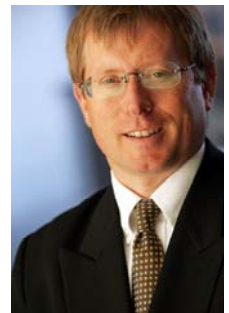


Away From the Noise, the Real Crisis in Euroland

Naturally, the financial press has recently been dominated by the amazing events in Europe and the saga of which government 'faces bankruptcy' or an ignominious bailout by either the EU or the IMF. Despite considerable domestic opposition – some of which extended beyond the mere vocal – Greece and Ireland have already been forced down this unpopular route and we suspect that it will only be a matter of days before Portugal joins them on this journey. Next year, we can expect Spain, the fourth largest economy in the Euro Zone to join them in what will probably be a much sterner test for the EU's rescue apparatus. Indeed, we suspect that once Spain's government finally acknowledges the extent of the declines in local property prices and in so doing forces the banks to reassess the true health of their balance sheets, we can expect more pressure on Spain's budget finances and a probable "buyers' strike" in the Spanish debt markets that forces a rescue – and further painful austerity for the country.



Andrew Hunt
International Economist

Admittedly, there has been some 'good news' for the beleaguered peripheral countries of Europe in that the ECB, albeit rather begrudgingly and apparently without complete unanimity amongst its decision-makers, has in recent days begun to participate at the margin in the periphery rescue process by beginning to purchase modest quantities of government bonds again and it has also probably agreed to extend its shorter term liquidity injections. We suggest that it has only probably agreed to do so because the ECB Board frequently manages to send conflicting messages when several of its members attempt to speak in a variety of differing languages simultaneously but over recent days it seems to have excelled at this level of confused communication, with its members appearing to disagree in public as to what should be done to resolve the crisis. In practice, we cannot help but feel that on a net basis at the current time the ECB is only tactically adding liquidity to support the bond markets at the expense of the Euro's external value and Germany's likely inflation trajectory but we also suspect that the actions will probably be temporary since once bond markets settle, the ECB will probably attempt to conduct its sterilisation and take liquidity back out of the system. So far the ECB's approach seems to be a tactical micro-focused policy rather than strategic macro policy shift.

It is our feeling, however, this concentration on the 'detail' by both the ECB and the press perhaps portrays the crisis as something of a 'soap opera' and it clearly misses the key problem within the Euro, namely that the credit booms in the periphery that occurred in the 1990s and 2000s, and which have led in turn to the banking and fiscal crises that we now see unfolding, also created very high relative unit labour costs within the IPIGS.

At present, the ECB through the nature of its rhetoric and the limited terms of its assistance programmes still appears to be leaning towards the idea that the lack of competitiveness in the periphery should – or must, in their jargon - be solved by significant wage deflation of the order of 20-30% in the uncompetitive countries. Meanwhile, we would also note that the ECB / EU is also demanding that over the medium term the countries pay back a great proportion

of their existing foreign debts, a process that will also reduce domestic disposable incomes by a further 10-20% - or perhaps more in some cases.

The implication of this income loss arithmetic for Europe is that if these countries do not enjoy sizeable export or foreign direct investment booms (and in the Southern states that have very small export sectors, the booms would simply have to be immense to make any difference...), then real disposable incomes in the periphery are being required to fall by around 40% (i.e. 20% plus to restore competitiveness and 10-20% to repay their external debts).

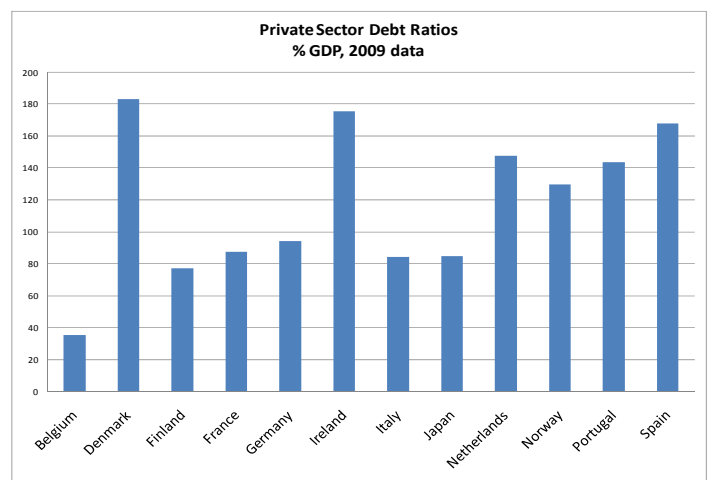
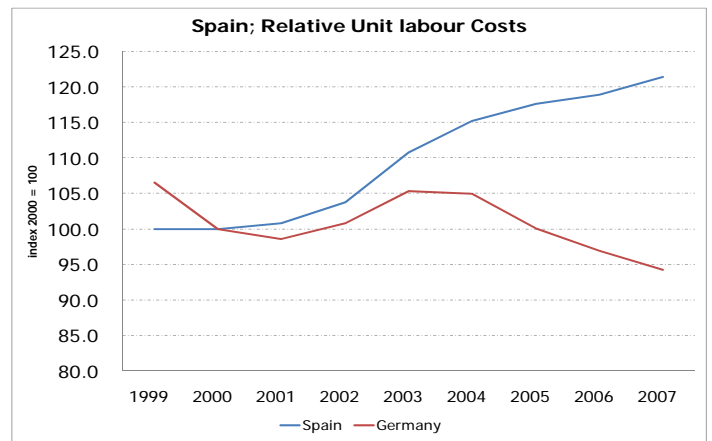
Such declines in effective disposable incomes would match those experienced by Asia in the late 1990s, an event that led to changes of government and political regimes in all of the countries concerned.

If incomes were to fall by such an amount, we can assume that the already very high private sector debt ratios in these countries would explode towards 200% plus ratios relative to GDP and large scale debt defaults could be expected to occur, although in practice we suspect that many of the countries would have been obliged to quit the Euro by their electorates long before these points were reached.

Therefore, we believe that if the ECB is to hold the Euro together, we believe that it must extend its tactical decision and begin to continue to monetise bonds in earnest, it must add yet more liquidity and it should also strive to depreciate the Euro further so that it can remove the need for the peripheral countries to deflate and create export recoveries in not just the core of the Single Currency area, but the periphery as well (and in Eastern Europe, which would seem likely to be a prime beneficiary of this process and probably the site of a new Euro Bubble). However, to do this would impart a huge inflationary bias to Germany, which we believe already has some potential for a higher trend rate of inflation. Such an event, we might hypothesise, will not be welcomed by Germany's price sensitive electorate.

Therefore, for the ECB to target a rescue of the PIGS risks alienating the German core of the Euro while tackling the German inflation problem risks forcing the PIGS to leave the Euro. However, if the ECB endeavours to pretend that it is a 'normal' central bank by in effect seeking to attempt to target the needs of the average Euro citizen (an entirely fatuous concept since Europe is not one country!), then this implies it not being tight enough for Germany but being too tight for the PIGS, a situation that will anger all of Europe's miscellaneous and independent electorates. In this situation, and with no sign of political union on the horizon, it is clear that the Euro's troubles will continue to bubble away and surface intermittently, even though the ECB may have managed a band aid over some of the problems of recent days.

Andrew Hunt
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Andrew's 2011 New Zealand Presentation Dates

Monday, 21 March 2011

9.00 am

Christchurch
 The George Hotel

3.45 pm

Wellington
 Wellington Club

Tuesday, 22 March 2011

7.15 am

Auckland
 Northern Club

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Wishing you a
Merry Christmas
& all the best for 2011

From us all at
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