The financial meltdown: an interview with Liam Halligan

Interview by Alistair Craven

IAM HALLIGAN is Chief Economist at Prosperity Capital Management (PCM) – one of the world's leading asset-management firms, with investments worth more than $2bn across Russia and the former Soviet Union.

Founded in 1996, PCM has consistently topped performance charts for emerging market funds. The firm has built a stellar reputation for its thorough research and "active" investment approach – and is now a major shareholder in some of the leading companies in Russia, Ukraine and Central Asia.

Along with his role at PCM, Halligan is also one of the UK's leading economics commentators. For the last six years he has written his highly respected "Economics Agenda" column in The Sunday Telegraph – which recently won him recognition as "Business and Finance Columnist of the Year" at the British Press Awards. Previously a full-time journalist, Halligan has been Economics Correspondent at Channel Four News and a Political Correspondent at The Financial Times, having previously covered Russia for The Economist and The Economist Intelligence Unit.

AC: Welcome to Emerald. Can you begin by telling us about Prosperity Capital Management and your day-to-day role?

Liam Halligan:

PCM is the largest asset-management company operating in Russia and the CIS. All our clients are from outside Russia – including Western pension funds, endowments and family offices – but we have a lot of experience working in the region. We opened our Moscow offices in 1996 and have a large on-the-ground team. Most people working for PCM – including many senior staff – are Russian. We're also unusual in that we are "long-only" and use no leverage in our two main open-ended funds. We’ve been derided for this in the past. But not borrowing to invest has given us the stability that will see us through the current global crisis, while many other Russia-focused asset-managers won’t survive.

I'm the company's Chief Economist. I'm based at our client services office in London, but I know Russia well – having lived there during my 20s – and visit the country often. My main job is to provide "top-down" analysis to complement the "bottom-up" company-specific research provided by the rest of our investment team. So I spend much of my time following the economy of Russia and the broader CIS. I also liaise with clients, provide strategic advice and generally help manage and represent the company.

AC: What's your outlook for share prices in Russia, and the economy more generally?

Liam Halligan:

Having out-performed during the first half of 2008, the Russian market has since suffered badly. Falling oil prices and heightened perceptions of political risk have combined with a
wave of forced selling, as leveraged portfolio investors have faced successive margin calls and have then had to sell into a falling market. At the same time, since Lehman Brothers folded in September and the global credit crunch became more intense, emerging markets in general have been at the mercy of a “rush from risk” as Western money has sought safe havens in gold, cash and sovereign debt. These factors have combined to drive the Russian market down around 60 per cent year to date.

But, despite that, the medium-term outlook remains pretty good. While investors in the Russian stock market were highly-leveraged, debt-levels among households and most firms remain very low - with a large share of investment financed instead from retained earnings. At the same time, Russia has a very strong skills base, a huge retail market (now the biggest in Europe) and, of course, is awash with natural resources. As well as producing 11 per cent of the world’s oil and 25 per cent of its gas, the country also has an abundance of land, timber, minerals and other valuable commodities.

In sum, we’re talking about the ninth biggest economy in the world. This is a market the multinationals simply cannot afford to ignore – and they’re not, which is why Russia’s FDI per capita last year was $370, which is almost 4-times higher than the emerging market average, more than 6-times higher than China and 16-times more than India. Russian carmakers, construction firms and retailers that PCM has invested in (and sits on the board of) are turning over billions of dollars each year. The credit crunch will slow that process for a while, but not nearly as much as it will affect companies in the West.

And yet the Russian market is now so oversold these firms are valued at only a tiny fraction of their Western peers – even though they’re operating in a fast-growth market and have much lower debts.

As Russia’s transition continues, the ongoing process of industrial restructuring and sector consolidation will continue to produce enormous productivity gains – even if those gains aren’t reflected in current stock market prices. But when the smoke clears, that will eventually change. Even after the recent asset-price lurch, Prosperity Quest Fund – our “event-driven” special situations vehicle – boasts an average annual dollar-terms growth rate of 41 per cent since 1999. Russia has already generated stunning gains for canny, long-term investors and will do so once again, not least due to the pace of change that’s going on there, the energy and drive of its people, and the country’s wealth of real unimpaired assets.

