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Volume 21, No. 47 | 1731 North Marcey, Chicago IL 60614 | www.biancoresearch.com

Commentary

Market Opinions and Topics of Interest

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May 24, 2010

Europe Has Short-Circuited Default/Devaluation Adjustment Mechanisms

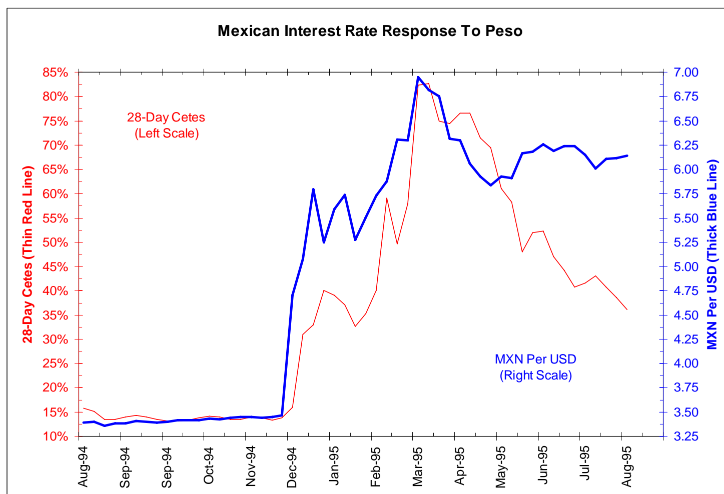
As noted in January in the context of China's peg of the yuan, a government can fix an exchange rate or it can fix its own short-term interest rates, but it cannot fix both.

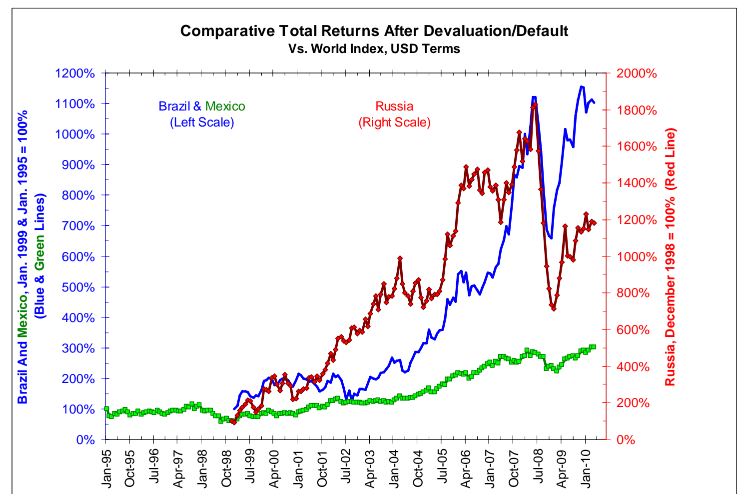
As discussed in a recent Special Report, the European Monetary Union has demonstrated this principle via the divergence of its various national yield curves and greater interest rate volatility. This pattern of yield curve divergence and higher interest rate volatility will continue until and unless the perceived credit quality of EMU members converges into a narrower band.

Mexican Experience

As the Mexican peso (thick blue line, left-hand chart) weakened and then collapsed in December 1994, 28-day interest rates (thin red line) shot higher to arrest the currency's decline by making it more expensive to borrow. Both instruments worked in tandem to allow Mexico's economy to adjust to the macroeconomic shock. This experience would be repeated throughout the 1990s in the Asian crisis, the August 1998 Russian default and the January 1999 Brazilian devaluation.

If we map the performance of the Mexican, Brazilian and Russian stock markets (green, blue and red lines, right-hand chart) versus the MSCI World index in USD terms, with each market re-indexed as closely to the date of devaluation as the data allow, we see how countries can and do prosper after a period of currency devaluation and high interest rates.



