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All Roads Lead to Frankfurt (not Rome)

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As markets and even the Eurozone's population becomes increasingly exasperated with the region's policymakers and their apparent inability to solve the current, deep-seated crisis in the Euro system, many are beginning to wonder if maybe a few countries, such as Greece, should simply opt out of the single currency experiment for a while. Indeed, the generally well-respected former UK Finance Minister Nigel Lawson recently suggested that this should be allowed to happen and he used as his template for this the dissolution of the Latin American Currency Union in 1920. Unfortunately, we would disagree with Lord Lawson's proffered template – the world today is a very different one to that which prevailed during 1920 and for one country, or even a group, attempting to leave the Euro would be akin to attempting to be "a bit pregnant".

It is estimated that at present there are just over USD450 trillion of notional Over-The-Counter (OTC) interest rate derivatives within the global financial system (these are just the plain vanilla ones – the more complex ones are simply not measured…) and nearly half of these contracts are thought to be denominated in Euro. If one or some of the countries were to unexpectedly leave the Euro, then it is highly likely that many of these bilateral trades would not be able to be settled, a situation that would likely pave the way for a banking crisis that would make the Lehman Crisis appear mild by comparison. The stakes with regard to the Euro are impossibly high and the rational expectation is to believe that, given this potentially calamitous downside, the politicians and policymakers will one day "get their collective acts together".

For many of the world's bankers, though, a simple rational expectation of common sense is not enough – they know that if the Euro fails so will many of their business counterparties in the world's now amazingly complex situation and this fear of the unknown has effectively paralyzed them. The world's commercial and investment banks are simply hoarding their capital, reducing their risk levels and waiting even as US Federal Reserve Chairman Bernanke promises zero interest rates seemingly ad infinitum. Unfortunately, this inactivity by the banks has neutered the US and many other authorities' attempts at easing monetary policy. It therefore seems that the world is truly waiting for a resolution of the Euro Crisis and that none of us in either the real or financial market sectors can move forward towards some form of response to what is fast becoming a new global recession.

When the Euro Project was first announced, we drew extensively on the writings of Ricardo and Keynes to suggest that the project was deeply flawed and liable to fail in the longer term. There is, though, no satisfaction in these forecasts at the present time and we would rather be "wrong" about the breakup concept, at least in the short and medium terms. Indeed, we continue to believe that, at the heart of the Euro's problems, lays the mismatch between electoral/national boundaries and the boundaries of the currency area itself.

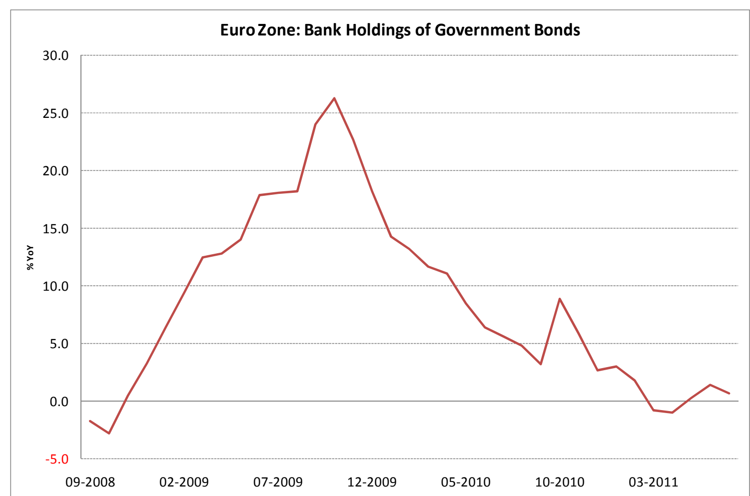
While the governments could easily overcome this problem by adopting the Euro as a uniform unit of account (that is, a unit of measurement – we measure prices in Euros just as we measure distances in kilometers), this mismatch has effectively reduced the Euro's credibility as a store of value and certainly the demand for the Euro as a store of wealth has varied greatly on a country-specific basis since it was introduced. For example, the Greeks and Iberians showed during the 2000s that they would rather borrow Euros than save them at the prevailing interest rate while the Germans adopted the reverse behavior. These widely differing money demand functions between countries both created the competitiveness crises that now beset the periphery and eroded the Euro's ability to act as a uniform store of value and hence the currency has a credibility problem.

Indeed, it is this fundamental credibility problem that has caused peripheral savers to attempt to desert the currency (which has in turn caused the crisis in the bond markets; as peripheral depositors have fled the banks, the commercial banks that two years ago provided the bulk of the financing for Europe's public sectors

have been obliged to curtail or reverse their purchases, thereby causing the funding crises that we are now witnessing). We also suspect that it is this credibility problem that has caused German ECB board members to resign rather than face the personal consequences of the system's failings.

