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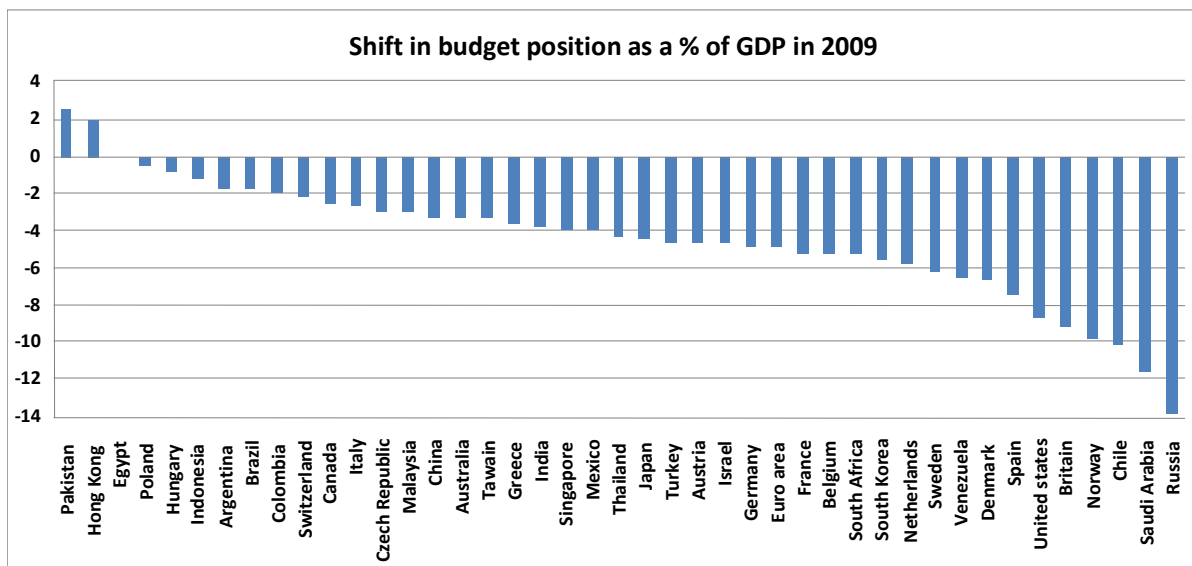
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**Weekly Letter no: 357**

**21st January 2010**

**DEBT PRIVATISATION?**

*The Economist* is one of my least favourite regular publications: anonymous yet opinionated, it combines a nauseating political correctness on its home turf with pungent critiques of faraway places. One of the redeeming features of *The Economist* is the data section in the back. Astonishingly, all but one of the 43 countries listed in the current issue are expected to record a budget deficit in 2009. The list runs from Norway's gas-fuelled surplus (9.9% of GDP) to the UK's embarrassing deficit (-14.5% of GDP). There is no escaping the colossal global transfer of financial responsibility to the public sector. In the comparable issue a year ago, fourteen countries recorded budget surpluses and one was in exact balance. The average shift is 4.5% of GDP, with the range of budgetary adjustment shown in the chart. To varying degrees, governments are grappling with an immense moral hazard problem. Safety nets that were designed as a temporary refuge for the few are in danger of becoming refugee camps. Last year's project was to head off the threat of a deflationary slump; this year's project is to stabilise public finances in a way that does not jeopardise the fragile recovery in final demand. Thirty years ago, the public sector owned significant utility and industrial assets. Today, most of these assets have migrated to the private sector. Any bright spark can figure out a way to sell off, or preferably auction, state assets; it will take a genius to devise a plan to privatise government debts. In the UK, the private finance initiative and public private partnerships have squirreled away more than £100bn of capital costs on private sector balance sheets in return for a stream of future payments stretching far into the future. However, the challenge to today's heavily indebted governments is to shed liabilities without offering anything in return. A parallel challenge for government is to charge for services that are currently free-on-demand, such as medical operations, tuition fees, fares etc. George Magnus, senior economic adviser to UBS, recently summed it up thus: "... a failure on the part of any



government to step up to the challenge of fixing public finance, especially given the uncertainties related to central bank exit strategies, could easily trigger adverse financing problems in local currency and bond markets, which may then spill elsewhere. A spike in long-term interest rates may not be easy to forecast, but seeking cost-effective portfolio protection against it might be worth its weight in gold, or ... whatever.”

