a dime in the Straits of Hormuz. You're going to run aground.

EJ: Alex, great to have you here. Thank you very much for your time and truly unique expertise and experience.

AJ: Thank you.

Alex Jurshevski is a Canadian international finance professional. He is the Founder and CEO of Recovery Partners and has more than 20 years of experience in investment management, M & A and advisory work. Recovery Partners offers Principal Investment and Risk Advisory Services in the area of distressed assets and turnaround management. During his career, Alex has been involved in over US\$40 billion of financial restructurings and over US\$20 billion of primary transactions. He has been a managing director of the Bankers Trust and has also worked with the Investment Banking Division at Nomura. He was on the European Management Committee at Nlplc and was also the Chair of the Emerging Markets Trading Committee. But his most important claim is to have been head of portfolio management operations for the New Zealand government in the New Zealand Debt Management Office (NZDMO). He has also been a member of the Advisory Panel on Government Debt Management and the World Bank's Government Borrowers Forum.