In a currency system that is inherently non-credible, or at least less than fully credible, it is incumbent on the policymakers in power (that is, the European governments and most of all the ECB) to appear über-credible but this is a task that the squabbling, frequently economically illiterate policymakers have spectacularly failed to do; rather than being irreproachable bastions of economic policymaking, they have appeared like squabbling politicians more concerned with their own personal/national self-interests and this is further undermining the Euro system and making the probability of its demise increase almost daily. Hissy fits at conferences, resignations and divisive press briefings will do nothing to stop bank runs in the periphery but if the ECB does not act credibly before long, it will not only scupper the Eurozone economies, it may cause a devastating breakup of the Euro and a further impairment of other countries' ability to manage their own affairs (even outside the Euro area).

The first best solution for the Euro would clearly be that it had never existed. The benefits of a single unit of account must surely have now been completely outweighed by the trillions of Euros spent defending the system and the costs of the peripheral property busts. The second best solution would be to create an instant fiscal union and dissolution of the individual nation states so that the countries concerned became regions of the same state with one rather than many governments, rather than individual states with their own national identities, electorates and specific aims. Then, the Euro might achieve domestic credibility with one electorate backing it but we view this as an improbable outcome and one that history suggests might be even less optimal in the long term – the creation of artificial countries in Europe such as Czechoslovakia or Yugoslavia has never been a success.



This then takes us to the third best outcome – the creation of a new reformed ECB with enhanced credibility and for us this would seem to represent the last chance for the Euro. Below, we outline eight key features that we believe that the new ECB would need to appear credible in the hope that this list will provide something of a checklist for investors who might wish to judge whether any forthcoming policy responses from Frankfurt and Brussels might be enough to rectify the current potentially disastrous situation.

Firstly, we believe that the ECB will always suffer a credibility problem as a result of the multitude of people speaking on its behalf and the variation in meanings that could result from even a single statement being translated 14 times. The Chairman should therefore be the sole spokesperson and an official ECB language adopted, although rather ironically we suspect that the common language would be English. At the same time, we suspect that the Board of the central bank should be streamlined in order to create a faster decision-making process.

More importantly, we would also suggest that the authorities should broaden their policy mandate from simply controlling inflation to also focusing on sustaining economic and employment growth, so that the residents of the troubled periphery can see some merit in remaining in the system and not simply want to leave. In addition, we should also like to see the ECB accept its past errors and accommodate them rather than attempting to reverse them. That Spain has been allowed to become so uncompetitive is a shame but rather

than forcing a puritanical deflation on them so that they can atone for their previous sins, the ECB should just accept that the Euro needs to be a weaker currency in order to accommodate this situation. In a similar vein, the Union might also look towards the creation of longer term fiscal planning and fiscal reform rather than resorting to successive knee-jerk, emergency, eleventh-hour summits and meetings. The notion of a common Euro Bond should also be pursued.

Finally, we would also advocate a larger and restructured Eurozone Financial Stability Facility (EFSF) of the region of EUR2 trillion in size and the creation of improved interbank settlement systems so that the infrastructure and rescue policies appear credible to the average man and the markets alike.

In the near term, the key features for markets would probably be the adoption of a dual mandate/GDP target, the encouragement of a Euro that was nearer EUR1.20 than EUR1.40 and a marked expansion of the ECB's balance sheet via loans to a new-style EFSF, rather than through direct bond holdings of low-quality peripheral bonds.

In practice, we suspect that ECB policymakers will have different ideas and that some of these measures may not be practical either politically or in the timespan under which markets seem to be working at present. We can only hope, though, that in compiling this list, we have created some form of framework in which the actions of European policymakers can be judged, since, if the problems in the Euro are not solved, the world economy may become a more difficult place.

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JP Morgan Alternative Asset Management 2011 New Zealand visit

Tyndall has presentations organised for the upcoming visit of Paul Zummo, Managing Director and Chief Investment Officer from JPMAAM. Paul is based in New York and is visiting New Zealand for the first time. We are honoured to have him make the time to visit us here while on a research trip to Asia. He was one of the founders of JPMAAM back in 1994 and has seen some interesting times in his tenure.

Tyndall has employed JPMAAM since 2001 and the JP Morgan Multi-Strategy Fund II Ltd has been an allocation in our Balanced Fund since 2002.

Cities:	**Auckland**	**Monday, 10th October**	**10am & 12pm**	**Tyndall Offices**
	Wellington	**Tuesday, 11th October**	**12pm**	**Wellington Club**
	Christchurch	**Wednesday, 12th October**	**10am**	**The George Hotel**

For further details please contact helen.mckenzie@tyndall.co.nz

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