Issue # 1

GEFIRA

The European Perspective. Preparing for the world of tomorrow

1 Introduction

The European banking system is on the verge of collapse. That said, Europeans are still in a financial and economic position to pull themselves out of the abyss.

The coming year will be decisive for the world's most resilient and vibrant continent: Europe, with the old continent facing many challenges. The situation in the Middle East, strained relations with Russia, the deteriorating situation in Turkey and the refugee crisis will challenge Europe's future, but in the end it will be the financial and the ongoing banking crises that will be decisive and will force European leaders to change course.

The European Monetary Union (EMU) is under strain and lacks any form of leadership and its member countries are much more politically tied together than the EU countries. Lack of leadership hampers progress in the EMU and prevents a solution for the financial problems of the Monetary Super Power.

Europe went from the "Lisbon Strategy", a strategy that should have made Europe one of the most advanced and prosperous economies in the world, to the "Frankfurt Strategy", a strategy that prevents the world's most advanced economy from growing.

Not only is Europe performing poorly due to the lack of financial control, we also see a significant risk for European industry, especially the German car manufacturers. Cheap credit and the misallocation of funds worldwide have resulted in an emergence of massive automotive overproduction. The collapse in oil prices due to overproduction and the wave of bankruptcies that are now ensuing could serve as an example for other businesses. For the motor vehicle sector, we are seeing three different trends in three different continents. In the US, automobile sales are stimulated by increasing consumer debt, China is stepping up production and gaining market share without anybody noticing, in Europe Volkswagen's lobbyists are dictating Brussels' policy.

Toernooiveld 116
6525 EC Nijmegen

To contact us feel free to email us at: info@gefira.org.

From the "Lisbon Strategy" to the "Frankfurt Strategy"

The euro political framework

The member countries of the European Monetary Union (EMU) are much more politically and economically tightly-knit together than the members of the European Union as a whole. There is a sharp distinction between the EU and the EMU, which politicians and the media fail to draw. Once becoming a member of the EMU, it is extremely hard to leave it as we saw in the case of Greece, while a possible Brexit, the UK leaving the EU, will be close to a non-event.

The lack of a political foundation for the EMU renders it inactive and this can derail not only the EMU but the whole European Union, and it even has the potential to bring down the entire financial world as we know it. The current credit crisis in combination with political upheaval arising from problems in the European Union and challenges in the Middle East will put the EMU under extreme stress. The political reality in Europe can cause a breakup of the EU, but dissolution of the EMU will not happen soon. The Schengen treaty can be suspended, the Euro cannot.

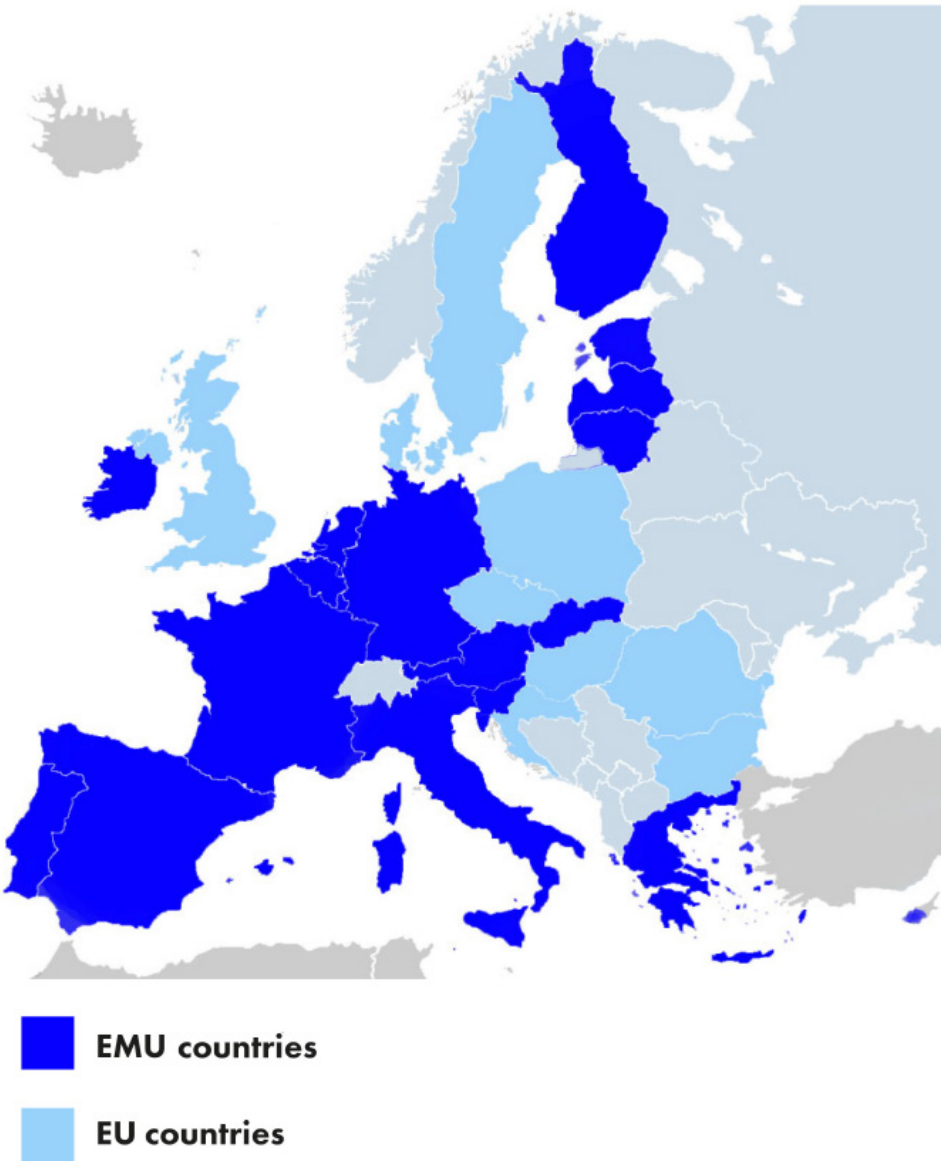
The Brussels-based European parliament lacks the legitimacy to decide over the EMU as 33% of its members represent non-eurozone countries. There is a confusing political situation in Europe, with Berlin seen as the economic centre, Frankfurt as the monetary centre and Brussels as the political centre, while none have real significant power, thus making an unmanageable crisis out of every serious problem.

The referendum in the UK and a possible Brexit is a distraction from current European problems, and we expect that such core European countries as France and Germany will not be spending as much time on it as the UK Prime Minister, David Cameron, may

Toernooiveld II6
6525 EC Nijmegen

hope[1]. In 2011, the French President, Nicolas Sarkozy, bluntly told him: "You have lost a good opportunity to shut up." He added: "We are sick of you criticizing us and telling us what to do. You say you hate the euro, and now you want to interfere in our meetings."[2] We felt sorry for Mr Cameron, but Brussels, Berlin, and Paris now have more serious problems at hand than a possible Brexit.

European Monetary Union versus European Union



1 So what does Europe really think about the Brexit debate? The Guardian 2015-10-18

2 Nicolas Sarkozy tells David Cameron: shut up over the euro; The Guardian 2011-10-23

Toernooiveld 116
6525 EC Nijmegen

To contact us feel free to email us at: info@gefira.org.

