EUROZONE- BREAKING UP IS HARD TO DO
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"They say that breaking up is hard to do,
Now I know that it's true.
Don't say that this is the end.
Instead of breaking up
I wish that we were making up again.
I beg of you don't say goodbye.
Can't we give our love another try?" Neil Sedaka, "Breaking Up Is Hard to Do"

CONCLUSION

The decline in the Euro FX does more than reflect Europe's sovereign debt and banking crisis. Europe does not stand or act alone. Euro currency weakness underlines the continuing epic worldwide economic disaster that emerged in 2007. The sustained slump in the Euro FX since spring 2011 warns that the worldwide economic recovery that began around early 2009 is slowing. Some headway has been made in containing Eurozone (and other European) problems, but that progress has been insufficient and it probably will remain so for at least several more months. The Euro FX will depreciate further from current levels.

BREAKING UP IS HARD TO DO

In the long-running worldwide economic crisis show, European economic- and political- problems often have seized the limelight. However, apart from its geographical reference, "Europe" is a somewhat imprecise notion. Despite the noteworthy political and economic ties within the broad European Union and the narrower Eurozone currency group, countries retain great independence. Yet although one land's domestic politics intertwine with and often reflect its economic issues, these often entangle with those of its neighbors. Official and unofficial European arrangements are distant from the "more perfect union" created after much time and substantial bloodshed by the assorted states of the USA. And of course European countries vary greatly. Germany is not Greece.

The ongoing European (and global) sovereign debt and banking disaster is complex. Domains differ in their exposure and responses to the crisis. Italy is not Greece, and so on. Much commentary focuses on whether a small nation such as Greece (Ireland, Portugal) or even a big one such as Italy (or Spain) will really and truly default on its debts, as opposed to merely repackaging them in fancy fashion or pushing them further out into the future. Bound up with these issues is the question as to whether Greece or some other nation will exit the Eurozone. Some nervous businesses even have made contingency plans for the possible end of the Euro (Financial Times, 11/30/11, p1). Thus the fate of "Europe" and the Eurozone prompts numerous summits by European political and economic guardians and captures worldwide marketplace and media attention.

Let's focus on the Eurozone and the European currency ("Euro FX"). Not only are there numerous political (economic) treaties and institutions in place making a withdrawal from the Eurozone cumbersome. In addition, although members of the European Union (and the Eurozone) have different visions regarding the "united Europe" they would like, most perceive significant benefit from existing arrangements. Thus, especially in today's troubled universe, European

leaders do not want nations- even those of relatively modest economic power such as Greece- to depart the Eurozone. Of course, if a nation elects to default on its debts and flee the European Union or the Eurozone, other countries will not become violent and march in with their troops. Thus in order to preserve - and eventually perhaps improve upon- existing arrangements, European leaders will undertake Herculean efforts to buy time and fix (or stabilize or postpone) problems.

TANGLED WEBS AND PARTIAL SOLUTIONS

The diversity of Eurozone (and European; and other) nations and their interrelated difficult economic (political) problems build a labyrinth. Understanding, keeping up with, and accurately describing the tangled proposed rescue solutions and related actions (and their evolutions) is very challenging. Diverse and sometimes misty and esoteric sermons of central bankers, finance ministers, politicians, and other marketplace pundits create a noisy rhetorical maze. Currency, stock, interest rate, and commodity price twists and turns, often violent, frequently fuel fears, excitement, or confusion.

Despite this complex and often perplexing situation, what conclusions roughly (even if incompletely) summarize Eurozone affairs? Some of these viewpoints are open to more qualification and debate than others.

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First, despite the major sovereign debt and banking problems, the Eurozone's political and economic leadership has the political desire and (ultimately) sufficient economic power to preserve the Eurozone. This means keeping even members such as Greece within it. The problems of the so-called peripheral nations in key respects have become those of the entire fraternity. The Eurozone may rely on outside economic help from the International Monetary Fund or other countries to help pay for the repairs. However, the region as a whole will, "if push comes to shove", resolve the thorny difficulties itself. And even if Greece did exit the Eurozone, remaining Eurozone members probably would band together to keep the Eurozone intact.

For some time, the so-called fixes may involve pushing the problem (dangers) off to a more distant future. The buying-time strategies (hoping that economic recovery eventually will enable a genuine escape) of course will have some costs. For example, picture inflation risks, slower growth, and some suffering by creditors.

