

JVB Financial Group, LLC

## CRONIN'S CORNER MONTHLY

### A Perspective on the International Economy

January 2012

by Keith Cronin, JVB Senior Vice President of US Credits and International Sovereign Trading

As arguably one of the cradles of modern civilization, and certainly the cornerstone of Western culture, its place in history is adorned with examples of its omnific potency. Ancient Greece thrust upon the world some of the first works of literature; it was almost exclusively the architect of democracy and classical western philosophy and laid the foundation for the Roman Empire that was to succeed it. The Greek alphabet has been in existence for nearly three thousand years and its presence today can be seen in many dimensions of science and mathematics, but one doesn't have to delve into such realms to see the antique symbolism of Greek. Today the letter 'Epsilon' has come to represent to a weary financial theater an exclamation of danger. A symbol of recklessness born from political obsessions, hopscotched across a gullible and expectant populous and bounced on an economic platform. That the creators of the Eurozone would take the Greek letter "€" and use it as the inspiration for symbolic representation for what would become a shambolic union clangs of an almost rhapsodic irony. Thus, the symbol for the Euro, €, absorbing its hereditary from Hellenic origins and representing all that is tenuous about the European model of economic union has endured, in its short life, an almost parochial history. Having been influenced by Greece in the past, suffocated by her in the present the question remains whether Greece will prove to be the unit's financial Cassandra and be responsible for the Euro's ultimate demise.

The idea of Europe adopting a common currency dates back to the late sixties when member countries of what was then called the European Economic Community floated the idea against a proposal of greater economic and monetary union within the community itself. Following the collapse of the Bretton Woods system, the idea remained shelved and it wasn't until after the unification of Germany that it re-emerged. In fact, many countries (specifically the UK and France) were opposed to a united Germany and thus the French cajoled the Germans into committing to a monetary union in return for French support of German unification. The ink of German historians may someday darkle copybooks on what, today, it could be argued were two momentous errors by the Germans. The first was the unification with the East which undoubtedly detracted (and still does) from West Germany's economy and carried with it huge costs associated with a process that is yet not complete. Differences between what was West Germany and its eastern brethren are even to this day still apparent as Angela Merkel would surely attest to, herself being from what was once East Germany. The other being the adoption of a common currency. The Germans were extremely suspicious of ceding their powerful Deutschemark for a new common currency but the union carrot was too enticing as the economic benefits of a closer Europe under the panopoly of one

currency and one monetary authority proved too great to resist. The economic benefits, of course, being for Germany. From the beginning the flaws with the Euro were obvious and whilst experts across the globe highlighted them, Europe's politicians were determined now to forge ahead. The Euro was the ultimate symbol of European integration and the United States of Europe was born. Not quite. The basic flaws of a unit that was ambitious in concept but specious in design have revealed the currency's foibles and the short term-ism of European thought at the time. The incommensurate monetary policy that would be applied uniformly across Eurozone nations regardless of divergences in their economies saw bubbles and deficits flourish as cheap money was devoured by nations in the periphery. This same monetary policy being uncoupled from a fiscal counterpart across a continent of asymmetry might, it was hoped, some day eliminate the economic disparities and Europe might become a continent full of Germanies (A vision or an obsession?)

The euro's inauguration however was underwhelming. Having debuted in January of 1999 at over parity versus the US Dollar the currency began to depreciate and traded as low as eighty-three cents at the end of 2000. In 2001 the G7 intervened to support the common unit and it once again began its climb versus the Greenback. This ascent would take it to as high as 1.60 against the Dollar and despite the ungluing of the European dream it still trades today comfortably above parity against the American unit. So, what has been behind the Euro's climb versus the Dollar?

As the recent denouement in Europe has proven, the Euro's creators placed economics as the secondary function for the very existence of the common currency, despite the wing-dinging across the continent of the economic benefits that it would garnish. Essentially it was a trophy of European unity and fundamentally a political statement. When countries first adopted the Euro, exchange rates were agreed that were hoped would eliminate, or at least reduce, trade imbalances. Wage disparities across the zone would inevitably and eventually lead to some imbalances but it was hoped that the Euro would, somehow, manage to mitigate against them. This didn't happen. Whilst placing limits on wage growth ("inflation, inflation everywhere but no-where to be seen"), productivity rose much quicker in Germany than in countries like Spain and Italy. German exports boomed and the country (as did Holland) ran massive current account surpluses to the detriment of many of its neighbors who today are the countries with economic metrics drowning in red. The Germans tried to save their way to prosperity and whilst most of Europe ran deficits, Germany ensured that they did not. This was a key pillar of support for the Euro. It had been widely accepted that before the inception

(Continued on page 2)

#### ABOUT KEITH CRONIN

Keith Cronin is  
Senior Vice  
President of  
US Credits and  
International  
Sovereign



Trading at JVB

Financial Group, LLC. With almost a decade of fixed income trading experience, he began on HSBC's retail desk and moved on to HSBC's proprietary trading desk, wherein his specialty became trading Investment grade US Corporate Bonds. Mr. Cronin is a graduate of the University of Cork in the Republic of Ireland with an Honors Masters Degree in Economics.