The European Union as a cooperation of independent nations, as Cameron would like to see it, has nothing to do with the current reality of the European Monetary Union (EMU), whose member countries have no say over their fiscal, monetary, or border policies. While Brussels and Frankfurt can determine Greece's economic and political destiny, the United Kingdom can decide on these issues on its own. We will not be surprised if the European Union (EU) shrinks to the size of the EMU area rather than the other way round.

Politicians still do not grasp how much the European Monetary Union ties the member countries together politically, with the prevailing idea that a monetary unit could exist without "sovereign" supervision. By constituting the Eurogroup[3] in 2009 the European political elite started to understand that the EMU needs some political control, yet the European ruling elite still believe they can leave the future of the EMU in the hands of the civil servants in Frankfurt, the seat of the European Central Bank.

The Eurogroup is the recognized collective term for informal meetings of the eurozone finance ministers, i.e. from those member states of the European Union (EU) which have adopted the euro as their official currency.

Without the recognition that it is the European Monetary Union that spearheads European political processes rather than the European Union, the economic future of the EMU looks bleak. The EMU is in need of a comprehensive economic, social and security policy, healthy doses of self-interest and a political legitimacy that is not diluted by non-EMU countries.

The EMU has been in disarray since the start of the 2008 financial crisis, and it will not be fixed without some legislative supervision. The EMU bloc has an extremely highly-skilled and hard-working population, but this vast resource of labor is unfortunately not used. Portuguese, Spanish, and Italian unemployment is sky-high while the German elite hope to solve local labour shortage with people from the Middle East and Africa, a clear sign the European internal labour market does not function effectively.

Structural financial problems in the eurozone left to the ECB

The biggest financial problems for EMU are:

1. A fragmented banking system with too much debt and a lack of capital; the eurozone banking system is fragmented by member states. Banks de-

3 The Eurogroup is the recognized collective term for informal meetings of the finance ministers of the eurozone; Wikipedia

Toernooiveld 116
6525 EC Nijmegen
To contact us feel free to email us at: info@gefira.org.

pend on national governments, while these governments do not have the monetary capacity and authority to solve their banking problems properly because they lack their own "national, independent" central bank as an ultimate backstop.

2. The eurozone states have to finance themselves in the financial markets. In Europe sovereign states that are using the euro are officially subjected to the same rules as corporations: an unprecedented situation that has never happened before in history. The eurozone countries cannot rely on a central bank that can always solve their debt problems by printing money.
3. Regional differences, with Germany having a massive trade surplus and peripheral countries having to cope with a trade deficit.

As the European population becomes increasingly skeptical about further political integration, it is left to the ECB to try and solve these three problems. Europe and especially the EMU are (caught) between a rock and a hard place.

ECB monetary tools that do not solve Europe's problems

The simplest and most straightforward policy to address a systemic debt problem is the creation of inflation and economic growth. When prices increase, money loses its value. Due to inflation the purchasing power of 100,000 euros of savings is much less now than 20 years ago. A 100,000 euro loan today has a much lower value than 20 years ago. The general public is not aware of the mechanism of inflation and will accept it as a freak of nature, yet inflation of 4% or 5% per annum can reduce a debt burden by 25% within just a few years without political fall-out. Real inflation will dissolve the banking debt as well as the public debt held by countries, even remedying productivity imbalances between countries, since a trade surplus will result in extra savings while a trade deficit results in extra debt. Inflation will reduce both the debt and savings over time.

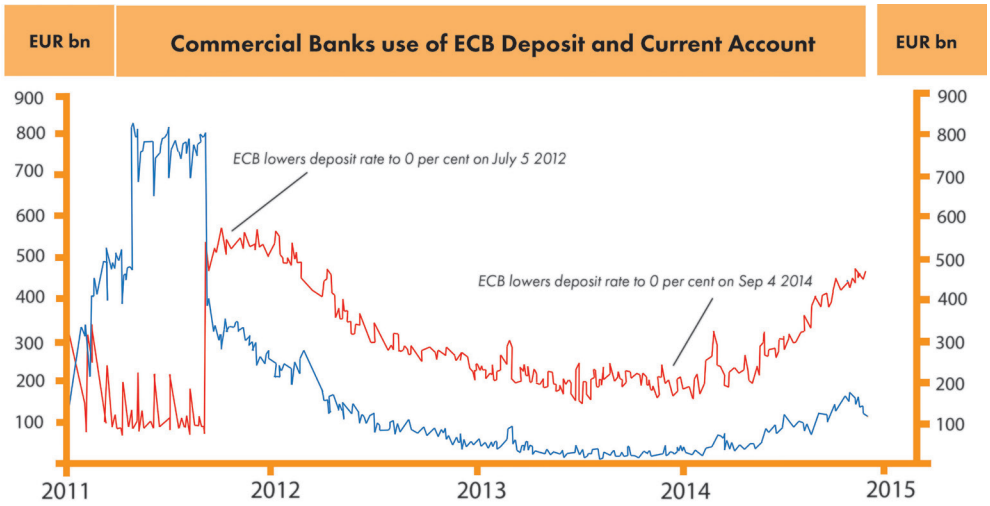
To create inflation and to restore economic growth the ECB came up with two dramatic measures.

1. Quantitative Easing which the ECB started in March 2015 with the purchase of sovereign bonds[4]. By buying bonds the ECB has to print money, increasing the money supply and which, in theory, should create inflation.
2. Negative interest rates. The ECB requires depositor banks to pay interest on their excess reserves deposited with it. Banks have to deposit a fraction of

4 European Central Bank quantitative easing: the detailed manual; Breugel 2015-03-01

Toernooiveld II6
6525 EC Nijmegen

the money they receive from depositors at the Central Bank. This is the so-called reserve requirement, money that they are not allowed to lend. Today banks have much more money deposited at the ECB than is required and the ECB is charging negative interest on these funds in the hope of getting the banks to lend it commercially.



Source: bawerk.net

Both measures have failed to work because European banks also have to comply with the so-called Basel rules which set out how much capital they need to support their commercial lending and proprietary trading activities. For funds held at the ECB and state obligations they do not need any capital, but if they lend to small and medium-sized companies, they have to have more capital than if they lend to large corporations. It is this capital that banks are lacking. This lack of capital that prevents them from lending money to the real economy. These negative interest rates and quantitative easing resulted in an increase in the price of shares and bonds. This ECB action also makes lending to large corporations cheaper as banks can pay them to borrow because it is cheaper to do that than to pay the ECB for holding their excess deposits.

From an economic perspective this is the worst possible situation: why should companies increase productivity if they can borrow money for free from their bank? At the same time as large companies can borrow money for nothing, small and medium-sized companies have to pay up to 8% interest as these loans require banks to have more capital to back them.

Toernooiveld II6
6525 EC Nijmegen

European banks are insolvent beyond repair

Another strategy to eradicate the current debt burden is through bankruptcy. When a business goes bankrupt its creditors can lose all, or part, of the money they are owed. Humble pensioners in the US saw their retirement savings vanish when General Motors filed for a Government assisted Chapter 11 bankruptcy in 2009.

It is much harder for banks to file for bankruptcy in the modern banking system without causing massive problems for the economy at large. Modern banks are interwoven with each other, and it takes a very long time before bankruptcy authorities understand and can unravel the web of obligations and claims related to derivative positions, financial vehicles and external claims and liabilities. The bankruptcies of banks and retirement funds have wider implications for the society, they could cripple economies and bring financial transactions to a standstill. Since bank deposits and pensions are regarded as personal possessions, bank bankruptcies could undermine the trust in the financial backbone of society while pension fund bankruptcies would erode social solidarity.

