

Euro Fatigue

Many people outside Europe – and even some inside the Euro area - have asked, not unreasonably, why the politicians do not just put the whole thing out of its misery and call an end to the single currency. After all, they argue, there have been countless currency regimes that have failed over the last 250 years, even including some within the US’s own borders! In fact, it took the US more than a hundred years to gain a single currency. Unfortunately, although there have been plenty of failed currency unions in the past (our personal favourites have included ones based on tobacco leaves as a standard and even one that was based on a goat standard; the latter failed when people began hoarding female goats and only males were in circulation), none have, though, involved large derivative markets denominated in the currency at risk.



According to the lowest estimate that we have seen, there are around \$70 trillion of Euro-denominated over-the-counter (OTC) “simple” interest rate contracts in existence currently. This amount is roughly the equivalent of five times US GDP but we have also seen estimates that suggest that the true number may be three times this amount once some of the more exotic instruments are included. In practice, no one knows whether these contracts would settle or “clear” in the event of a breakup of the Euro in the near term. If they did not, then the global financial system could suffer a Lehman Bros “moment” to the “nth” degree and quite simply no one knows whether this would occur or what value “n” would take. Hence the UK authorities, and many others we suspect, are telling their financial institutions to prepare for the worst.

In a real world sense, preparing for the worst implies attempting to minimise counterparty risks by not lending to anyone but the “bluest chip” borrower who has suitable collateral to offer and finding these “would-be borrowers” is not an easy task, with a result that credit availability around the globe has wilted. In the US, commercial lending growth – which was already weak – has stopped altogether and in Europe there are signs of a new credit crunch. Even in the famed BRICs economies there are signs of credit distress; the recent sharp falls in the value of the Brazilian Real and the Indian Rupee can be blamed on these countries’ new-found inability to fund their current account deficits through inflows of new credit. Prior to the crisis, it seems that many lenders were prepared to overlook the BRIC’s high inflation and signs of over-consumption but the new-found lack of credit supply within the global economy has revealed that many of these “high-concept” plays were in reality merely wearing the Emperor’s new clothes and we suspect that China will soon join its BRIC peers in this respect, although Chinese equities have already suffered a torrid year as the economy has succumbed to stagflation. In time, this situation may even begin to affect the Chinese currency. As Warren Buffet was once moved to remark, when the (credit) tide goes out, you find out who is swimming naked.

India: Currency per USD



Australia and New Zealand have so far been spared this fate for now, since although they do suffer a bias towards a weak balance of payments, they are nevertheless perceived to be blue-chip borrowers but the suspicion must be that if risk appetite continues to wane amongst lenders, they too may find themselves drawn into the credit contraction.

Moreover, for central bankers, such as those at the Federal Reserve, the Bank of England and even the Bank of Japan, this Euro-induced sclerosis must be particularly galling at this time of weakening global growth since, not only is the Euro crisis carrying with it the threat of a financial catastrophe, it has also neutered their recent attempts at creating easier domestic policy regimes of their own either through extended rhetoric or outright re-introductions of QE regimes.

It would therefore seem that some solution to the Euro crisis must be found before too long, even if it is a template for an “orderly breakup” of the currency experiment over the medium term – since to offer the OTC markets time would also create the ability for them to re-write their contracts as they are progressively “rolled over”. The Euro can and we might argue should be dismantled and an orderly breakup arranged - albeit at huge expense to taxpayers around the world – but this clearly is not what the politicians in the core of the Eurozone want – even though in many cases their electorates are more equivocal on the subject. Interestingly, on a recent visit to Germany, we found many people on the streets that were opposed to the Euro although whether they realise that a Euro breakup would cost Germany some 25% of its GDP in banking system recapitalisation funds is another question...

