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Euro Saved for Now; Europe Still in Recession and Debt Denial

The post-financial crisis years have not been kind to Europe. The eurozone has suffered through a seemingly never-ending sovereign debt and bank capital adequacy crisis, which began in Greece but quickly spread. The euro rebounded only when the European Central Bank (ECB) in September made open-ended commitments to maintain the single currency and buy short-term sovereign debt as required (albeit with some potential conditionality). As we monitor developments in Europe, we are struck by a number of incongruities that threaten to plague the economy, even if the currency has temporarily stabilized.

Euro Saved for Now

The ECB was established specifically to manage the single currency. Had it failed to provide the commitments necessary to secure the future of the euro, it would have destabilized Europe, opening itself to charges of dereliction of duty and, certainly, abandonment of its raison d'etre. Nevertheless, the medicine is likely to come at a steep price. The ECB's long-term and open-ended commitment portends a lengthy period of very low short-term rates and balance sheet expansion. The euro probably would be yet weaker than it is today if the U.S. Federal Reserve, the Bank of England, and Bank of Japan had not made largely similar commitments to maintain near-zero short-term rates and balance sheet expansion for years to come. **Put another way, the U.S. dollar, British pound, Japanese yen, and euro are all sick currencies to some degree. The challenge for currency market practitioners is to decipher which ones merely have the flu and which ones are in intensive care**. That means projecting which of these currencies is likely to be stronger boils down to assessing their relative weaknesses. It is not a pretty picture.

Fundamental and quantitative models of currency movements typically rely on two relationships: relative interest rates, and trend or momentum patterns in exchange rates. Neither factor provides much guidance in the current environment. As already noted, **for currency markets, there is no signal whatsoever from relative interest rates,** since the central banks of the four major currencies are all mired in extended stretches of extremely low rates. And while currency markets historically have been the poster child for the maxim – "the trend is my friend" – the trends lately have proven unreliable. This reflects the reality that **among the major currencies political decisions, rather than economic drivers, have taken the lead in determining short-term exchange rate movements**.

Political decisions have their own dynamics, decidedly different in nature from the evolution of economies. In an atmosphere of crisis, pivotal political decisions are typically born of brinkmanship. Because it is inherently binary, the political decision-making process itself may emerge as a source of market disruption. It confronts market participants with sorting through the complex expectations embedded in a probability distribution with two modes: typically, a low-probability scenario in which policymakers flirt with severe financial disruption by failing to take appropriate policy actions, and a high-probability scenario in which everyone muddles through the crisis by virtue of last-minute ad hoc policy actions. Moreover, the uncertainty created by political brinksmanship fosters an overall loss of market confidence and a persistent sense of gloom. In short, with each major country temporizing over its own political quandaries, the binary nature of political decision-making in crisis overwhelms any discernibly persistent trend in currency markets. (The interested reader may wish to see the academic analysis in "Thoughts on Volatility, Correlations, Expectations Formation, and Risk Management in the Era of Dissonance, *Review of Futures Markets,* 2012.")

Austerity and Denial

Though the ECB has come to the rescue of the single currency, at least for now, the economies of Europe face austerity for a long time to come. **The demographic reality of Europe is that the population is aging, not growing. Without strong labor force growth to power dynamic economic activity, there is little to no hope that Europe can grow its way out of its massive overhang of government debt**. This has not stopped the European Union (EU) from trying to devise bailout plans that assume that all EU debt issued in a rescue plan will be repaid in full. The assumption that debt restructurings and write-downs can be avoided is tenuous. Two things would have to occur for the European governments in deepest debt to avoid restructuring; neither is likely in the short run.

First, **European countries must devise a way to cut their government pension obligations**. Meaningful fiscal spending reform, from Spain to France and beyond, depends on tackling pension costs. Greece, with its back to the wall, has cut government pensions by 10%. But France has moved to lower the retirement age, and Spain has declared cutting pensions politically unacceptable. This is the wrong direction for obtaining fiscal balance. But cutting government pensions would spell political doom for any politician who embraces reality. Denial is currently the preferred course.

Second, banking systems must be recapitalized. It is not just fiscal austerity that is holding back growth in many European countries. **When banking systems do not function well, economies do not grow**. Of course, there is a justifiable and appropriate movement for tougher bank regulation. But if Spain and other European nations want growth to resume, they need to get their banks recapitalized sooner rather than later. Progress on this front shapes up to be torturously slow, since the implication is that someone has to take some big losses in the process. Our perspective is that a poorly-functioning banking system deserves more or less equal responsibility with fiscal austerity for the current recessionary environment in many European countries.

Taken together, our assessment is that Europe will remain in debt denial (restructurings are probably necessary), austerity will be in place for many more years and the banking system has years more to go before having the capital and profitability to function properly. This makes it difficult to become more optimistic about the European economic outlook, even if we are, for now, no longer worried about the break-up of the euro.

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