AC: During your time in Russia in the 1990s you wrote an influential column in The Moscow Times and were heavily involved in the Russian government’s attempts to stabilize the country’s nascent post-Communist economy. How do you reflect on this period?

Liam Halligan:

It was an amazing time to be in Russia. I feel privileged to have been there. When I first went to live in Russia as a young academic in 1994, it was a society in extreme flux. The Soviet Union had collapsed, and with it the stark certainties of the planned economy. Prices had been liberalized, inflation was running at around 30 per cent a month, the government was deeply indebted and the voucher privatization was in full swing.

“Numerous Western investors assume Russia is ‘closed’ and ‘moribund’. My experience is the opposite.”

Nobody knew what would happen and which way Russia would go; onward towards a market-based system, however chaotic, or back to the old days - which, for all their restrictions and brutalities, was seen by many as preferable to the turmoil of the mid-1990s.

The economic policy challenges were enormous. A big problem was a lack of data. The numbers from Goskomstat, the state statistics body, were still being compiled as if the economy was being directed by a central plan. Official data was not only very difficult to interpret, but took almost no account of the up-and-coming private sector. So a bunch of us from the London School of Economics got together with the smartest Russian economists we could find and started a journal called Russian Economic Trends. We would take Goskomstat’s data and attempt to make it intelligible to an outside audience. We also did our own rudimentary surveys of the private sector. Pretty soon, Russian Economic Trends was required reading – and Goskomstat actually started helping us. Then ministers began to get involved, and our little group of Russian and Western economists were often asked to write policy papers – sometimes at very short notice – on a whole manner of economic and financial issues. And when stock trading began, our Russian Economic Trends monthly updates would routinely move the market. It was heady stuff.

What I remember most from those days was the enormous gulf between my experiences in Russia and perceptions back in the West. On visits back to London, otherwise intelligent people would ask me if the army was swarming the streets of Moscow and if I wore a bullet-proof vest in bed. Russia was written-off by many – often gleefully – as a basket case that had been conquered by Western power. Very few people I knew took the time to assess what was actually going on, and to judge the economic and business potential of this vast and dynamic country. And even fewer believed me when I reported that our group of economists was often asked into the ministries and invited to say – honestly and openly – what we thought the government should do.

The same “iron curtain of the mind” operates today. Numerous Western investors are still making the lazy assumption that Russia is “closed” and “moribund”. My experience is the opposite. Russia has its problems of course, and can be sometimes be a frustrating place to operate. But it is also a land of enormous commercial opportunities. Most Westerners I know who have spent any time there, and who’ve bothered to open their minds beyond the tired “cold war” stereotypes, feel the same way.

**AC: Generally speaking, what is your take on the current global economic turmoil?**

**Liam Halligan:**

This is the biggest credit bubble in the history of man. And now it has burst. What is happening goes way, way beyond the ordinary ups and downs of the business cycle. An essentially self-imposed financial crisis is not only affecting the lives of ordinary firms and households but, in many cases, turning them upside down. That is a very sorry situation which must be prevented from happening again.

The regulatory failure – and the gross irresponsibility shown by the mortgage brokers, investment banks and ratings agencies that generated this crisis – is deeply shocking. History won’t be kind, either, to the central bankers who, having lowered rates in the aftermath of 9/11 and the dot-com crash, kept them low far too long – so pumping up this credit bubble. The great de-leveraging will take not months, but years. And I fear that the politicians’ current response of slashing rates willy-nilly and refusing to face up to the real problems will not only prolong the agony, but sow the seeds of the next crisis too.

If we are going to have a hope of avoiding a repeat crisis in a few years’ time, it’s not good enough to say we must “avoid the blame game” and “look to the future”. Very tough
questions need to be asked, investigations need to happen and individuals need to be held accountable and punished. Those who perpetrated fraud must go to jail. It’s as simple as that. This crisis has its roots in fraud – right up and down the system, from the mortgage brokers who sold loans they knew would fail to the investment “professionals” who rolled-up these debts into securities and stamped them “triple-A”. And unless that fraud is punished, and seen to be punished, it will keep happening again and again.