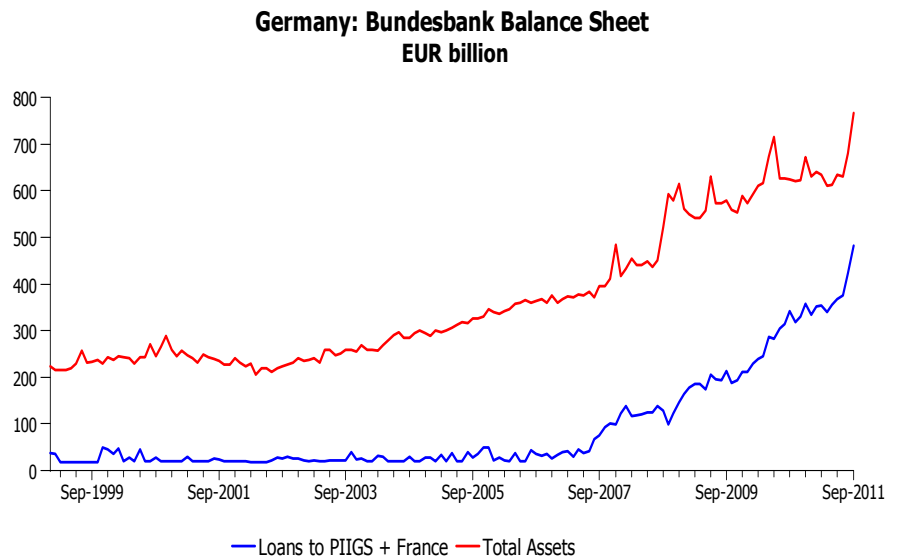
The problem for the politicians that want to retain the Euro – or the economic tsars that have been appointed in their places in Italy and Greece – is that they do not have a plan about how to solve the crisis. In the near term, the authorities have found ways to manage some of the fallout from the crisis but they appear not to have a master plan and in some cases they have even turned off the automatic “stabilisers” of the system that should be acting to create some form of equilibrium in the system, albeit a far from happy one.

For example, at present Germany continues to run a modest trade surplus with its peripheral Eurozone partners. This implies that there is a net flow of money out of the periphery and into Germany. At the same time, many depositors and savers in the periphery fear an imminent breakup of the Euro and they are rushing to move their money out of Greece et al and into Germany. It is estimated that around 1% of deposits in Greek banks are leaving every day in favour of either the Swiss Franc, Sterling or, most noticeably of all, deposits in German banks in Germany. This situation implies that there are massive amounts of money leaving the periphery and massive amounts of money entering Germany.

In theory, all of this money arriving in Germany should be flooding the German banking system with excess liquidity and thereby encouraging the German banks into an unprecedented lending spree that could in turn finance booming property prices, consumer spending and, most of all, rising wages in Germany. Were this to happen, Germany would tend to become less competitive and the problem at the centre of the Euro, namely the poor competitiveness of the periphery, would be solved by an unpopular rise in German inflation. Germany's banks, though, are short of capital, its citizens are risk averse and the economy seemingly incapable of generating inflation, partially as a result of its aging demographics. Hence, this part of the Euro's automatic adjustment mechanism is not working.

On the other side of the equation, the money leaving the periphery should be robbing the banks in these areas of liquidity, thereby causing a new credit crunch and depressing economic activity. These events should then be exerting a deflationary influence on the economies that helps them to restore their competitiveness. This is not being allowed to happen either, though, because of a major design fault within the Euro. As a result of a technical omission within the rules for bank settlement procedures within the Euro payments systems, the German Bundesbank has been obliged to lend back to the peripheral banking systems the money that is fleeing their countries, thereby preventing the liquidity crisis/deflation that would be needed in the periphery to restore its competitiveness (not that, were it to occur, it would be terribly pleasant for those concerned).

Unfortunately, as a result of this requirement on the German central bank to lend to the periphery, the Bundesbank now has a balance sheet that is overwhelmingly composed of what might perhaps be described as “dodgy” loans to the periphery and, if these loans were to be defaulted upon in the event of a Euro breakup, then German taxpayers might find themselves facing a half-trillion Euro bill to recapitalise their own central bank. The Bundesbank is no longer the conservative institution that it once was and this may even explain why it has seen an unprecedented turnover of presidents this year – two have resigned.