In 2009, the European Banking authorities refused to split up the European banks into retail and investment banks. The former offer payment transactions, simple loans and savings deposit facilities. Investment banks are licensed to trade in securities and offer complex derivative products to their clients.

This split would make supervision and bankruptcies so much easier to deal with because investment bank losses would be shielded by the retail banks. Instead, they invented a solution (the EU Bank Recovery and Resolution Directive [BRRD]) that enables bankruptcy without the help of taxpayers; banks have to create a recovery and resolution plan themselves that sets out how they would carry out an effective resolution in case of failure. The plan also stipulates which capital providers should be sacrificed first in case the bank becomes insolvent. The ECB supervises these plans[5]. It should come as no surprise that this will not work.

In the run-up to the 2008 financial crisis the national banking authorities overestimated their ability to monitor national banks and just weeks before the banking system collapsed, the national banking authorities still had no idea what was going on in their banking systems. We remind our readers that the banking system was regarded as the most regulated and monitored sector in Europe.

5 Crisis management; European Central Bank

To prevent European banks from collapsing, the European Central Bank started a frantic attempt to find new capital for the European banks.

Capitalization means that investors fund banks, and this investment can be used to cover future losses or return a possible future profit. Professional investors are willing to take an early position because they hope to sell their stake at a profit before things start to go wrong. Most professional investors know that the European banking system is in bad shape, but investing in banks is a risky business as professional Wall Street investors learned the hard way.[6]

In 2013, ETF Trend wrote: "Interest in Greek banks has been rising among noteworthy professional investors. Earlier this month, John Paulson, who made winning bets on the sub-mortgage crisis and subsequent rebound in U.S. bank stocks, said his fund had substantial stakes in Piraeus Bank and Alpha Bank."[7] Before Paulson was able to sell his investment to retail investors and pension funds, Greek bank stocks collapsed, and he lost 100% of his investments in just two years. According to Yanis Varoufakis, Greece's former Minister of Finance, the Greek banks were insolvent beyond repair and the ECB and Paulson both knew it, and Paulson and the ECB were in cahoots to attract new investors[8]. Long before the Greek financial crisis came to a head, the Netherlands found out that the European plan to solve bank bankruptcies did not work properly when SNS Bank went bankrupt due to problems in commercial real estate.

SNS is a good example that Central Bankers lack the experience and knowledge to exercise adequate supervision and are not able to manage bank bankruptcies in an orderly fashion.

While the national and international banking community saw the Dutch private mortgage market as a significant risk, SNS problems were related to the commercial real estate and not to private mortgages. The enormous problems in the former were already visible for everybody who wanted to see in 2008, except for the Dutch Central Bank. Due to an enormous overcapacity in available office space, one could have expected rents to drop by as much as 40%. Instead of offering leases at a lower rent for example, a two year rent free period on a five year lease was offered. Since, on paper, the rent for a square meter did not change, accountants did not need to write down the value of unoccupied rental properties which, in some cases, had hardly been occupied for years.

---

6 Panic Sets in Among Hardy Hedge Fund Investors Remaining in Greece; The New York Times 2015-06-28

7 After Hedgies Rush to Banks, Mobius Warms to Greece; ETFTrends 2013-10-21

8 A Greek Euro is not the Same as a German Euro; Gefira 2015-06-26

Toernooiveld II6
6525 EC Nijmegen

Investors and bank regulators were made to believe that the market value had hardly changed for millions of unoccupied square meters of real estate arguing that tenants still paid the same rent for the same square meters as before 2007. It took the bank authorities three years to spring into action. Our team has been assured by people with knowledge of the real estate business that the real estate managers have already found new accounting tricks to fool the helpless bank regulators.

It is important to understand that these fraudulent accounting tricks were the bases for the banking solvency. Not only did the supervision simply fail, but also the bankruptcy process did not go as planned. The bankruptcy and subsequent nationalization of SNS wiped out shareholders and some bondholders. The Dutch government wanted to go further with its bail-in than it eventually did. One of the reasons it abstained from doing so was the threat that a bail-in would raise financing costs not only for other Dutch banks, but also for banks in other countries. The SNS nationalization cost the bank's investors one billion euros and the Dutch taxpayer 3.7 billion euros[9].

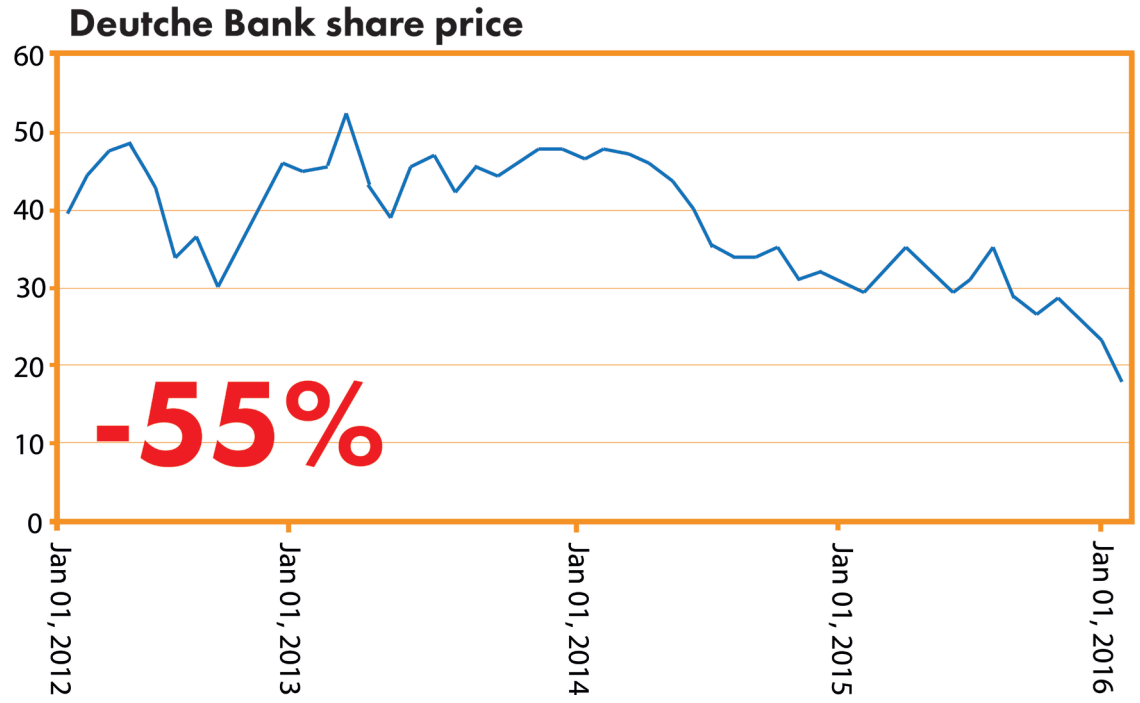
In a bail-in procedure bank creditors have to pay for all the bank losses. First, shareholders, then bondholders and, finally, depositors. Bonds are also ranked, with the so-called subordinated bonds suffering non-repayment first before senior bonds are affected. This is in contrast to a bail-out where all losses are suffered by the taxpayer and the shareholders.

In 2012 the banks started to fail in Cyprus, threatening the whole Cypriot economy and at the beginning of 2014 the ECB and the IMF accepted the country's bank restructuring plan, a country with about 1.2 million inhabitants.

The victims of the Cyprus bank collapse were primarily Russian citizens, which however resulted in little or no political backlash while Russian public opinion was indifferent to the problem. President Medvedev's reaction: "They continue stealing what's already been stolen", echoing Lenin's infamous phrase, 'Steal what has been stolen.'