The substantial role of the Euro FX in official reserves underlines the importance of the Eurozone and its Euro FX in the world economic order. Most of the world surely does not want the Euro FX to disappear entirely, or to suffer a massive depreciation (as opposed to a further small or even a modest depreciation). Thus at some point ("if really necessary"), the world outside of Europe would ultimately bail out Europe.

Look at the International Monetary Fund's "Currency Composition of Official Foreign Exchange Reserves" statistics ("Cofer", 12/30/11). The claims in Euros as a percentage of allocated reserves (which are part of total foreign exchange holdings; the other reserves are unallocated) in third quarter 2011 are about 25.7 percent (2Q11 26.7pc). In 4Q10 they were 25.9 percent, 4Q09 27.6pc, 4Q08 26.7pc, 4Q07 26.3pc, and 4Q2006 25.1pc. Compare the claims in 4Q00 of 18.3pc. The United States share of official reserves is larger, with 3Q11 at 61.7pc. But even in comparison, the Euro FX is significant. These huge official claims in Euros (whether via currency

or financial instruments) thus parallel the importance of the Eurozone and its commerce within the global economy.

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However, for at least the near term, substantial economic problems will keep confronting Eurozone (and other European) players. And European progress to date in solving them probably has been insufficient and looks like remaining so for many more months (or longer). More substantial effort to cure ills may develop (new schemes could emerge), but these are needed sooner rather than later. Things likely will drag on for some time, with slow policy progress occurring. A worsening of the crisis, however, may induce quicker and more dramatic action.

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At the outset- and despite numerous summits and extensive speechmaking, keep in mind that significant (stricter) fiscal (and political) Eurozone (and European) union remains distant. Despite the European Union's December 2011 summit, efforts to improve fiscal integration and establish semi-automatic sanctions for indiscipline did not receive unanimous approval. Britain objected. Although all members of the Eurozone agreed to the general principles, an intergovernmental deal outside of the EU framework remains to be negotiated. Thus the substance of the deal remains to be fleshed out and formally agreed upon. Not only may this take time, it may face legal challenges.

Regarding any long term goal of fiscal union (or even much closer ties than currently exist), it probably will take a very long time for diverse Eurozone nations to agree upon and enact a shared vision. Germany has stressed that this process will take time.

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The euro area economic situation is dreary and will remain so for the near term horizon. The European Central Bank (12/8/11) cut its euro area 2012 GDP estimate range to -.4 percent (downturn) to 1.0pc. The 2012 forecast is slightly sunnier, .3 to 2.3. As a sign of current and prospective gloom, the ECB cut rates another 25 basis points in December to one percent, even though "Inflation is likely to stay above 2% for several months to come". The economic outlook for the euro area has "substantial downside risks".

The ECB's December decisions to engage in longer term (three year) refinancing to support liquidity, ease collateral standards, and reduce the reserve ratio further evidence substantial continuing Eurozone financial problems. These accommodative actions, along with low rates, display the ECB's effort to supply liquidity in order to buy time for action by other sentinels on the sovereign debt and banking fronts.

The International Monetary Fund's managing director, Christine Lagarde, recently commented that the European debt crisis is growing to the point that it will not be solved by one group of countries. In addition, the overall world economic outlook "is quite gloomy". Incidentally, how does she characterize the Eurozone? This monetary union "has not been properly completed by an economic and fiscal union", although this union "is currently in the works". (Bloomberg, 12/15/11).

The Bank of England cautions that the Euro area crisis is one of solvency, not of liquidity. See the Bank of England in its Financial Stability Report and remarks by the Governor of the Bank of England (also note Financial Times, 12/2/11, p6).

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The ECB's lengthy "Financial Stability Review" ("FSR"; December 2011) summarizes and offers details on interconnected risks to euro area financial stability (p10). There are four. "Contagion and negative feedback between the vulnerability of public finances, the financial sector and economic growth" is one. There are "Funding strains in the euro area banking sector". Remember "Weakening macroeconomic activity, credit risks for banks and second-round effects through a reduced credit availability in the economy". Finally: "Imbalances of key global economies and the risk of a sharp global economic slowdown".