It seems that the quality of the Bundesbank’s balance sheet has been sacrificed so that the periphery could avoid a monetary deflation, although we would remark at this stage that the type of deflation that would have occurred might well have been on a par with that which occurred in the 1930s following similar problems in the operation of the gold standard. In practice, we can suggest that the Euro system is currently being held together at the expense of the Bundesbank’s balance sheet and continual “subsidies” to peripheral bond markets via the ECB’s bond purchases. These measures are treating the symptoms – not the underlying problems – and hence the crisis is rumbling on (in fact, the Bundesbank’s actions are implicitly preventing a solution from occurring because no one would like that particular solution to occur...).

Faced with this situation, we think that only relatively few outcomes are possible. One outcome would be that the German Bundesbank simply withdraws its support for the system (perhaps as a result of a legal challenge in the German Constitutional Court) and we would then expect a “1931 Credit Anstalt” moment that unleashes a deflationary shock to the periphery, a banking crisis and probably a disorderly breakup of the Euro. This is potentially a wildcard outcome but thankfully we give it only a relatively low probability of occurring.

Another option, with a higher probability, is that, rather than ending its support for the Euro, the Bundesbank dramatically increases its balance sheet and floods the Euro system with money. Germany has repeatedly said that it will not do this but if it did, the Euro would likely fall and Germany inflate – two events that might return growth to the periphery and thereby significantly ease the crisis. German voters might not like the inflation and the rest of the world might not like Europe’s competitive devaluation but the currency project might be saved in this way.

Alternatively, the forthcoming Euro summit might deliver the creation of a European fiscal union or even a single super-state. Europe’s population is opposed to this but, as we have noted, many have already been disenfranchised and therefore this is not quite the outside probability it was once, although we continue to see this as a minority probability scenario.

To our mind, the most likely outcome is that the next summit simply offers, in exchange for yet more growth-sapping austerity, yet more but still finite Bundesbank help, some further assistance from the IMF, a little support from the European Financial Stability Funds and some vague noises about fiscal union in an attempt to postpone any day of reckoning. We doubt, though, that this will save the union and instead suspect that even if the politicians do succeed in extending its life, they will do so only until the residents of the periphery (many of whom stand to see their incomes fall back to levels not seen since the mid-1990s under the austerity regimes) finally rise up against the Euro and demand its suspension. Fortunately, by then the OTC markets may well have adjusted their contracts to encompass the Euro problem but for Europe’s banks and budget deficits – including those in Germany – the demise of the Euro system even a year or two hence will still be mightily expensive.

In summary, it really is make or break for the Euro over the next few days; the best outcome for markets would be a Bundesbank monetisation that weakened the Euro at the expense of higher German inflation, while the worst would be a withdrawal of Bundesbank support for the Euro (that is, the Bundesbank is obliged to stop recycling funds back to the periphery). The “kicking the can option” that we deem most likely, though, will only provide a temporary stay of execution, although at least that would pave the way for an orderly breakup in a year or two’s hence. It is the latter scenario that we favour as being the most likely and financial markets might even welcome it in the near term at least given that in many senses they are already tending to price in some form of near-term Armageddon outcome.

Andrew Hunt

International Economist, London

Andrew’s Summer 2012 New Zealand Visit

Timaru – Community Trust Conference	Thursday, 15 th March	1.15 pm	
Christchurch	Monday, 19 th March	9.00 am	The George Hotel
Wellington	Monday, 19 th March	4.00 pm	Wellington Club
Auckland	Tuesday, 20 th March	7.30 am	Northern Club

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Helen McKenzie at helen.mckenzie@tyndall.co.nz or visit us at www.tyndall.co.nz
 Phone: 09 307 6366 / 021 608 849

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