Italy and Portugal are now the next challenges in the unresolved ongoing banking crises in Europe, while the problems in Germany with Deutsche Bank are extremely worrisome.

9 Six lessons for Europe from the nationalization of SNS Reaal; Breugel 2013-03-13



More than 9% of Italian banking loans could be classified as bad loans with a total value in excess of 200 billion euros[10]. Bank shareholders, bondholders, and depositors with more than €100,000 could suffer the effect of any Italian bail-in(s) beginning in 2016.

In 2015 four small Italian banks were rescued at a cost of 3.6 billion euros, which saw thousands of retail investors losing money in the deal and caused a retiree to commit suicide shortly after. At the heart of the problem was these Italian banks were selling their clients so-called bank savings products that in reality were high-risk bank obligations. After the recent turmoil, a poll released by Ipsos showed that 60% of Italians believe the government is handling the situation poorly[11].

The current Italian banking crisis has revealed that the European banking solutions are not working. Italy has managed to work out a so-called smoke-and-mirror deal for 200 billion euros of bad loans. Clearly, Italian Banks cannot be rescued within the current ECB framework, so the European Central Bank and the Italian government came up with a workaround. These bad loans will be sold to the market in so-called tranches; the first tranche carries the lowest interest, but will always be paid before the other tranches. In addition, this first tranche comes with a state guarantee, which implies that taxpayers are still on the hook.

10 Monte Paschi eyes 1.8 bn euro non-performing loan sale; Reuters 2015-11-7

11 Italy's risky outlook for 2016; Global Risk Insight 2016-01-17

Toernooiveld II6
6525 EC Nijmegen

In 2015, in Portugal, investors learnt the hard way what it meant to invest in European banks. The Portuguese authorities split Banco Espirito Santo, the nation's largest lender, into a "good" bank and a "bad" bank. One group of bonds was moved from the good to the bad bank, thus shifting a nearly two billion euro debt from Novo Banco, the good bank.

The value of this initial, approximately two billion bank debt in the bad bank plummeted by 80%. The European-Portuguese deal was a breach of the "pari passu" principle which makes it mandatory to treat all senior bondholders on a par. In Portugal, the authorities handpicked five senior bondholders to bear the brunt of this treatment.

The problems in the banking sector are not limited to the periphery of Europe. The troubles that Deutsche Bank is facing now show that they are now reaching the heart of Europe. In asset size, Deutsche Bank is the world's twelfth largest bank. In June, the joint CEO unexpectedly resigned. Deutsche Bank's derivative position is estimated at around 52 trillion euros i.e. 14 times the German annual GDP (Germany is the world's 4th economy), so serious problems affecting Deutsche Bank can change the future of Europe and crash the whole German economy.

The Frankfurt Strategy is not working

Unfortunately, it is evident that the "Frankfurt Strategy" is not working. Greece is the most dramatic case of a European failed banking policy. There is much misinformation about the situation in Greece. According to our assessment, Greece is not a full euro-area member anymore, but vested interests want people to believe otherwise.

After the five-week shutdown of the Greek banks the country is still subject to capital controls, which makes it very hard for their small and medium-sized entrepreneurs to do business abroad.

There is a complete lack of parliamentary supervision over the EMU and its political ambitions. The 2000 Lisbon strategy promised to make Europe the most competitive knowledge-based economy in the world by 2010, calling for a new method of "open coordination" to promote sustainable economic growth with more and better jobs and a greater social cohesion[12]. It seems the Europeans have embarked now on the "Frankfurt Strategy": a strategy that is ultimately left to technocrats of the ECB, which unfortunately lacks the mandate and is constrained by the rule of law within the EMU.

12 Lisbon Strategy; EFTA

Toernooiveld 116
6525 EC Nijmegen
To contact us feel free to email us at: info@gefira.org.

George Soros[13] and the Peterson Institute[14], an institute that does not shy away from having the most corrupt Ukrainian oligarchs on its board, are now calling for the EMU to issue eurobonds covered by the EMU countries. Neither Soros nor the Peterson Institute is mentioning any democratic, political supervision which should be a minimal requirement. The EMU needs a stability mechanism, eurobonds, and a fiscal policy that is above the states, but without legislative control by the taxpayers and the electorate, these bonds would be another handout to the American financial elites like Soros and the friends of the Peterson Institute. Every eurobond that may be issued by the EMU should be issued according to European law.

Now that the German automotive industry is in serious trouble, and the collapse of Deutsche Bank is becoming a reality, the credit crisis we mentioned in Gefira Anticipation Bulletin No. 0, in combination with a political crisis which is in the making, threaten Europe's growth engine, i.e. Germany.

The current European political elite are not able to solve Europe's problems adequately.

We see two significant political shifts as a result of the arising financial problems and which are now also threatening Germany.

1. The German elite will reconsider their rigid monetary stance. We wonder if Angela Merkel will survive the coming crisis. Apart from the financial threats that destabilize Germany, we are noticing a crack in Merkel's position:
    - Ankara is blatantly blackmailing Merkel and Brussels; we cannot believe the German political elite will accept being humiliated by Turkey's AKP[15];
    - Angela Merkel's confrontational policy toward Russia has been undermined by Horst Seehofer's visit to Vladimir Putin this month. Seehofer is the leader of the conservative Christian Social Union (CSU), Angela Merkel's Bavarian ally in the government[16];
    - The German Chancellor's handling of the refugee crisis has already resulted in a great deal of criticism.
2. We expect that the Eurogroup will become the leading political force in the European Monetary Union at the expense of the European Union.

---

13 The EU Is on the Verge of Collapse'; The New York Review of Books 2015-11-02

14 A New Fiscal Policy for Europe; Peterson Institute for International Economics 2016-02

15 Shocking Revelations in Leaked EU-Turkey Negotiations Reveal Erdogan's Threats to Flood Europe with Refugees; The Pappas Post 2015-02-11

16 Da treffen sich zwei Merkel-Gegner; Zeit 2015-02-03

Toernooiveld II6
6525 EC Nijmegen

It's not only Volkswagen. The entire automobile industry faces market troubles

The scandal that surrounds Volkswagen diesel engines has rocked the automotive manufacturing industry, and its repercussions are highly likely to continue for some time yet. The German concern, a world potentate with revenues that are comparable with Portugal's or Greece's GDPs, may have to bear far-reaching consequences for several years hence, which may also bring about significant changes in the structure of the company. The general situation in the automotive market may also have an adverse effect on the manufacturer, so much so as the market is slumping not only in the US but also in China. The chances are that Volkswagen will have to be rescued by an external entity.

VW is dogged by problems that are graver than they appear to be

The scandal over the exhaust emissions resulted in numerous accusations and claims being lodged against Volkswagen. Not only in the USA, where 500.000 vehicles fitted with the "defeat device" software have been sold, but also in Europe where 8.5 million cars' exhaust emissions exceed current legal levels; or in South Korea, where Volkswagen was a leading diesel engine car manufacturer. The scandal concerns a total of 11 million vehicles, a number that is larger than its 2014 record sales (10.217 million cars). 2015 sales slumped to below 10 million.

