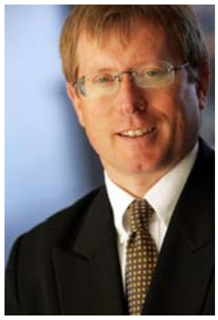
Tyndall Comment

June 2010

Money, Money, Money.

It costs $12 for a glass of good Otago Pinot Noir at our favourite watering hole just outside Queenstown and to many policymakers in Europe this quantifying of a 'price' would seem to represent the sole purpose of money (the denomination of prices, that is, not the buying of pinots!). Clearly, money, be it dollars or pounds, is a form of measurement yardstick that tells us how much something is in a convenient form – it implicitly tells us how many days we must work or how much we must gain from our investments in order that we can buy that new car or house without the need to think in complex barter arrangements. Unfortunately, many of Europe's politicians only see money in this rather narrow light and therefore implicitly ignore its other functions.

Chief amongst money's other functions is as a 'store of value' or savings instrument. Of course, money itself is essentially barren and its ownership does not yield any great aesthetic benefit or value to all but a very few of us; instead most of us hold money so that we can buy something in the future or prepare ourselves for some future unknown eventuality or crisis, although a few people may hold it speculatively. However, in both cases, the owner of the money – be it in the form of cash or a deposit in a bank – is expressing through their holdings of these instruments their confidence in the notion that the money that they are squirreling away will be worth something in the future.



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In order for money to 'work' as a store of value, one has to be sure that its value will not be destroyed by inflation or financial failure and that it will still be a valid 'medium of exchange' in the future. In practice, the reason that people may have confidence that money will act as such a store of value for the future rests not on people's trust in the intrinsically worthless piece of paper called a bank note or even their bank statement but on their level of trust in the 'state' or government infrastructure, since it is the state that defines what is money and which, in theory at least, safe-guards its value.

European Union vs New Zealand

We quote this little piece of apparently long-forgotten money theory (it actually comes from Keynes' pre-Keynesian 1931 Treatise on Money) simply because this is the fundamental fault line in the Euro at present. We find it impossible to separate the concept of money from the concept of the nation state, but in Europe this is exactly what has been concocted under the Euro System. In theory, the value of the Euro is safeguarded by the ECB but the ECB itself reports to the 16 governments that are members of the Euro and of course each of these governments has their own national economic and political objectives. Unlike New Zealand, there is not a single central bank, mandated by a single government whose electoral boundaries correspond to its monetary boundaries in Europe; instead there are a collection of changing governments each with different perspectives which happen to agree at this particular point in time on each using a common currency. In theory, any of these governments might change their mind at any point and this must intrinsically be a much weaker situation than one under which New Zealand's voters appoint one government which then appoints one central bank which is charged with acting in the best interest of the 'average New Zealander'. The North and South Islands may disagree about many things but at the end of the day they are one country with one government and one central bank whose interests should be aligned with all of New Zealand, not just one geographic part of the country.

The problem with Europe

This, however, is not the case in the Euro Area (we do not call it Euroland since it is not one country). For example, the fundamentally weak Greek and Spanish economies need a weak Euro and easy domestic monetary conditions if they are to avoid crippling depression and probable social unrest and this is what voters in these countries will be pressing for. However, Germany, Holland and Austria would most likely face higher rates of domestic inflation under such a regime, something which is anathema to their aging populations since it would see the real value of their savings eroded by rising goods prices. Similarly, the Southern Europeans also need fiscal transfers from the core of the Euro Area but the taxpayers in the core have little appetite to provide the funds necessary to keep Spain's overly generous unemployment benefit system solvent. However, voters in Germany presumably see no reason why they should help foot the bill for the 50% of Spanish under 25s who are currently unemployed and 'on the beach' as the Germans see it. Consequently, the "German Bloc" believe that the Southern Europeans should cut their wages, cut benefits, raise taxes and 'tough it out' rather than be bailed out, although even a basic analysis of the debt crisis facing the Southern Euro Zone countries reveals that this deflation route is not practical either economically or socially (little wonder that none of our German friends intend to head south for the summer holidays this year – a cold welcome is apparently assured).