### FOOD PRICE INFLATION

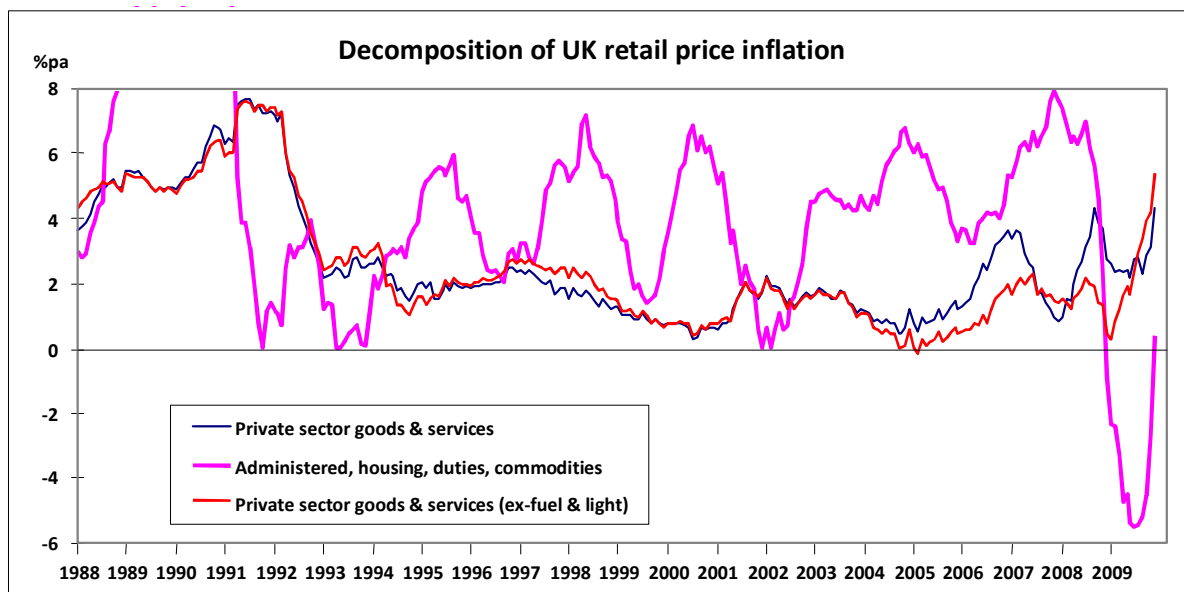
Following last week's Halkin lunch, Andy Smith has kindly released the [slides](#) from his presentation in electronic form and an abbreviated pack is attached. For those who wish to read more about ICAP's stock analyses, please contact Andy directly at [andy.smith@icap.com](mailto:andy.smith@icap.com).

### EVEYLN GARRISS ON IRAN: HIGH AND DRY

It is some months since we last featured the [Browning](#) Newsletter. The January issue carries a fascinating article on Iran, which is suffering some very severe and stressful climate changes. “On 18th December 2009, Iranian forces entered Iraq and seized one of its oil wells. This was not for the first time.” Evelyn reports that the incident ended quietly two days later, but Iranian forces did not leave Iraq and remain entrenched in their positions. No shots are fired, but Iran is keen to create distractions from its climatic crisis. “Iran is a high, dry nation. Geographically, the nation consists of valleys and basins which usually have a single large city surrounded by peasant farmers and migratory pastoralists.” “With 70 million people and only a relatively small area producing food, Iran is very vulnerable to even minor changes in precipitation.” “Iran is an expert in the Great Game. Its ultimate goal is not in pursuit of oil or money, but for power.”