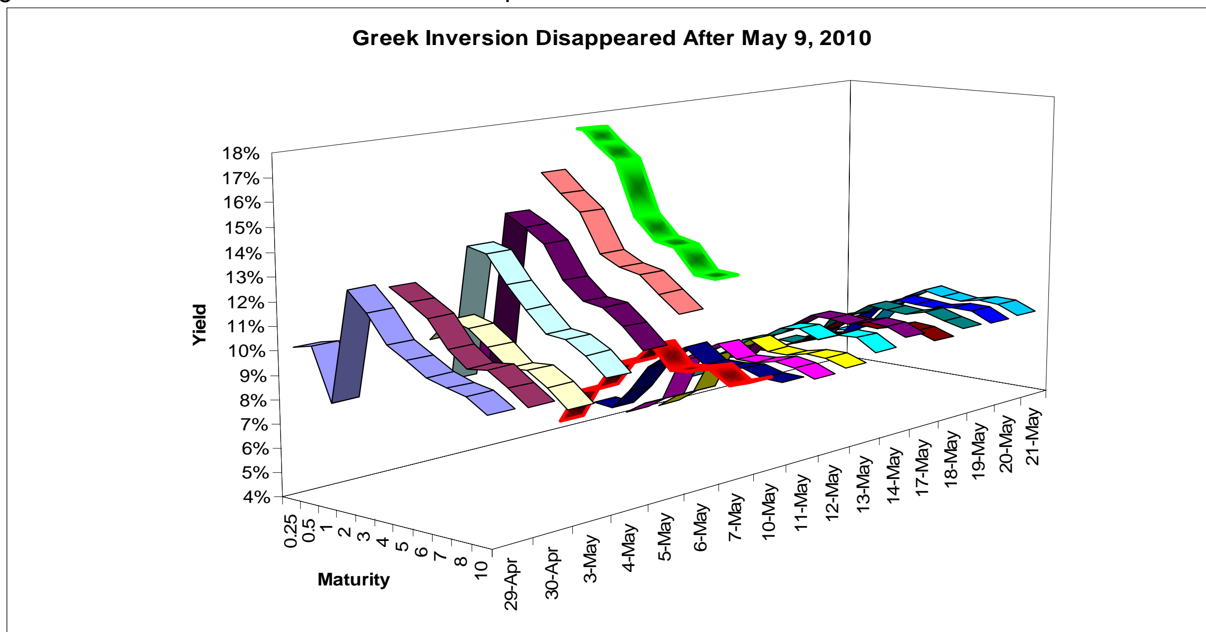


The European Situation

The spikes higher in short-term interest rates in default/devaluation situations generally are accompanied by either an actual inverted yield curve or a pseudo-inversion; the "pseudo" derives from the virtual disappearance of longer-dated interest rate instruments unless they carry a currency protection as did the Mexican *tesobonos*, or dollar-linked bonds, of that era.

The combination of the euro linkage and the willingness of the EMU members and the European Central Bank to backstop weaker credits such as Greece force a different situation for these countries than existed in the examples above and in the various South Asian economies affected by the Asian crisis of 1997-1998.

We can illustrate this by mapping the Greek government yield curve before and after the May 9, 2010 actions; May 7th and 10th are highlighted in bright green and red ribbons, respectively.



Conclusion

The adjustment mechanism of allowing currency devaluation did not exist for Greece, nor does it exist for other EMU members. The adjustment mechanism of higher short-term interest rates raises the cost of borrowing in Greece and thereby encouraging saving and discouraging debt has been shut off by the European actions.

This leaves a steeper yield curve with higher long-term interest rates than would exist otherwise as the only adjustment mechanism; higher interest rate volatility contributes to an expansion of the liquidity premium.

As long-term interest rates are more determinative of investment patterns, we can conclude the shared European actions will result in a higher cost of capital and lower growth rates throughout the Eurozone than would exist otherwise.

Restated, the cost and ultimate benefits of higher short-term interest rates and currency devaluation within the weaker credits of Europe have been transformed into the cost of higher long-term interest rates within the entire Eurozone with the benefits being uncertain beyond the avoidance of an immediate crisis.

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