FSR data hint at parallels between Eurozone ("in general") and American problems in corners of the indebtedness realm. Maybe Europe's difficulties are less severe than America's, but they are not insignificant. The general government budget balance deficit (there is of course significant national variability here) was 6.2pc in 2010 (a big jump from the -2.1pc in 2008). The deficit slipped to -4.1pc in 2011 and is forecast to fall to -3.4pc on 2012 and -3.0pc in 2013. (FSR, Table 2.1, p48). The OECD notes that central government gross borrowing of the OECD countries in the euro area peaked in 2009 at 18.7pc of GDP. Although it is projected to drop beneath 15.0pc in 2012, the 2012 height nevertheless remains well above 2007's roughly ten pc elevation. ("Overview OECD sovereign borrowing outlook 4", December 2011). Besides, how optimistic should one be regarding current and future deficits? Spain warned that its 2011 deficit reached eight percent of GDP, an increase of two percent from the prior estimate (Financial Times, 12/31/11-1/1/12, p2).

In any event, continued deficit spending means that Europe's debt mountains and related financing challenges remain. Overall Euro area general government gross debt was 70.1pc of GDP in 2008 and 88.0pc in 2011. It edges up to 90.4pc in 2012 and 90.9pc in 2013. Greece's is predicted at about 198 percent in 2012 (163 percent in 2011), with Italy's a lofty 121 percent (the same as 2011).

Greece remains a mess. According to the IMF, "there is still quite a long way to go". ("Transcript of a Conference Call on Greece", 12/13/11). The IMF notes continuing discussions about the 50 percent nominal haircut by the private sector on Greek debt. After several months of discussion and much talk of a real deal, the absence of finality on the haircut issue is troubling.

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Bank recapitalization remains a substantial challenge. According to the FSR, the capital shortfall of the euro area banking sector is about Euro 113.2 billon (Table 4.1, p79). National needs vary. The Greek shortfall is E30bb, Spain's E26.2bb, Italy's E15.4bb, and Germany's E13.1bb.

European banks probably are selling off quite a few assets rather than relying entirely on raising capital in order to satisfy European Banking Authority and Basel III capital ratio rules. This process, if it reduces bank lending, may add to European (and other) economic weakness. In addition, there have been notable withdrawals of deposits from Eurozone banking institutions, particularly in Greece. In regard to the potential "run on the banks" issue, deposits at foreign banks in the US have fallen (Financial Times, 12/15/11, p17). Also, United States money market funds have slashed their exposure to European banks.

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Many American households are under pressure. Net worth remains below pre-crisis peaks. Europe's consumers also may be stretched. According to the ECB's FSR, Euro area household debt to GDP ratio has risen steadily from around 50pc in 2001 to over 65pc in 2009-11, with household debt to gross disposable income soaring from 75pc to just about 100pc (Chart 2.1,

p34). In addition, the debt to GDP ratio of non-financial corporations in the Euro period leaped from about 60.0pc in 2000 to nearly 85.0pc in recent years (Statistical Annex, Chart S9, p7).

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Review some specifics on creative mechanisms Europe has created to help escape its economic crisis.

Much talk and effort was spent on the creation of the European Financial Stability Facility ("EFSF"). However, many observers believe it lacks sufficient funds to solve the sovereign debt and bank recapitalization issues.

Of the EFSF's about Euro 440 billion original capacity, after recent bailouts of Greece, Portugal, and Ireland, only about E250bb spare capacity is left. Italy and Spain have funding needs of about Euro 1,000 billion in the next three years. (Financial Times, 11/30/11, p21; 12/10/11, p2, 12/20/11, p4). Italy must refinance about Euro 200bb (about $260bb) in government debt by April 2012 (NYTimes, 12/30/11, pA11). The Italian prime minister very recently declared that the European Financial Stability Facility needs to be "significantly bigger" (Financial Times, 12/30/11, p1). Hopes of leveraging available EFSF funds have produced little tangible results. Talk of ECB lending to the EFSF remains talk.

Recent months generated speeches about potential help to Europe from China and other developing nations via a special purpose vehicle or an arrangement with the IMF. So far, actual creation and funding of such plans has been elusive.

A new Eurozone rescue fund, the European Stability Mechanism ("ESM"), however, will have Euro 500 billion available. It will be operational in July 2011 (12/9/11 European summit decision). The ESM is separate from the EFSF. The EFSF, set to expire in 2013, supposedly will not operate in tandem with the ESM (Financial Times, 12/10/11, p2). Perhaps this relationship will evolve.