### UK INFLATION: TOO MANY COINCIDENCES

In a speech to Exeter University, Bank of England governor Mervyn King maintains that “inflation remains manageable and should soon subside.” His faith is touching, but misplaced. He notes that “the earlier significant depreciation of Sterling, while part of the necessary rebalancing of our economy, is offsetting to some extent the downward pressure on inflation from the large amount of spare capacity”, but fails to acknowledge why the pass-through effect is so large. My contention is that private sector inflation (the red line in the chart) has surged because the disruption to the global supply chain has weakened competition and allowed Sterling weakness to be readily embodied in Sterling prices. Last week, I ordered a new fridge at a price that was roughly 30% higher than that charged for the comparable product last year. Most fridges are generic, but manufactured on the Continent: there is no genuine competitive pressure bearing down on the Sterling price. Mervyn King's story about inflation is largely a story about the thin pink line that is shooting back towards the zero inflation boundary. The real story is the breakout of private sector inflation from a 17-year range.



### DIARY DATE

Our next event is a lunch on Thursday 11th February when Vince Whitefoord, of pension managers and advisors Whitefoord Ltd, will review the UK pensions landscape and consider the outlook for the sector in the light of the 2008 bloodbath, and subsequent recovery, in equity prices. We have other events in process and will keep you informed of developments.

**Peter Warburton**

### EUROPEAN COMPETITIVENESS: A TALE OF TWO CAR COMPANIES

Two adjacent articles in Monday's *FT* highlighted a particularly European approach to economic 'recovery', but one that may, thankfully, be failing. In [France](#), the government doggedly insisted that it does have a deal with Renault committing it to continued manufacture of the Clio in France. While, in [Italy](#), Fiat's plans to close one of its plants in Italy have met reluctant quiescence from a much-weakened Silvio Berlusconi. With great difficulty, and at some cost, both car companies seem set to get their way. A small victory for competitiveness over sclerosis.

### UKRAINE: RUSSIAN RUMBLINGS

An issue that has rumbled through Europe over the last couple of years – literally in the case of Georgia – is the question of Russia's relations with its sometime satellite states. Georgia represented the sort of 'direct action' that is unlikely to be repeated; gas and oil have proved to be a powerful weapon, but one that also provokes hostile reactions and could ultimately prove self-defeating. A more subtle approach is apparent in Ukraine's presidential election. *Der Spiegel's* [verdict](#) on the outcome of the first round – 'Russia is the clear winner' – was based on a result that saw the current president heavily defeated by the pro-Russia candidate, Viktor Yanukovich. Russia has not needed to be heavy-handed or blatant in achieving this result, the tide of popular disillusionment with incumbents around the world was running especially strongly in Ukraine, where the economy has suffered so severely. Nevertheless, it will be quietly satisfied that its manipulations have borne fruit. But, it is not over yet: the final outcome will be decided in a run-off between Yanukovich and the charismatic, co-leader of the 'orange revolution', Yulia Tymoshenko. She gained around a quarter of the first-round vote against Yanukovich's one-third. All will be decided on 7th February.

Mind you, Russia does have a powerful backstop: the Nord Stream gas pipeline between Russia's Baltic coast and Germany, which will allow Russia to 'turn off the taps' to Ukraine, while continuing to supply western Europe. After much multi-country negotiation, particularly on environmental issues, the project needs only one more permit, which is expected to come through in time for construction work to begin in April, with first deliveries of gas expected as early as next year.