AC: You said that the 1997 Bank of England Act, which granted independence, was “seriously flawed” and all but guaranteed an outcome like Northern Rock. Can you elaborate?

Liam Halligan:

Giving the Bank of England operational independence over interest rates in 1997 was the right thing to do. But while the same legislation meant the Bank retained overall responsibility for “financial stability”, the close “supervision” of the banking sector was transferred to the Financial Services Authority (FSA).

So we’re in a situation where the Bank is meant to ensure the integrity of our banking system, but now lacks the power to extract the really detailed information it needs from the banks to ensure normality.

The FSA, meanwhile, lacks the Bank’s previously long-standing day-to-day contact with the banking sector and the resulting relationships which are the best type of “early warning system”.

Our so-called “tripartite” arrangement, with the Bank of England, the FSA and the Treasury trying to maintain the stability of the financial system between them, was set up with the best of intentions. And, in my experience, there are some talented professionals working in all three institutions. But the design of this regulatory structure is such that, looking form the outside, it appears that important issues are almost guaranteed to fall through cracks in the floorboards.

Could a situation like Northern Rock have happened under the old system – when the Bank of England, close to the banks both culturally and geographically, was keeping an extremely close eye on what was happening? Perhaps, but I suspect the probability would have been less. There is plenty of other work for the FSA to do, and it is a vast improvement on the miasma of regulatory bodies we had before. So it’s not like we need a confidence-sapping root-and-branch reform of the UK’s regulatory arrangements. But something clearly needs to change, and I think a good start would be to reconnect our central bank to the banking system, restoring Threadneedle Street’s responsibility for banking supervision.

AC: You propose that “full disclosure” must happen between the banks and our regulatory authorities. What exactly is full disclosure, and why is it so important?

“The regulatory failure – and the gross irresponsibility shown by the mortgage brokers, investment banks and ratings agencies that generated this crisis – is deeply shocking.”
Western governments have thrown billions and billions of dollars of liquidity at their banking systems and inter-bank markets remain frozen. As long as that remains the case, of course, credit lines to firms and households will stay blocked and the global economy will fall deeper and deeper into this slump.

Why are the inter-bank markets frozen? Because the banks don’t trust each other to pay back loans so will only lend to each other at rates that remain way above base. And they don’t trust each other because nobody truly knows how much sub-prime toxic waste is out there and which bank could be the next to fall and so be unable to repay its debts.

Banks urgently need to rebuild the integrity of their balance sheets. In other words, the numbers they produce regarding their exposure to sub-prime need to be believed once more. Because trading in these securities is unregulated and there is no central exchange, nobody knows the true extent of the potential losses out there. This vacuum is being filled with spiraling estimates, driven by supposition and fear, which are acting like an anchor around the neck of investor sentiment. But the most immediate implication of the lack of knowledge is that the banks – there is no other way to put this – think they’re lying to each other. So they don’t lend to each other. And that lack of lending between them is having a devastating impact on credit flows more generally.

Governments need to get tough. The nation’s top bankers need to be assembled in a private room and be forced to put their cards on the table. It should be made very clear that failure to disclose anything that bankers can later be proved to have known about their exposure will be deemed a criminal offence. If that sounds drastic, then I’d point out we’re in a drastic situation. Once the exposures are clear or clearer at least, we need further consolidation. The weaker banks that have made the worst decisions need to be taken over by those that are stronger, having acted more prudently. That’s how capitalism works – or is supposed to work. At the moment, governments and regulators are stopping this fundamental process from happening, which will only store up more trouble for the future and prevent us from pulling out of the slump we’re in.

So we need “full disclosure” between banks and the regulators, but behind closed doors. Only once the banks have been further consolidated and the deals done should the result be announced to the public. This is another serious flaw in the 1997 legislation which forces such discussions to be made public before they’ve been resolved. The result was the grotesque and wholly unnecessary images of queues outside Northern Rock – scenes that not only panicked the public unduly, but which went around the world and did irreparable damage to the UK’s reputation as a centre of financial excellence.

Full disclosure won’t be popular of course. The careers of many senior bankers will be wrecked and the recriminations will fly. Some very big figures in the banking industry are going to look silly. But with our interbank market frozen, and generations of banking convention and expertise being thrown to the wind, the entire Western world is looking silly – and generating a major global slump, to boot.

