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Germany's Iron Butterfly

Angela Merkel - not quite yet an "Iron Chancellor" - has been having a hard time lately. Her handling of the Greek crisis has been dismal, as she dithered when firm action was required. Her party was trounced in the North Rhine-Westphalia election, causing the loss of its majority in the Bundesrat. She is now coming out with a raft of unilateral and uninformed policy decisions on short selling.

Why should we care about what is happening in Germany?

A number of reasons spring to mind. Germany is Europe's largest and richest economy. With the mantras of sound money and European integration, the German federal state has, for the last 50 years, been one of the two leaders of Team Europe, actively promoting greater integration in the belief that a Europe united by economic agreements was less likely to be a Europe prone to war. Germany's mainstream politicians were unanimously enthusiastic supporters of the Euro - as long as it was as solid as the Deutsche Mark - and of the inclusion of new member states. As such, Germany and the other founding members were content to let weaker countries join the "club", even turning a blind eye to some of their new partners' blatant abuses. As always, no one really minds when all is going well. And of course, lest we forget, Germany had its own internal project: the multi-trillion merger of East and West, entirely financed by industrious Wessies. It now turns out the German voters are less enthusiastic about this big plan, as they painfully realise that they have been sold a pup by their political classes. Not only have they bailed out East Germany (alone!) but, after having subsidised French agriculture and the infrastructure of Southern Europe for more than twenty years, they are now being asked to foot the bill for bailing out failing Eurozone countries.

It is decision time for Mrs. Merkel and there is only one alternative: Either bail all of them out or ditch the Euro project and

return to the comfort of a splendid Deutsche Mark isolation and fiscal orthodoxy. Mrs. Merkel's wing fluttering is a direct response to this realisation. At heart, she does probably wish to be a good European and to keep the experiment going. But her electorate is not convinced as to why they should pay higher taxes to pay what they see as the Club Med's "dolce far niente". Why should they bear the pain because others have avoided the medicine for so long? "We are Europe's fools again!" Germany's biggest selling daily, Bild, said on its front page on May 11th after Angela Merkel's cabinet had approved Germany's share in the Euro rescue package.

This brings us back to Mrs. Merkel's surprise decision to end naked short selling and CDS speculation on European government debt and 10 specifically named German financial companies. There is even talk about extending the ban to all German stocks, government bonds and the Euro FX market. I think one of the reasons for this unilateral decision is that, to assuage her voters' discontent, Mrs. Merkel does what too many politicians do: she points the finger at someone else. And she has found the ideal culprits: speculators! "We must succeed at putting a stop to the speculators' game with sovereign states," she boldly declared after talks with Greek Prime Minister George Papandreou. For those who missed the message, she added: "We can't allow speculators to be the profiteers of Greece's difficult situation." How convenient! The "vampire pack" of international hedge funds, speculators, banks and other cosmopolitan interlopers is classic black propaganda. And the German government is not alone in this nauseating frenzy: The French have always blamed their woes on Anglo-Saxon capitalists and the Obama administration is now joining the fray. Ask yourself why Goldman Sachs - now dubbed the "vampire squid" in the American media - is being singled out as the sole culprit in the CDO meltdown, in which it was far from being the largest actor.

Of course, Mrs. Merkel is digging in her heels for domestic purposes, presenting the short selling ban as punishment for vampire speculators in order to regain much needed political capital from an increasingly disenfranchised electorate. I don't think Mrs Merkel needs to start wearing garlic necklaces and sprinkling holy water: research piece after research piece has shown scant evidence that the credit crunch was caused by hedge funds. And no one has ever suggested that Greece requires a EUR100 billion bailout because of short sellers... In fact, most hedge funds publicly announced they held no Greek positions. The sad and simple truth, confirmed by the EU's very own statistical division, is that Athens' numbers were garbage. You can shoot the messenger, but the fact remains: Greece is broke. The institutional investors who still owned Greek debt had no choice but to sell. Even a high school student can work out that if everyone wants to sell something, and no one wants to buy it, the price will fall. To a lesser extent, the same is true of the Euro. No wonder it has depreciated against most currencies in recent months: There is no good macro news coming from the region, the political landscape is blurred and the fiscal situation throughout the EU can only get worse, in spite of some laudable efforts to contain deficits. The future of the single currency looks shaky at best and most investors, from central banks to individuals, probably need to think twice about maintaining or increasing their pile of Euros.

As investors, we need to assess the impact of the German blanket ban. First of all, one might conclude that if Mrs. Merkel wants to prevent naked short selling, she lacks confidence in European financial stability and in German financial companies. In fact, it will be interesting to monitor the stock price of the 10 "protected" German institutions. Indeed, the immediate short-term effect of this ban has been to increase market distrust of the Eurozone. Unsurprisingly, the other EU countries are privately incensed with Mrs. Merkel's surprising and unilateral decision. Secondly, it is clear

that the implementation and subsequent policing of such a ban is a legal nightmare. Any German bank, based in Frankfurt, London, New York or Tokyo is going to think twice about getting involved in securities covered by the ban. It might see a loss of business, but it cannot take the risk of being sued either by the government or by individuals for aiding and abetting short selling. Nevertheless, the ban will probably work as a short-term solution to impede the downward slide of the Euro and of German bank stocks.

A better way to achieve the Euro's stability would have been for Central Banks to jointly intervene to smooth the Euro move, bloody the nose of the shorts and remind market participants that there is no such thing as a sure thing. The options available to shore up the stock market are less obvious. In the aftermath of the 1997 Asian crisis, the Hong Kong Monetary Authority allowed the use of its reserves to buy equity markets, in particular the Hang Seng components, as a way of providing liquidity and maintaining an orderly market. As of yet, this has not been attempted in Europe. The ECB, local Central Banks and other quasi-state entities, such as governmental pension and superannuation funds, could join their efforts in this way, more efficiently and to better purpose. My hope is that whilst the noisy politicking is taking place, the politicians are also thinking of ways to inject liquidity into the markets. But I am not holding my breath.

I believe that, ultimately, Germany will not leave the Euro, even if this becomes a key issue in the next federal elections. I do think Mrs. Merkel will push for – and obtain – a much stricter enforcement of sound fiscal rules, even if this leads to some countries being ejected from, or electing to leave, the Eurozone. That would be positive news. If she achieves this, Mrs. Merkel might yet earn her iron wings.

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