(Continued from page 1)

of the Euro and the ECB that the Deutschemark and the Bundesbank were the de facto leading forces within Europe. When the Euro arrived it assumed a Deutschemark-esque type of mantle insofar that if Germany was sound, so too was the Euro. Conversely, since the late eighties the US current account deficit had been growing steadily and in 2006 peaked at over 7% of GDP. With the divergence between America and Germany's deficit metrics becoming more acute, the Euro continued to grow in stature. Such momentum fed into itself as countries like China and Russia with huge foreign exchange reserves and a giddy eagerness to attempt and deaden the muscle of the Dollar, diversified into the Euro thus fueling even more demand for the common currency. The Euro, we think, also got support from the philosophical blueprint of the ECB. We have said that the ECB basically dethroned the Bundesbank as Europe's most powerful central bank but it also inherited most of its mandates with the most important being, of course, the perpetual crusade against inflation. The unbridled German obsession with controlling inflation was undoubtedly inherited by the ECB. The FED, whilst always citing stable prices along with maximum employment as their main mandate, has never really shared the same intense dread of inflation that their European counterparts do. Thus, with the ECB always waxing more hawkish than the FED, the almost perpetual interest rate differential potential between the two economies also provided support for the Euro and to this day it still does. With Fed funds close to zero and the main repo rate in Europe at one percent (at the time of writing but destined to fall we think), it provides, ceteris paribus, the opportunity to use the dollar as a carry unit and relocate into higher yielding units – the Euro being one of them. Another reason we think for the Dollar's decline versus the Euro may have to do with the emergence of the world's developing economies and particularly China. The rapacious demand for commodities by the Chinese over the past decade has changed the dynamic in many markets and in commodity markets in particular. The People's Republic is the biggest importer of Iron Ore in the world, the second largest oil consumer and uses about forty percent of the world's copper supply. Over the past ten years there has been a uniform upswing in commodity prices in items from silver to oil to copper to the price of food, which we saw result in demonstrations across many countries in the Middle East and Africa. The fact that these commodities trade in the US Dollar as their prices have gone up, thus the Dollar has fallen. Higher commodity prices would signal a 'risk-on' environment and when risk catches a bid, the Dollar would be sold and currencies like the Euro bought. The appreciation of the Euro versus the Greenback is no real mystery but it obviously begs the question now as to whether now the Euro can survive the debt debacle that currently suffocates the Euro-zone.

We think at this stage that it's not a question of whether the Euro survives or not but within what kind of Euro-zone will it continue to exist. At the time of writing it seems quite plausible that the seventeen nation Euro-zone bloc will assume a drastic transformation in the forthcoming year. In fact, we think it's inevitable. As it all started with Greece, thus there may it end. Greece's membership of the Euro-zone is,

euphemistically, tenuous. As the second bailout is primed for employment it reminds that one of the few things being employed in Greece at present are bailout packages. The austerity measures that have been poured upon each other have had, and will continue to have, a tremendously detrimental impact upon an economy that is in tatters. We think a Greek default will be unavoidable and their exit from the Euro an inevitable consequence. What happens after they leave is open to infinite conjecture as it has never happened before and thus there is no precursor to use as a benchmark. Of course it will depend on how controlled an exit can be and whilst Greece will suffer, at least they will have control of their own currency again and can start to rebuild their economy without crippling austerity. After Greece, perhaps Portugal will be the next in line for an exit visa but once again such a scenario, we think, does not necessarily spell disaster for the Euro-zone or its currency. It will be when, and if, Italy or Spain go to the bad that the spiral may begin. The proposed five hundred billion euro permanent bailout fund (European Stability Mechanism) that will be introduced this forthcoming summer is at a minimum threshold and will need to be significantly pumped up if it is to provide an effective firewall for Italy and Spain - a proposal that continues to get rejected by Germany. However, we think that Europe's financial 'elite' will wait and see. If the IMF can first raise more funds before the ESM's arsenal is seriously revaluated, thus the IMF 'begging bowl parade' will likely continue. Ironically, even a pledge by Europe's leaders to raise the fund's dimension into the trillions might be enough to push Italian and Spanish yields lower and thereby cheapen their borrowing requirements. They may never even have to do it and the fund may never need to be tapped to its maximum extent but Europe's politicians do not seem to interact with the world of irony, only duplicity. The Euro itself, we believe, will live and die upon the commitments of Germany and Germany alone. We have already opined that its creation was in the image and likeness of the fabled Deutschemark and as long as Germany stays committed to the common currency we are not likely to see its collapse. Whilst most Germans are likely to claim that they would prefer to have the Deutschemark re-instated, the Euro has always been an effective ersatz of the old currency and furthermore such nostalgia for the old D-Mark wasn't as clamorous when Germany was running huge current account surpluses. It is very unlikely that Germany will – or can – walk away from the Euro as the costs involved economically, financially and administratively would be astronomical but we are likely to see the number of countries using it start to dwindle. If the Euro then becomes the unit for only the fiscally healthy and those committed to the German model of fiscal prudence, the Euro has the potential to become the world's pre-eminent unit as long as the US remains mired in its own horror show of undisciplined fiscal fecklessness. However, "If" is a deep word that can echo oblique deafening tones of vacant hope. We have seen vacillation pore from frustration as this crisis has unfolded with Europe's undeniable economic powerhouse being caught up in parochial politics. The Euro's future and the Eurozone's path all lead to and from Berlin. The question is, how many countries will be allowed or are willing to keep walking this path.

Keith Cronin  
January 2012



2700 N. Military Trail, Suite 200 / Boca Raton, FL 33431 / (561) 416-5876 / [www.jvbfinancial.com](http://www.jvbfinancial.com)

**For Broker Dealer / Institutional / Advisor Use Only**

This material is intended for broker dealer, institutional, and advisor use only, and is not to be distributed to individual investors. This document has been furnished to you solely for your information and may not be reproduced in any manner or provided to any other person. The information contained herein is based on sources that we believe to be reliable, but we do not represent that it is accurate or complete. Nothing contained herein should be considered as an offer to sell or a solicitation of an offer to buy any financial instruments discussed herein. All references to prices and yields are subject to change without notice. Any opinions expressed herein are solely those of the author. As such, they may differ in material respects from those of, or expressed or published by or on behalf of JVB Financial Group, LLC or its officers, directors, employees or affiliates.