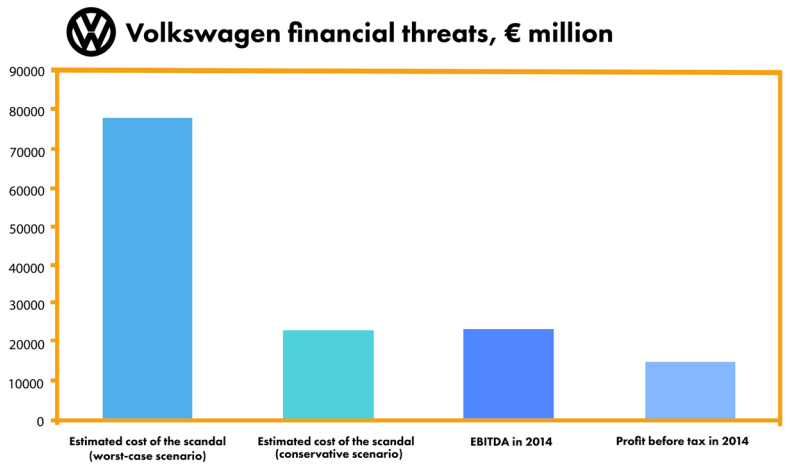
Credit Suisse analysts have tentatively put the total cost of the affair to Volkswagen as high as 78 billion euros, five-fold its 2014 profit. This total is also 60% higher than the costs booked by British Petroleum over the 2010 Deepwater Horizon oil rig explosion in the Gulf of Mexico[17]. The costs of this 2010 ecological disaster have been a financial burden on BP ever since, despite the fact that the company's annual revenue is in ex-

17 Volkswagen scandal may cost up to $87 billion; CNN: Money 2015-10-02

Toernooiveld II6
6525 EC Nijmegen

cess of 300 billion dollars. The magnitude of the problem that Volkswagen is facing is comparable to that of BP, which is why it has employed the services of Ken Feinberg, a Washington lawyer, who acted on BP's behalf processing compensation payments to the victims of the Gulf of Mexico disaster.

More careful assessments from Credit Suisse put the cost at 23 billion euros. That's an amount of money that Volkswagen might be able to raise, since after nine months of 2015 trading its management could allocate 6.7 billion euros to recall-related expenditure, and still have 22 billion euros in ready cash. This may not be sufficient, though, since at the beginning of the year the American Department of Justice lodged a civil complaint demanding 41 billion euros[18]. Volkswagen will have to bear the lion's share of the compensation paid to Volkswagen owners due to, among other claims, their vehicles' loss in value; this may amount up to 33 billion euros.



The Volkswagen management board realize that the 6.7 billion euros that have been put aside may not be enough. This assumption may be borne out by VW's announcement that 'investments will have to be re-evaluated' and 'efficiency programmes enhanced;' and by the fact that VW is applying for a bridging credit of 20 billion euros with 13 banks[19]. To top it all, rumours have been leaked to the press that some of its brands – MAN, Bentley, Lamborghini or Ducati – might be sold. It is also no secret that Matthias Mueller, the president of the VW management board, has come under severe criticism from board members for his policy towards the Americans[20]. The erstwhile head

18 South Korea plans criminal case against VW executive; Financial Times 2016-01-19

19 VW ready to sell assets should loan repayment falter; Reuters 2015-12-03

20 Porsche, Piech families support embattled VW CEO, report says; AutoNews/Reuters 2016-01-17

Toernooiveld II6
6525 EC Nijmegen

of Porsche does not seem to fully grasp the moral aspect of the whole scandal and how it might affect possible solutions.

Also, the authorities of the German state of Lower Saxony, who have a 20% share in VW, are running out of patience. In January Stephan Weil, Lower Saxony's prime minister, demanded a clarification of the affair and its causes from VW management. He also hastened to say, 'We stand by the company in good times and in bad times'[21],which might be taken to mean that should VW get itself into trouble, it may count on a helping hand.

The European Commission is even more annoyed, since it is being blatantly ignored by VW; Commissioner Elżbieta Bieńkowska carries absolutely no clout with the VW management. The EU is holding a grudge against the concern which is paying out considerable compensation to American VW owners with no intention of paying anything for the benefit of European ones, mainly British, German and French. What is more, due to the less restrictive European exhaust emission norms compared to those in the US, VW diesel engine vehicles in Europe might only have to undergo minor modifications, whereas in the US it may be necessary to replace the whole vehicle (115,000 of them).

VW management's line of thought is simple: the company's image can be saved in the eyes of 500,000 US VW owners by making them a payment of 500 or even 1,000 dollars. It is not feasible to make such payments to the 8.5 million European ones, which is not to say that VW does not face trouble on the old continent. An investigation will also be pursued by the European Anti Fraud Office (OLAF), an office mandated by the EU, with the aim of checking whether loans from the European Investment Bank to VW (4.5 billion euros) were spent in accordance with their intended purpose, i.e. to improve the 'conservation of the environment'[22].

The European Bank for Reconstruction and Development has also lost confidence in Volkswagen's reliability and so has frozen 250 million euros' worth of financing[23]. This intended financing amounts to a quarter of VW's investment in one automotive plant in Września (near Poznań), Poland. The factory manufacturing the Volkswagen Crafter will still be built, but the loan will have to be arranged with some other bank, at a higher interest rate. VW's financial reliability has slumped, which can be seen in its lower ratings and negative prospects.

21 VW given deadline to come clean by No. 2 shareholder; Bloomberg 2016-01-25

22 Volkswagen emissions cheating was 'an open secret'; The Week 2016

23 Exclusive: Volkswagen Poland factory funding on hold; Reuters 2015-12-15

Apart from the claims filed by institutions (not only the US Department of Justice, the Environmental Protection Agency, the California Air Resources Board, OLAF, but also Sweden and South Korea as well as North-Rhine Westphalia) and the costs of repairs, compensation and customers' claims, VW may also face the threat of having its investors demanding their money back. Hundreds of millions of euros are being claimed by Nieding+Barth, which will act on behalf of 66 institutional and thousands of individual investors from the US and Great Britain[24].

The majority of VW shares (some 53%) is owned directly or indirectly by the Porsche and Piëch families, who have made significant investments to take control of VW (in which Porsche SE [the family holding company] has a majority shareholding...), which attempt, however, has failed because Lower Saxony with its mere 20% shareholding enjoys special voting rights. There is little mention made of the 17% share owned by the Qatar Investment Authority, the biggest holder of VW's preferred shares. Investors have grounds to complain about VW management because the shares have lost 30% of their value due to the latter's deliberate fraud that has been ongoing since 2006.

European courts of law, especially the German ones, may well save VW and refrain from meting out too severe a penalty, if only not to run a risk of having the company go bankrupt, a company that employs 440 thousand Europeans, mainly in Germany. The Braunschweig prosecutor's office has withdrawn from carrying out an investigation against Martin Winterkorn, VW's erstwhile CEO. Still, legal proceedings into tax avoidance and individual cases of fraud and acting outside one's authority are underway.

No illusions should be entertained that the American courts, known to be so keen on fighting fraud against customers, will treat Volkswagen leniently. The seriousness of the legal procedures can be seen even now as the Americans are accusing the Germans of thwarting the investigation proceedings citing the fact that in four months VW management has not been able to arrive at a compromise with the California Air Resources Board and the Environmental Protection Agency over the repair of 500,000 vehicles with defective software, whereas in Europe the repair of 8 million cars has already been authorized (apart from changing the software, the engines will be fitted with a flow straightener which drivers with no environmental concerns will try to neutralize).

