

Monthly Comment

November 2011

Another Euro Summit

Markets, perhaps in a triumph of hope over experience, somehow appeared to believe that the latest EU emergency summit would somehow deliver some form of shock and awe response that would solve the single currency's obvious problems and the associated financial crises that these problems had created. Admittedly, we had rather more modest expectations, believing instead that the European leaders would simply try to produce a statement that, while it might placate financial markets in the near term through talk of managed write-off processes and insurance schemes, would offer relatively little that might have solved the underlying problems within the system, namely the South's lack of competitiveness, the lack of growth in major countries such as Italy and the Euro's lack of credibility with the general public. This was indeed the outcome of this latest in a long line of much-hyped but ultimately disappointing summits.



In the prepared statement offered by the leaders following their deliberations late into the night, point two in the document stresses at the outset their continued commitment to price stability in the region. Since Germany accounts for 29% of Eurozone GDP, this is tantamount to saying that German inflation must remain under 3% for the foreseeable future in order for the ECB to hit its price stability target, a commitment that implicitly reaffirms the Union's belief that the periphery must suffer unit labour cost deflation in order to regain its competitiveness. In theory, this labour unit cost deflation could occur via productivity growth (something that the document blithely suggests without giving any details just how it should be achieved) but for an economy such as Italy, in which 67% of the population work in the service sector and 11% are employed in either the construction or agriculture sectors (in which it is notoriously difficult to raise productivity growth), we are somewhat skeptical that productivity growth can be achieved in the medium term, let alone virtually overnight.

Even amongst the 20% of workers employed in the Italian manufacturing sector, headline productivity growth over the last 10 years has only managed 0.5% YoY (a fact confirmed by the country's appalling loss of global export market share over recent years – while the debate may rage as to just how much deflation Italy needs, the trade data shows that, whatever it is, it is a significant amount) and, while in a “glass-half-full” sense this offers opportunities for productivity catchup, something dramatic would have to change for this to occur.

Raising productivity involves changing education systems, worker expectations, long-term capital expenditure and changes in working practices, events that can take years to achieve; even the UK's “Thatcher revolution” or Rogernomics took 10-15 years to really deliver concrete results. Consequently, if Italian unit labour costs are to be reduced in the near term, wage deflation seems likely to be the more expedient option but, as the official data suggests, even this may be hard to achieve. Despite Italy's weak economic performance over recent years, wage inflation is still proceeding at a decidedly positive 3% YoY rate.



Therefore, we can suggest that the EU statement implicitly says to Italy (let alone the other peripheral countries) that they must work two years longer before they will be allowed to retire, that they must experience nominal gross wage deflation in the interim and probably acute real disposable income deflation in the near

term in order to both regain their competitiveness and provide a bulwark for the system as a whole against any further contagion from the Greek (and others'?) debt defaults (voluntary or not, this latest EU agreement amounts to a default on its debt obligations by Greece).

In fact, if the suggested EU policies are enacted as planned, then this implies that Italian per capita GDP will be down by 8-10% in real terms compared to 2001 and essentially unchanged since the Euro Project was first mooted in the mid-1990s. In practice, Italy might have experienced a period of low nominal interest rates since the Euro was created and its headline rate of inflation might have dropped from 4% to 2% on average since the Euro was created but real economic growth in per capita terms will have been virtually zero.