### LATVIA LATEST

Was it just a few months' ago that Latvia's crisis threatened to bring down the Swedish banks and undermine the credibility of the IMF/EU/ECB support system? Well, that's a long time in crises (or perhaps there is only room for a handful of crises at any one time). Anyway, Moody's has just updated its verdict on Latvia: "The economy is no longer in freefall and is stabilizing", "Financial stress is down significantly and the Treasury's liquidity position is good." As a result, the outlook on the Baa3 rating, the lowest investment grade, may be lifted to stable from negative if there's a "continuation of the positive trends in the economy and a stabilization of the asset quality in banks." A Bloomberg [story](#) adds detail: "After a 19 percent economic contraction in the third quarter, the government of Valdis Dombrovskis has appeased international lenders by implementing an austerity budget and restricting the deficit. Interbank lending rates have dropped, credit default swaps are down and industrial production grew the most in at least three years". If only Greece were so tractable.

**Robin Aspinall**

### CHINA: RAGE AGAINST THE DYING OF THE LIGHT

Almost 5 years ago (actually in the 24 March 2005 Letter), I wondered what the world looked like in Moscow or Beijing given the Soviet Union's collapse and US military adventures in Afghanistan and Iraq. That question came to mind again in response to this article in *The Times*: [Chinese Whispers](#). The subtitle to the article summarises the two themes running through it, the problems of Iran's nuclear ambitions, and China's refusal to play the western game: 'International diplomacy to curb Iran's nuclear ambitions is being thwarted by Beijing's inaction and obstructionism'.

This sounds like rage against the dying of the light (in fairness, Dylan Thomas' [poem](#) calls for rage rather than objecting to it: "Do not go gentle into that good night. Rage, rage against the dying of the light."). The Times article is suffused with the belief that the west's objectives are benign and China's are malign. Nobody ever went into battle thinking anything other than 'We are the good guys', but emotion of this kind is an enemy to effective analysis. This is power politics at its most raw.

There are three major points to consider, and it is better to do so with a clear head informed by reason rather than emotion. First is the rise of China. China is unique in that its rate of growth is compounded by the sheer size of its population. It is this combination that makes China a plausible superpower. The Chinese economy has overtaken or will imminently overtake the Japanese to become the second-largest in the world, and it has just overtaken Germany to become the largest exporter in the world. Both of those feats have been accomplished with a vast number of people still living in poverty.

Even if the dramatic recent rate of growth slows down, China is already a power of substance. Just as important, the same calculation applies to military strength – multiply growth by numbers, and China is powerful now – and has even greater potential. The final element is the alien nature of the country to the west, and most particularly its political system. Realistically, none of this is going to go away. China has already reached a size where, regardless of motives, it is inevitably going to generate friction. Just as squash players bump and push each other as they both seek to occupy the central part of the court, so China and its competitors will inevitably compete for resources.

Second, within these general trends, are specific questions of what is happening in China's economy right now. The biggest question is whether China is in a bubble and, if so, how advanced it is. Bank lending grew at an unsustainable rate of 155% year/year in the first 10 months of 2009. Every statistic from China is eye-popping, but again this should not prevent open-eyed analysis. Just as Japan did not abolish the basic laws of economics in the 1980s, so China has not abolished them today. According to the IMF, home ownership rates in China have risen from 17% in 1990 to 86% in 2005 (page 18 of this [Working Paper](#)). At the same time, demographic trends are heading in the same direction as Japan (at a discreet distance of 20 to 40 years). UN population projections for China's total population and growth rates to 2050 may be found on pages 62 and 73, with life expectancy on page 98 of this 2006 [World Population Prospects](#) report. For how long can Chinese property lending and price rises continue at their recent rate in the face of these trends? (Again, compare Japan 20 years ago).

Third is what the west can do about this. A determinist view of history suggests there is not a lot we can do. China will grow and the rest of the world will shrink in relative terms. The period of sole US hegemony was inherently unstable; the vacuum it created has opened the way to a new superpower. There is an alternative. Western countries, led by the US, could work to enhance their own power – but do we have the will to take China on at its own growth game? So much easier just to rage.

**Robert Brooke**

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