This additional help via the ESM may be insufficient to fully meet Eurozone sovereign debt and banking needs. Combining (assume this is permitted) the upcoming ESM with the EFSF's available firepower of E250bb gives E750bb, a huge sum. Maybe it will be enough to scrape by, but recall the estimates of Euro one trillion financing needs of just the nations of Italy and Spain over the next three years. However, this rescue package probably will be inadequate if the European (and worldwide) economic recovery remains feeble or a downturn emerges. Moreover, these ESM funds may be needed sooner than July 2011. Much of course depends on private sector and non-European official demand. What if individuals and institutions in the private sector, or the non-European official domain, substantially reduce or lose their appetite for Eurozone debt?

What happens to these various financing platforms if France loses its top grade rating?

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Will the ECB engage in direct money printing via bond (or other securities) buying to resolve the sovereign debt and banking problem? Probably not. The ECB underlines that existing law makes monetary financing of governments impermissible. Admittedly the ECB began to engage in bond buying in May 2010, but it sterilizes these operations via deposit taking from commercial banks. Thus the ECB can claim not to be printing money. However, banks are not obligated to deposit funds with the ECB, so there is potential for shortfalls in sterilization.

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The European Union proposed contributions of Euro 150 to 200bb to an IMF facility to help the European situation (Financial Times, 12/20/11, p4; FT, 12/10/11, p2). However, the UK refuses to contribute to the IMF plan unless it is part of a wider international effort. Japan is reluctant to contribute, as is the United States. Contributions from China and other nations to this or a similar IMF fund have not become a reality yet. So for the near term, there's not been much progress on this front.

The International Monetary Fund's "usable resources" at end November 2011 were about $628 billion ("Financial Resources and Liquidity Position"). This sum is not entirely available to rescue Europe from its sovereign debt and banking problems. After all, some of the money may be needed elsewhere in the world. Perhaps in combination with Europe's ESFS and ESM, a $100 or $200bb tranche of that $628 billion would offer useful help. However, it may take a worsening of the crisis to bring that into play (especially if the ESM is not ready to operate or sufficient in size).

However, there also has been marketplace and central bank talk of funneling money to the IMF via the European Central Bank. What does this discussion of lending to the IMF by the ECB indicate? It hints that some European watchdogs believe that current (and upcoming) Eurozone rescue mechanisms may be insufficient to meet crisis needs, and that those currently available via the IMF likewise will be inadequate.

This lending via the IMF admittedly may never occur. The European Central Bank President emphasized again (12/8/11) that the Treaty does not permit monetary financing of governments. In another words, US money printing (quantitative easing) by the ECB via buying government (or other securities) is supposedly forbidden. However, this is perhaps a little murky; there could be a loophole regarding some concepts of direct and indirect monetary financing by the ECB. So maybe backdoor indirect lending via the IMF (as opposed to unsterilized bond buying) is a route to money printing. The ECB stated: "The issue of whether the IMF could be used as a channel is legally very complex." This complexity language hints at exploration of potential legal maneuvers. It nevertheless probably would take some time to put into practice (and survive legal challenges).

IS CURRENCY DEPRECIATION A SOLUTION?

European political and economic steps taken thus far to formulate and implement satisfactory (sufficiently complete) solutions to the financial crisis may work. However, adequate success for at least the near term is at best quite uncertain, and arguably unlikely. One reflection of this has been the frequency of the summit meetings and ongoing efforts by policy leaders and economic experts to improve upon their outcomes. The rather steady depreciation of the Euro FX since around early May 2011 further indicates that satisfactory solutions to the European (and worldwide) financial crisis have not been achieved, and that it probably will remain difficult to produce a sufficiently desirable and permanent outcome for quite some time yet.

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Think of the Euro FX on an effective exchange rate basis, not merely as a cross rate against the dollar or some other currency. Depending on circumstances, perhaps substantial currency weakness (depreciation) can help some nations (or sectors within them) to boost economic growth. Also, sovereigns- including European ones- have a currency antidote that could assist them. Debtors with foreign creditors benefit (to some extent and up to some point) via the

depreciation of the currency in which their debt obligations are denominated. Maybe further Euro FX declines thus would help Europe to recover better from its ongoing weakness, including its sovereign debt and banking issues. This would help to support and preserve the Eurozone and its institutions.

Some might argue that recent Euro FX tumbles reflect deliberate depreciation by policy generals, or at least tolerance of it.

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During the crisis that began in 2007, the song of "weak US dollar equals strong stocks (use the S+P 500 as the benchmark), strong US dollar equals weak stocks" has been popular. Strong stocks (weak dollar) are associated with economic recovery (and rallies in commodities in general), weak equities with a declining economy. Now think of the Euro FX versus US dollar cross rate. If one replaces the dollar with the Euro FX in the phrasing, the tune becomes "strong Euro FX equals strong stocks, weak Euro FX means weak stocks".