There is yet another vital factor, often left out of the news coverage, a geopolitical one. Germany and the US, formerly close allies, are currently not on the best of terms. Espionage affairs have heightened the tension between the two countries. Germany is

24 VW Faces Investor Claims Over Emissions Scandal in Germany Too; Fortune 2016-01-18

also attempting to pursue its own foreign policy that is sometimes out of tune with America's, especially where cooperation with Russia in the Middle East is concerned. Furthermore, VW is in competition with General Motors and Ford, which were bailed out by the US Government, and who do not specialize in diesel engine manufacture (diesel engine cars are far less popular among American customers than European ones and so have a limited market share).

It cannot be ruled out that the weakening of Volkswagen may lead to a complete disappearance of diesel engines on the American market, which is increasingly setting its sights on electric cars, and further on autonomous (self-driving) automobiles or driverless cars. Elon Musk, the founder of Tesla Motors Company, has already started lobbying California emissions regulators to 'pressurize Volkswagen into becoming a manufacturer of zero-emission cars'. His letter was signed by 40 businessmen connected with the 'clean-energy' industry, and pro-ecology activists[25]. VW is one of the very few automotive manufacturers which has not promoted the idea of designing autonomous cars.

It is not only VW that will run into trouble

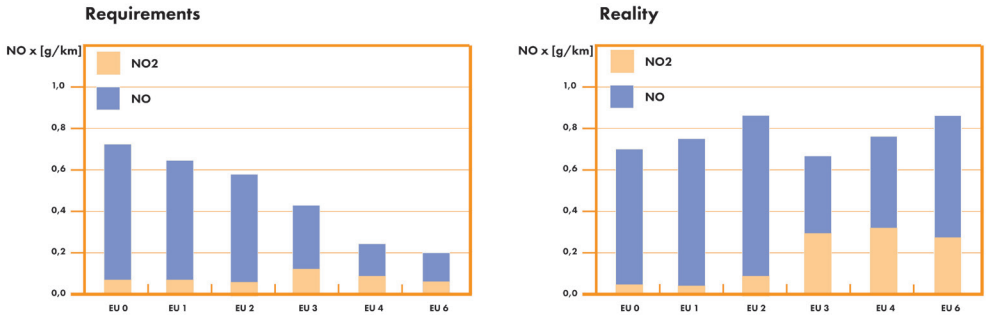
The fight against car manufacturers that cheat on exhaust emission levels is likely to also involve manufacturers other than Volkswagen. The examination carried out by the ADAC and Emissions Analytics also demonstrates that makes of cars such as Mercedes, Honda, Renault, Nissan, Hyundai, Citroen, Fiat, Volvo, Mazda, Mitsubishi and Jeep fail to meet European emission targets[26]. The only difference is that they did not use defeat device software to hide their non-compliance.

The problem occurred out of the blue. As far back as 2006 the European Federation for Transport and Environment called everyone's attention to the fact that the nitrogen oxide exhaust levels markedly diverged from the ever stricter legal requirements[27].

25 Volkswagen emissions cheating was 'an open secret'; The Week 2016

26 More manufacturers found to violate diesel emissions standards – but blame the test, not the vehicles; ExtremeTech 2015

27 Who adds pressure for stricter Euro-5 standards; T&E Bulletin No 146, 2006/3



Source: EU Impact Assessment

Renault found itself in trouble at the beginning of 2016 and so has become a target of investigation. This time no fraud could be proved. Other European manufacturers are likely to get off scot-free: they will either manage to prepare themselves to ward off looming trouble or they will be treated leniently by their own authorities due to them losing market share to VW over the last few years.

The market is slowing down, a bubble in the USA

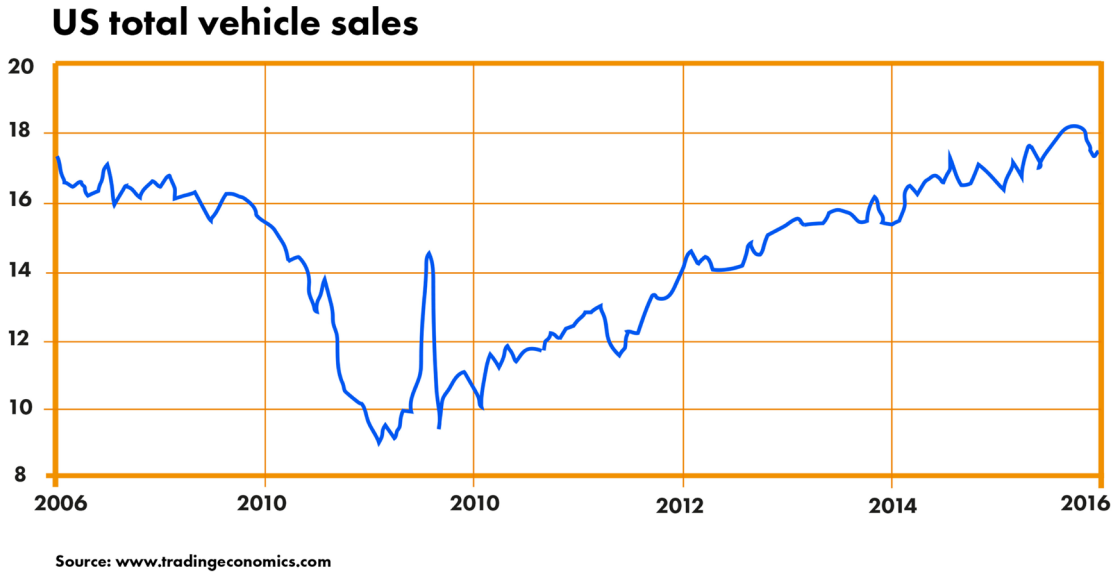
Recent data reveals that the automotive industry market has reached its maximum size or is unavoidably nearing it. 2015 EU car sales were over 9%higher than in 2014, but still failed to reach 2007 levels. And in all probability these levels will not be reached this year because the European Automobile Manufacturers Association predicts a mere 2% increase for 2016[28]. The two leading manufacturers, Volkswagen and PSA Peugeot-Citroen are slowly losing their market share (24.6% and 10.4% respectively), as are General Motors and Ford, in the latter's case due to the rising dollar.

From the European point of view it is not only the domestic economic situation that gives cause for worry but also external circumstances. The EU countries export approximately 35% of all the vehicles that they manufacture. The fact that the American and Chinese automotive markets are facing substantial challenges, not to mention the Russian and Brazilian ones which plunged into recession long ago, does not help Europe either.

Asia is the most important market for European vehicle manufacturers as it (mainly China) takes 34% of their exports. Some 28% of European production is directed to North America, first and foremost the US. Car sales have been on a rapid rise there over the last few years, which is connected to faster economic growth, low petrol prices and

28 European car sales growth to slow to about 2 percent in 2016 – ACEA; Reuters 2016-01-21

low interest rates. The 'boom' in the American vehicle market brought about by low interest credit can safely be labelled as a bubble generated by the Fed and other financial institutions.



