

A View from the Trenches Toronto, Monday, February 8th, 2010

Good morning,

During the weekend, we did a fair bit of reading and, among other things, watched an interview Mr. Martin Redrado (now ex-President of the Banco Central de la República Argentina) gave. It was an unusually interesting interview to watch (the interview was in Spanish and can be replayed at: <http://www.tn.com.ar/2010/02/04/politica/02133330.html> . We will refer to his comments made from **minute 10:30 to 11:42**). As you may know, Mr. Redrado gained public attention after he refused to hand over \$6.6Bn in reserves of the Banco Central to the Argentina's Treasury, to service upcoming debt maturities. Mr. Redrado had to eventually resign. In the interview, Mr. Redrado was asked why he thought the Treasury should not use the so called "excess reserves" of the Central Bank, if the amount of reserves is higher than the monetary base in pesos (which the reserves back)? Mr. Redrado answered that **the question denoted a misunderstanding** and gave an historical example: In 1989, at the time Argentina had hyperinflation, the amount of reserves was actually higher than the amount of "currency in circulation". Redrado continued to point that the relevant metric a Central Bank should follow is not "Demand for currency", but the **potential** demand for currency. He explained that under the **institutional uncertainty** Argentines face, they may not renew term deposits at maturity (a component of M2). As these term deposits mature, they become demand deposits, which people then convert into USD. Therefore, the Banco Central has to maintain an **optimal** level of reserves that will guarantee enough supply, to a **potential** demand of USD . Term deposits must not be ignored. Therefore, according to Mr. Redrado, Argentina has no such a thing as "excess reserves". (Here, the concept of currency is tricky. Argentines demand USD as a reserve currency, while they demand pesos as a transaction currency).

Why do I take you precious time to tell you this? Why should you care about this story, if you live in the developed world?

Last Friday, Mr. Jeffrey Rosenberg, Bank of America's Credit Strategist wrote an interpretation on the current crisis that the so-called Euro zone peripherals face (i.e. Greece, Italy, Portugal and Spain; "**Default (even a sovereign one) is a liquidity event**" in "US Fixed Income Situation", Fixed Income Strategy, February 5th, 2010, Bank of America). According to Mr. Rosenberg, there is no currency crisis. As these peripherals have their debt denominated in Euros, "... *this crisis is a long term "solvency" crisis precipitating a short term liquidity crisis...*". Therefore, this is not a typical sovereign currency crisis (not your father's crisis), with investors fleeing the countries financial markets, and all we need is "**liquidity support**". What does Mr. Rosenberg mean by liquidity? He shows us two tables. In Table 2, we see "Fundamentals behind solvency concern". Which ones are these? Fiscal Deficit as % of GDP, GDP, Sovereign debt (in \$ and in % of GDP) and the required adjustment, as a % of GDP. In Table 3, there is a display of liquidity needs of the Eurozone. The metrics are (for each member country, in Euro) 2010 bond maturities, Rolling short term debt, Fiscal deficits and total financing needed. From this point of view, the natural conclusion is to obtain the scale of the liquidity support required.

After having heard Mr. Redrado, I could not help smiling at Mr. Rosenberg's naivness. Every currency crisis, **absolutely every one of them**, is the consequence of the assessment made by its holders, that their currency no longer can serve **both** to transact and to act as an asset to save. The currency can no longer be used to save. Why? **The reason is always institutional. It doesn't matter what the trade or fiscal deficits are (the USD is the best example) or what a government's financing need is. At the heart of a currency crisis you have a crisis of confidence in the government. The currency holders ask themselves: "Will we be "taxed" for holding pesos, or Euros?"** The extreme case of Argentina is a good example. Note that if the Central Bank's reserves belong to a government's Treasury, changing pesos for another currency constitutes an **act of fiscal rebellion!**

In conclusion, in my view, the Eurozone peripherals are **not** facing a liquidity crisis. **The issue is far more serious. The whole European Union is facing an institutional crisis. Will the Eurozone behave as a Confederation or as a Union? Under our perspective, the cost for the Eurozone of not standing up to the circumstance and showing a firm resolution, will be far, far more expensive than the product of the existing government financing needs times a higher cost of borrowing, as Mr. Rosenberg wants us to believe. The European Central Bank must not believe for a second that what is at stake is a "short term liquidity problem of peripherals". Paraphrasing Mr. Redrado's wise comments, the European Central Bank must understand that in these peripherals there is also a **potential** demand for a reserve currency that will be triggered violently without notice, if the Eurozone acts as a Confederation, rather than a Union. In this case, liquidity support lines will be useless and will only delay a horrible end. What does the Eurozone need? A unified bond market.**

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