Consequently the declines in the Euro FX over the past several months confirm worldwide economic sluggishness (and slumps in stock marketplaces and commodities). So further falls in the Euro FX may reflect- or help lead to- even more declines in equity and commodity playgrounds. That additional Euro FX debasement may even reflect or accelerate an economic downturn (not just stagnation) in some regions, and not just European territories. Thus Euro FX currency depreciation alone will not solve the Eurozone's (or overall European) problems.

Any implementation of money printing policies by the Eurozone (ECB), whether indirect or indirect, will tend to weaken the Euro FX. Witness the bearish consequences for the US dollar of the two massive Federal Reserve quantitative easing rounds. Even serious consideration of such money printing policies probably would weaken the Euro FX. All this assumes the US and other key nations do not join the ECB in a global money printing festival.

Tied into the foreign exchange situation is the issue of interest rates for the assorted European nations. Thus far in the recent aspect of the crisis, rates have not spiked throughout the entire European sovereign sector, just in troubled ("risky") countries. The ECB's willingness to keep policy rates low helps to avert a rate boost in nations such as Germany (compare the US and the Federal Reserve). Nevertheless, sovereign debt rates have jumped higher for Greece, Italy, Spain, and others at various times during this disaster. Thus substantial (not merely modest) declines in the Euro FX eventually could place pressure on the ECB (not just on many nations within the Eurozone) to raise rates.

What's a bottom line for the Euro FX? From the current international standpoint, further modest Euro FX depreciation perhaps would be tolerable. But as discussed below, the Euro FX is nearing some critical levels. From America's standpoint, although Europe is a major trading partner, most of the focus has been on China. The US just last month declined to brand China as a currency manipulator.

However, given the marketplace links just described, players and policymakers probably do not want a massive Euro FX breakdown. Besides, many nations would like to maintain a relatively weak currency in the current world landscape.

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What are some key Euro FX benchmarks to watch on its continued decline? Examine the cross rate versus the US dollar first. The EuroFX reached about 1.286 in late December 2011, just under the 1/10/11 low (January 2011 was still relatively early in the Fed's QE2 policy foray). The EuroFX bottom at 1.259 on 8/24/10 is more important than this one, since it was at the advent of quantitative easing and near in time to a key S+P 500 bottom (8/27/10 at 1040).

The economic universe did not collapse when the Euro FX reached a major low on 6/7/10 at 1.188. However, it did not stay long around that depth. Importantly, the Euro FX rather rapidly climbed above troughs associated with bottoms in various worldwide stock marketplaces: 10/28/08's Euro FX 1.233 (China's Shanghai Composite low 10/28/08 at 1665) and 3/4/09's Euro FX 1.246 (S+P 500 bottom 3/6/09 at 667). **Thus watch the Euro FX 1.233/1.246 range as well as around 1.188 to 1.200. Sustained breaches of these ranges probably will encourage (confirm) stock marketplace weakness**. A 20pc fall from the 5/4/11 peak at 1.494 is 1.195. The NYTimes on 1/1/12 (p6) recalls the Euro was introduced as a trading currency in 1999 at 1.18. A 33pc cratering from the major high around 1.604 on 7/15/08 is about 1.069. A 33pc fall from the May 2011 pinnacle gives Euro FX .996.

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Recall America's broad real trade-weighted dollar measures. European policy makers and many others likewise pay attention to measures of the **real European effective exchange rate** (CPI deflated; first quarter 1999 equals 100). **The ECB has monthly data for the 17 Euro area countries against a group of 20 trading partners. For November 2011, that real effective exchange rate is about 101.3. This is just above the key low of June 2010 at 99.3.** A ten percent drop from the April 2008 major peak of 113.1 is about 101.8. The low during the October 2008 to April 2009 period, within which lows in the Euro FX cross against the US dollar was made, was November 2008's 104.3.

Based on nominal data (available daily, and thus for December 2011) for those 17 Euro area countries against 20 trading partners, the average nominal exchange rate for calendar December 2011 declined about 1.77percent from the November average. **Adjusting the real effective rate for November 2011 by this 1.77pc gives a December 2011 level of about 99.5. Thus by this key real effective exchange rate measure, the Euro FX is testing a critical level right now. It probably will be broken.**

A 20 percent fall from 113.2 is 90.5. The important February 2002 low was 86.6, with that in October 2000 at 82.6.