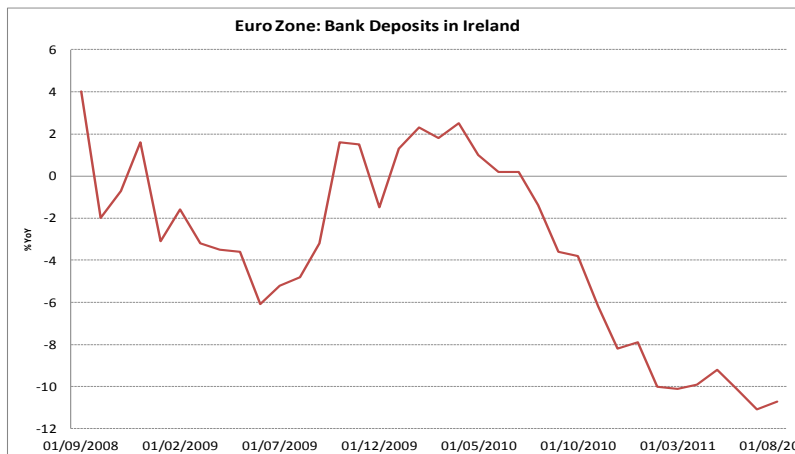


According to opinion polls, 49% of Italians earlier this year believed that the Euro had been good for their economy and some 46% thought that it had exerted a negative impact. We would suggest that given the deterioration in the economy since the first quarter (when this survey was compiled) and, given that the economy is likely to get worse as a result of the Euro summit, the support for the Euro will fall further to the point at which the doubters become a significant force in the next election. Already, the anti-EU “Northern League” holds significant political power and last weeks events may play into their electoral hands.

It therefore seems to us that the general thrust of the Euro agreement last month was “no change” in that the basic austerity/deflation prescription for the periphery – the previous bankrupting-of-the-South strategy apparently remains essentially intact with only a nod towards some ill-defined “growth objective” in the long term. In this respect, the German anti-inflation/deflationist wing clearly triumphed but this was probably always to be expected given Chancellor Merkel’s domestic political agenda and Germany’s position within the Euro system. What the summit did go some way towards addressing though, in the short to medium term at least, was how to protect the financial system – primarily the banks – from the fallout that this deflationist agenda will create, given the periphery’s high public and private sector debt ratios – and, for that matter, France’s. The summit, through its proposals for better bank capitalisation and Greek debt haircuts, did seek to address some of the likely fallout from the system’s problems, at least from a mechanistic point of view.

Similarly, the plans for an expanded European Financial Stability Facility (EFSF), although still beset with smoke, mirrors, ill-conceived concepts and frequently contradictory rhetoric were designed to deal not with the underlying problems in the union but with the consequences of the deflationist agenda. In fact, we continue to believe that the EFSF concept is structurally flawed. For example, is it guaranteed or not? How much of it is guaranteed if it is to be leveraged? How will it achieve its required credit rating given it will be charged with buying junk bonds? Who will fund it? If China does decide to fund it, then will the Euro rise and cause more problems for the periphery? None of these questions were addressed in the statement and yet they seem to be resolved.

Moreover, it can also be argued – and we would indeed argue – that creating a template for defaults will encourage more of them while simultaneously increasing bank capital adequacy ratios is a recipe for a further tightening of the credit crunch already affecting the Euro zone’s private sector, with all that this entails for growth prospects. Such an event would fit with the deflationist agenda noted above but we wonder whether it is truly practical in a real world sense?



In practice, when judging how successful or otherwise the summit was, a lot depends on whether you believe that people have been fleeing peripheral bank deposits because they believe the individual banks that they have been using are effectively bust or high risk depositories for one's wealth (if so, why would they be heading for equally bust German & other core banks?) or whether they are leaving the peripheral banks because they fear a breakup of the Euro as a result of its abject failure to bring growth and prosperity to the bulk of its population.

If you believe that the banking/sovereign crisis is the result of fears over individual banks in the periphery, then some of last month's anti-fallout measures should be welcomed, but if you believe people are buying German bank deposits, UK property and the Swiss Franc because they fear for the Euro Project itself, then October's continued support for the deflation solution to Europe's problems may well have been counterproductive in that it can only lower the periphery's support and therefore trust in the Euro Project further.

In the end, the summit provided the financial markets with what they wanted to hear: vague promises about fiscal and political union; some nod to improving growth rates and most of all a framework for write-downs and a state-sponsored Merkozy "put" for the debt markets and banking system. By promising these, the summit may have allowed the financial sector to divorce itself from the state of the real economies a little longer. By explicitly sentencing the periphery to more deflationary pressure, though the summit may also have undermined the Euro's popularity – and hence credibility – further amongst the general population. If this is true, then depositors will continue to avoid peripheral Euro assets in favour of cash or foreign assets and the banking crisis in the region will continue, thereby forcing more market turmoil and yet another emergency summit before too long.

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