US vehicle production has doubled since 2009, and car prices have risen by 15-25%[29]. The overwhelming majority of new automobiles are purchased on credit: 2015 Experian Automotive data revealed that 86% of the new car purchases were financed with loans[30]; the majority of used cars are also purchased on credit (56%). In the first nine months of 2015 households took on a total of one billion dollars in debt to finance their car purchases! The loan duration is the longest, and the amount loaned is the largest on record as well as the average monthly instalment. What gives grounds for concern is that loans are being given to any applicant without limitation, with one loan in five (18.7%) granted to an applicant with a poor credit record (i.e. subprime), a phenomenon that concerns a total of 14 million Americans![31]

Of course the financial market is full of securities backed by auto loans, including those that carry a relatively high risk. Does this sound familiar? Thomas Curry, the American Comptroller of the Currency, and the Consumer Financial Protection Bureau have already raised our awareness of the impending danger[32]. If the bubble bursts in this

29 Is the Auto Loan Bubble Ready to Pop? Mises Institute 2016-01-11

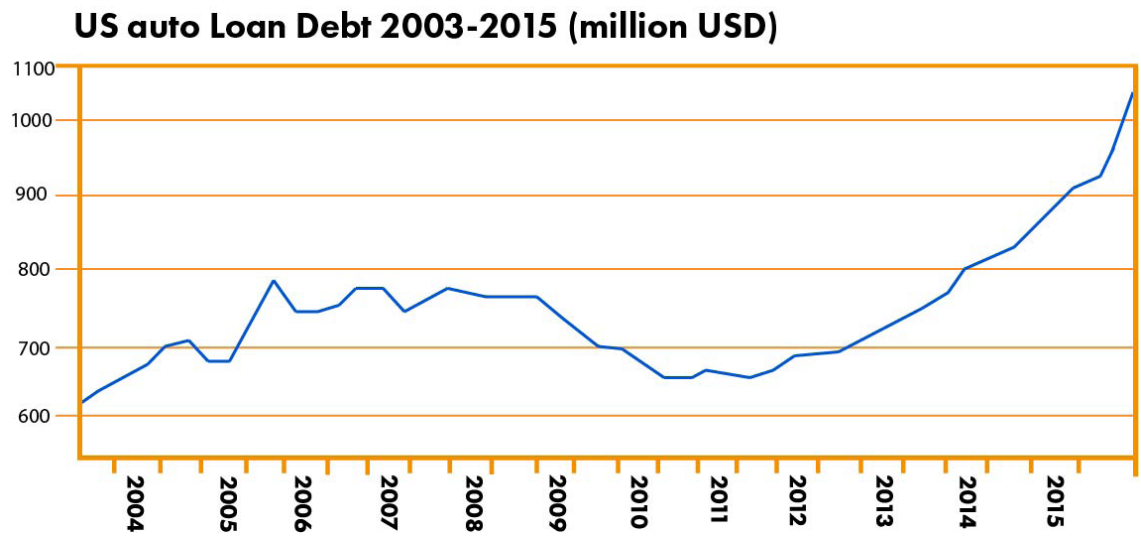
30 The Next Subprime Debt Crisis Is Coming; Casey Research 2015-11-30

31 Fed to rev up car loan rates slightly in 2016; USA Today 2016-01-31

32 Regulator Raises Red Flag on Auto Lending; The Wall Street Journal 2015-10-21

Toernooiveld II6
6525 EC Nijmegen
To contact us feel free to email us at: info@gefira.org.

market, it should not threaten the financial sector to the same extent as was the case in the 2008 crisis. There is a considerable difference between mortgage loans and auto loans. Cars are much cheaper, easier to recover and resell, and the duration of car loans is much shorter than that of mortgages[33].



If the car market bubble in the US bursts then it is the auto-loan related financial institutions that are threatened (Wells Fargo DS, Ally, Capital One and Santander Consumer USA) as well as the automotive industry itself, especially those running their own financial institutions, such as Volkswagen, which generates a significant profit through Volkswagen Financial Services[34]. In house finance companies that help drive the manufacturer during times of prosperity are just as likely to bring it down during a recession when cars do not sell so well.

China's overproduction will reduce profitability

The growth in the automotive sector is threatened not only in Europe but also in its largest market, China, where almost one quarter of the world's production is sold. Sales dynamics in China are slumping, from 16% in 2013 down to 7.3% in 2015[35], notwithstanding stimulation by the Chinese government, which in October last year cut the tax payable by half on the purchase of a 1.600cc size or smaller car[36], i.e. those most

33 Subprime Auto Loans Have Got Regulators Worried; Fortune 2015-11-20

34 Diesel scandal also raises concerns for Volkswagen's bank; The Irish Times 2016-02-02

35 China Car Sales Growth Slows Further; The Wall Street Journal 2016-01-12

36 China car sales accelerate after tax cuts; Financial Times 2016-01-12

popular with the Chinese customers. Experts predict, however, that the moment this tax 'promotion' is over, currently slated for the last day of 2016, then sales may plummet even more.

Car manufacturers have begun to compete for market share by enlarging their manufacturing capacities, acting just like crude oil producers, flooding the Chinese market with cars. The research conducted by the China Automobile Dealer Association shows that in November the average car dealer inventory level in China stood at 1.4 months of sales; since a level of 1.5 is regarded as alarming, so a high inventory like this may pose a problem[37].

Car manufacturers, especially domestic ones, do not seem to care, and keep increasing their production capacities, with a belief that when it goes from bad to worse the government will come to their rescue. It is not only the Chinese who are expanding their production capacity. Volkswagen, in keeping with their initial plans, is contemplating enlarging its production capacity out to 2019 by 5 million vehicles; Hyundai intends to raise its capacity by 50%, with similar expansion plans coming from Toyota and Honda[38].

The increase in manufacturing capacity lowers the utilization rate. It was not long ago that China's factories produced to their full capacity; this now stands at approximately 70% and falling[39], whereas the optimum utilization rate, the one that guarantees maximum profitability, is thought to be 75-80%.

The effect is all too obvious: vehicle stocks will be increasing and prices will be falling. Due to the economic slowdown demand for vehicles is not likely to grow since the Chinese fear losing their jobs and are not favourably disposed to commit themselves to such significant household expenditure. Faced with these circumstances, the manufacturers are reducing their margins to support sales. Chinese manufactured cars can be had at present for half the recommended list price. Western producers also give discounts: an Audi A1 is sold 35% lower than the list price, and a Volkswagen Tiguan can be bought at a 19% discount[40].

Market competition will continue at the expense of profitability. Western concerns may cherish a hope that the joint ventures created by them will be capable of a faster

37 China Car Sales Growth Slows Further; The Wall Street Journal 2016-01-12

38 Severe overcapacity haunts China's car makers; Nikkei Asian Review 2015-05-06

39 China's Demand for Cars Has Slowed; Bloomberg 2015-11-05

40 China's Demand for Cars Has Slowed; Bloomberg 2015-11-05

adaptation to new requirements regarding safety and exhaust emission limits that are expected to be imposed in the coming years. The Chinese government will probably respond to the problems of domestic manufacturers by means of consolidation and budget support.

We will be buying cars made in China

Overproduction must lead to the most natural result of them all: exporting Chinese cars to other markets, including those of the US and Europe. Up to now automotive exports from China have been negligible: fewer than one million cars in 2014. This will, however, slowly change. GM and Peugeot, 14% of whose shares are owned by the Chinese Dongfeng Motor Corporation, have already announced plans to export production from China[41].

The Volvo S-60 Inscription is the first car mass-produced in China and is gradually conquering the American market. As is known, Volvo is 100% owned by the private Zhejiang Geely Holding Group, which acquired the Swedish brand from Ford. Chinese car manufacturers are not likely to emphasize the made-in-China label; rather, they will go to great lengths to convince customers of the reliability and quality of their product, which is independent of the country of manufacture: the country of origin may be indicated by 'made by Volvo' or 'made by Mercedes' labels.