People argue that Libor (London Interbank Offered Rate) has been falling and it’s just a matter of time before credit markets return to some version of normality. I accept markets are driven as much by psychology as they are by fundamentals, and the interbank market is no different. But in my view Libor has been falling recently because Western banks have been effectively lending each other someone else’s money (emergency funding they’ve received from their central banks in return for low-quality collateral). We’ll see if Libor keeps falling when that bailout money runs out and banks are effectively lending their own money once more. In my view, this credit freeze won’t properly thaw until some version of “full disclosure” happens.
AC: You’ve been described as the “Michael Caine of Economics” Why?

Liam Halligan:

Oh yes! That was Matthew Taylor who currently runs the Royal Society for the encouragement of Arts, Manufactures and Commerce (RSA), but who at the time he coined that one was running the Downing Street Policy Unit. Before I started working for PCM I had returned from Russia and become a full time journalist – working for The Economist, The Financial Times and then Channel Four News. Matthew was hosting a fun quiz event – journalists v politicians – at the Labour party conference one year and he introduced me as “The Michael Caine of Economics”. Partly he was ribbing me for my broad London accent, of course. But I think, or at least, hope, he was paying me a compliment too. In my journalism, prior to PCM and also the columns I’ve continued to write for The Sunday Telegraph since becoming an asset-manager, I try to “tell it as it is” and adopt a down-to-earth approach that explains complex issues to as broad an audience as possible. In my experience, the best politicians respect you for that, even if you’re making their life more difficult.

AC: In one recent column you said that future historians face the task of “trying to unravel how the Western economies imploded in 2008 and a new world order emerged.” What is this new world order, and what does it mean for all of us?

Liam Halligan:

In 1998 a systemic financial crisis in the emerging markets caused “contagion” in the West. Just ten years on the same process has happened, but entirely in reverse. A crisis made in the West has now “infected” the entire global economy. That’s a symbol of how much the world has changed. The G7 countries between them now have less than 20 per cent of the world’s currency reserves and less than 6 per cent if you exclude Japan. The BRIC economies – Brazil, Russia, India and China – have 40 per cent. Again, that shows the extent to which economic power has shifted.

It’s almost a cliché now to say the future belongs to the emerging markets, and I’m not sure it’s entirely true. While many of the Western economies have deep-rooted economic problems – not least massive indebtedness, related demographic pressures and diminishing skills – those post-industrial countries that adapt well and approach globalization in the correct manner will remain well-off societies with low, but reasonably steady economic growth.

But, more and more, emerging markets will come to the fore. During 2007 the EM world accounted for half of global growth. That share will be higher still in 2008 and higher again next year too. It won’t be long before the “new new world” accounts for half of the overall global GDP stock - as the emerging giants of the East continue to drive forward the fastest industrial revolution the world has ever seen.

The credit crunch will take its toll on these economies of course. But, with the West on its knees, the relative growth rate of the strongest emerging markets will rise sharply in 2009 and 2010.

“The weaker banks that have made the worst decisions need to be taken over by those that are stronger, having acted more prudently. That’s how capitalism works – or is supposed to work.”
Western portfolio investors currently have less than 15 per cent of their assets in EM countries – a proportion that will steadily increase over the coming decade as the economies of these countries outperform, even if their nascent asset markets remain quite volatile.

These inevitable, historic trends – the decline of the Western hegemony, the rise of alternative centres of economic and commercial power and the eventual toppling of the United States from its position as the world’s biggest economy – were already playing-out quite fast.

This sub-prime crisis, in my view, has speeded-up the process even more. As a Westerner I’m somewhat alarmed at the pace of our relative decline, the fact many Americans and Europeans will have to endure falling living standards, and the inevitable political fallout that will bring. But as a long-term investor, it seems pretty obvious to me that emerging markets are where the action is, and where the bulk of one’s capital should be. I admit that, for now, that’s not a mainstream view. But I’d predict it soon will be.

December 2008.

“Those who perpetrated fraud must go to jail. It’s as simple as that. This crisis has its roots in fraud – right up and down the system.”