

Good morning,

Over the weekend, we came across an article from U.S. Congressman and former Presidential Candidate Ron Paul, with whom we can't help but sympathize (refer: www.ronpaul.com). The article was titled "Are U.S. taxpayers bailing out Greece?" and published on February 16th (refer: <http://www.ronpaul.com/2010-02-16/ron-paul-are-us-taxpayers-bailing-out-greece/>).

Briefly, Mr. Paul wrote: "...Is it possible that our Federal Reserve has had some hand in bailing out Greece? The fact is, we don't know(...)Unless laws are changed to allow a complete and meaningful audit of the Federal Reserve, including its agreements with foreign central banks, we might never know if this is occurring or not..."

Mr. Paul left us thinking, and after careful consideration, we realized that the implication of this exercise may (or not) be in contradiction with what we wrote on Friday. Let us explain:

To begin with, we believe that indeed, there would be a cost to U.S. taxpayers, if Greece defaulted. We don't think Greece will default, at least not in the near term, but there would be a cost nevertheless. The cost is not explicit and it would show its ugly face if a credit event was triggered under a sovereign (i.e. Greece's) credit default swap.

Why?

Any US financial institution with a net long exposure to Greece's sovereign credit default swaps would face an immediate and funding problem. Therefore, the Fed would be pressed to rescue such institutions, while at the same time, it would have to provide currency swap lines to the European Central Bank, to avoid a collapse of the Eurodollar market.

The cost regarding the financial rescue would be on US taxpayers. This would be an unnecessary and most disappointing cost. After so much "quatsch" on regulation, how would the current US Administration justify having missed a flag as big as that of sovereign credit default swaps. There is currently a lot of quatsch about sovereign credit default swaps, but all superficial. The economic ignorance of politicians prevents them from understanding what these derivatives really imply. As we wrote earlier, under a system of fiat currency, allowing banks to sell insurance on sovereign debt is no different than allowing children to sell insurance on the financial risk of their parents. But politicians focus on the greedy side of those who trade these swaps, which is really idiotic, because these derivatives represent a huge boost to systemic risk, even if they were traded for the most morally justifiable reasons. If somebody bought credit insurance on the parents of the seller of that insurance, be it the most educated, hardworking or honest kid, he or she would still be dreadfully misled by the formal aspects of the contract, which lacks any solid content. The solution does not reside in prohibiting them, but in requiring that collateral on such trades, at least on non-Emerging markets credit default swaps, be posted in gold. (Note: Why do you think I believe that a commodity collateral would not be required on credit default swaps on emerging market countries?)

On the other hand, the cost needed to save the Eurodollar market would be global. The global feature of this cost is driven by the violent foreign exchange volatility the world would have to bear, where the notion of a global reserve currency would be clearly challenged. This brings us back to the point made last Friday, when we wrote that a sovereign credit event would be deflationary, and that liquidity preference, in particular a strong demand for USD, would challenge the value of gold.

We kept and keep thinking about this one. Given the hypothetical nature of this event, we can only speculate as to what conditions would be necessary for gold to rally. The first one that comes to mind is a catastrophic situation, where the Fed actually bails both the financial institutions and the Euro market but the market no longer trusts monetary authorities and every USD facilitated by currency swap lines is swiftly bought with Euros and immediately exchanged for gold.

If you think this twice, you will acknowledge it would not be the first time a flight to safety of this nature takes place. In fact, it would make sense. But again, this should occur under a total lack of monetary policy coordination and something else: The firm conviction that stimuli programs are useless. This would be a true capitulation. What is the probability for this scenario? Not too high for now, but not too low either, in our view.