According to the press coverage, GM also is planning on selling China-produced cars, for example the Buick Envision crossover, in the US[42]. The American manufacturer is said to be thinking of moving production of some of its domestic models to China, which is becoming not only a components manufacturer but also a manufacturer of complete products, and even the owner or co-owner of global businesses. Another form of automotive market expansion may be an attempt to revive old European models with the aid of Chinese investment, as is the case with the German Borgward which is produced in Beijing[43] (though the roll-out of the first SUV was a failure).

China's development potential, despite problems, remains huge because in relation to the number of the inhabitants there are still too few cars in that country. It only remains to be seen when, after GM, Ford and Volvo, other manufacturers will open factories in China, among them European ones such as BMW. Within this context it is worth no-

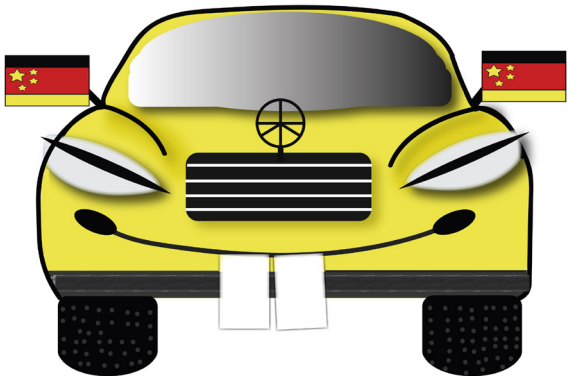
41 China car sales accelerate after tax cuts; Financial Times 2016-01-12

42 Buick shows photos of Chinese-made Envision SUV for U.S.; USA Today 2016-01-10

43 Borgward BX7-+ SUV mit gut 200 PS auf der IAA; Auto Motor und Sport 2015-09-08

ticing what huge problems Volkswagen is facing and what steps it can take to prevent a collapse. The Chinese once came to the rescue of the French; they can come to the rescue of the Germans as well, whatever form it may take.

Currently, it may be too early to predict a future conquest of the European and American markets by Chinese makes such as Geely, Great Wall Motors, or BYD, though some Chinese manufacturers are blazing a trail in Russia, Belarus, Slovakia and Bulgaria and even in Italy and the US. Thanks to a close cooperation with Western automotive manufacturers the Chinese are constantly upgrading their skills, enhancing technology and raising quality. Let us recall that not so long ago it would not have crossed anybody's mind to purchase a Chinese laptop or smartphone, whereas now Lenovo and Huawei have stormed these difficult markets and have a strong market share there. It is almost certain that in the future we will drive Chinese cars without even realizing it.



Toernooiveld II6
6525 EC Nijmegen

Recommendations

Car Industry

The US car industry has reached cycle-highs and the European market is saturated as well, so it definitely is not a good time to invest in companies that are dependent on diesel car manufacturing. Overproduction in China may affect the biggest producers and their joint ventures. Toyota, with its hybrid engines, may still gain an advantage over Volkswagen and General Motors which have a worse outlook. The best way to increase sales now is to launch good quality, cheap vehicles; the best way to increase margins is to sell price subsidized electric cars. Volkswagen's problems are far from being solved, and they remain detrimental to Germany's economic standing. In the worst case scenario we could see a GM-style rescue of Volkswagen.

US Banking

We have pointed out that the European banking industry is in extremely bad shape, so investment in European banks can be looked upon as a big gamble. For the moment US banks are off the radar and while European banks, such as Deutsche Bank, are in the cross hairs of the Anglo-Saxon financial media, American banks have been granting, and continue to grant, very risky car loans and have financed an energy sector that is now collapsing. Year-to-date Wells Fargo's share price is down 15%, Ally 23%, Capital One and Santander Consumer 57%. Compared with Deutsche Bank down 56%, these banks share prices are at risk of falling into a precipitous decline.

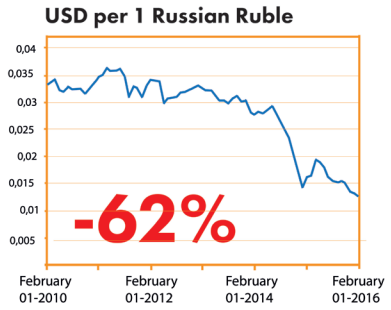
A dollar collapse? Not yet

There is no doubt the dollar is waning in importance and we expect it to lose value against both the Japanese yen and the euro. Both economic blocs (Europe and Japan) keep trying to defend the dollar but are running out of options, whilst China will try to

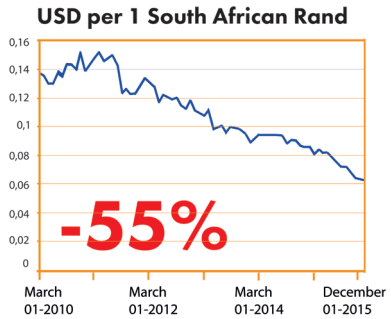
prevent its own currency from falling. In the current world order there are four power entities (Europe, Japan, China and the USA) that are still in the driving seat.

Now that commodity prices are falling hard and fast and economies are coming to a standstill, it is not the dollar that is collapsing, whatever the pundits want to have you believe.

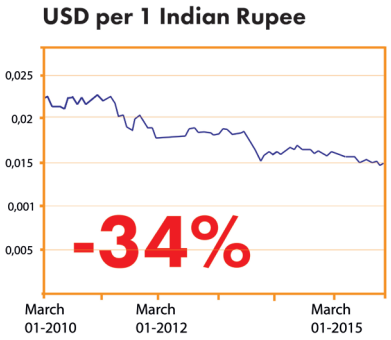
The BRICS currencies are falling rapidly against the dollar, with China the last man standing and while the BRI(C)S currencies are imploding, we do not expect the yuan to follow suit. Betting against China, the world's second largest economy, could be big mistake.

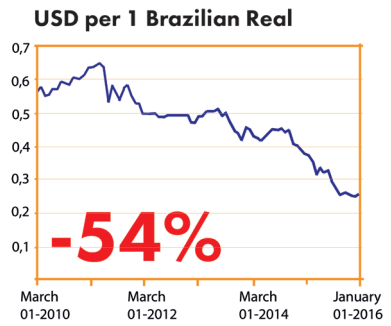


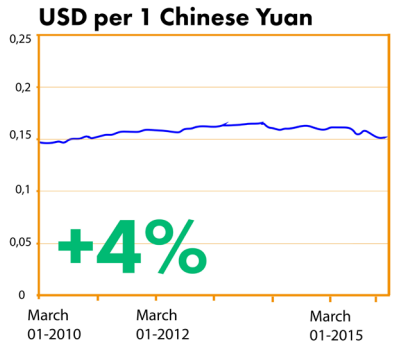
Source: Based on Investing.com



source: Based on Investing.com







Toernooiveld II6
6525 EC Nijmegen

To contact us feel free to email us at: info@gefira.org.

Alert

Gefira #02 will be devoted to negative interest rates and the end of cash as we know it. Our team is aware that these phenomena are coming, and there are signs that central banks are in a hurry to introduce these measures. For that reason we strongly advise exchanging 500 euro banknotes for lower denomination notes as soon as possible. There are signs that in some countries it will no longer be possible to effect this exchange but instead, savers will be forced to deposit their savings at banks; small savers with cash that has not been declared to the tax authorities, in particular, are at risk of suffering, apart from negative interest rates, an additional bank fee or a "fine". In the Gefira March issue we will explain all this in more detail. Savers who start to exchange their 500 euro banknotes for smaller denomination 50 or 20 euro notes now will be relatively safe.

Toernooiveld 116
6525 EC Nijmegen

To contact us feel free to email us at: info@gefira.org.