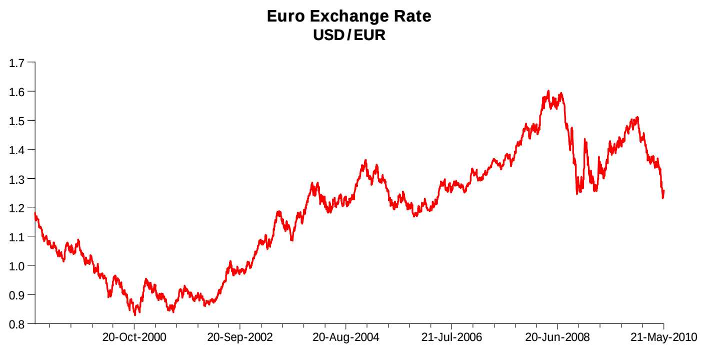
This fear of inflation and higher taxes in Germany as a result of the Euro and its need to support the Southern states probably does much to explain just why Chancellor Merkel's coalition recently performed so badly in an important German by-election and Merkel's undoubtedly politically motivated knee-jerk statement soon after the election to the effect that the Greeks might like to consider leaving the Euro was probably understandable in a German domestic context. However, for the major player in the Euro effectively to suggest that the Greeks were no longer welcome will have done nothing for anyone's confidence in the Euro. Of course, Merkel's comments did not detract from money's use as a measurement tool but certainly she undermined (or at least failed to think about the effect of her comments on) the Euro's ability to be a store of value for many of its users.

The End of the Euro?

In particular, if the Germans apparently wanted to eject you from the Euro, then you as a Greek resident might want to withdraw your savings from whatever Greek bank you were using and spirit them away into Frankfurt or somewhere else outside Greece. Similarly, if you were a foreign investor in the Euro, then Merkel's comments that pointed to a possible break up of the Euro would leave you wondering just what you would receive if the system broke up – would you be left with Drachma, Lira and Pesetas or would you get Deutschmarks back? Merkel's comments, in an instant, revealed the central, and we believe gaping, fault line in the Euro project, and following this statement it was not surprising that the Euro plummeted on the foreign exchanges and the crisis intensified.

Not the End, but Extreme Weakness

Perhaps uncharacteristically, we are optimistic that the Euro will not break apart this year, although it may do during the next European electoral cycle in a few years' time. In fact, we believe that the recently announced ECB rescue package, though badly conceived, poorly executed and appallingly communicated, will probably do enough to save the Euro as a concept at this time although we doubt that it will support the currency's external value. In fact, we know that a weaker Euro is in reality a necessary condition for a bailout of the Southern Euro Zone countries.



This, of course, amounts to nothing more than a competitive devaluation of the Euro that is designed to 'steal' profits from the Euro Zone's trade partners and ultimately recycle them into deflationary debt repayments in the South. For example, Korea's exporters can expect to be net losers from the Euro crisis and this must impact not only their profit forecasts but also their likely levels of CAPEX in the years ahead. However, the funds that Korea in essence 'bleeds' to Europe as a result of this process will likely be used by the Greece et al to service their debts, a highly deflationary series of events for global growth prospects. The prospect of this form of 'collateral damage' to profits is one reason that global financial markets have reacted to the crisis so badly.

How will Financial Markets Fare?

A second reason for the poor reaction from financial markets to the Greek Tragedy is the impact that it has had on measured volatility in the currency, equity and debt markets. In several of our recent monthly reports (including last month's), we have described how the shadow banking system has made a comeback and how it was implicitly supporting asset markets and 'risk assets' in general. One impact of the Greek and indeed Korean Crises has been to raise the reported volatility above the 'comfort levels' used in the mathematical models so beloved by the risk and compliance types of institution (contrary to popular belief, these models survived the 2007-8 meltdown) with the result that the shadow banking system, which was running full speed ahead in April, is now clearly in reverse. This essentially reflexive behaviour has ensured that just as markets needed more liquidity, the shadow banks have actually withdrawn liquidity and therefore exaggerated the effects of crisis.

Again uncharacteristically, we believe that global policymakers are slowly coming to realise both this reflexive behaviour in the banking system and the problems inherent in the Euro System and that they are now embarking on not only further liquidity injections but also a 'volatility reduction' exercise that should bring some stability to markets in the middle part of the year. In fact, we suspect that they may even succeed in generating a rally in risk assets such as the NZD but unfortunately the fact remains that the global economy is still in a remarkably fragile state and the structurally flawed Euro may yet throw up unwelcome surprises given its fundamentally poor design. Moreover, with inflation rising in Asia and China beginning a monetary tightening process, we suspect that 2011 may contain rather a lot of bad news for markets but for the next few months, the authorities may just be able to restore liquidity and to stabilise markets, even though none of the underlying problems in the Euro or even in the global financial system have yet been addressed.

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Andrew's 2010 New Zealand presentation dates:

Winter Series **6 August**	7.15am	Auckland, breakfast The Auckland Club
	12.30pm	Wellington, lunch at The Intercontinental
24 August	12.30pm	Queenstown, Copthorne Hotel
26 August Workplace Savings Forum	11.25am	Convention Centre Christchurch

Other Tyndall Manager Presentations:

JP Morgan Alternative Asset Management	Calvin Ho Managing Director
14th June	9am Auckland
	11.45am Auckland
15th June	9am Christchurch
	2pm Wellington

For further details of presentations, please contact enquiries@tyndall.co.nz