Time to dust off old euro crisis strategies

By Trevor Greetham

Draghi magic is wearing thin and feedback loop remains in place

Headquarters of the European Central Bank in Frankfurt©Reuters

The euro area has lived a charmed life in the two years since European Central Bank President Mario Draghi said he would do “whatever it takes” to save the single currency. But the magic seems to be wearing thin.

Growth is weakening, lead indicators are rolling over and a persistently weak earnings trend means European equities are making new lows relative to the US without being particularly cheap. A downside shock to European growth or an upside shock to US rates could widen peripheral bond spreads, hurt the banks and see a return of familiar vicious cycle dynamics.

Europe urgently needs policies to boost nominal growth. Japan offers a precedent here. It may take a witches’ brew of serious structural reform, unconventional monetary easing and sustained fiscal expansion to raise inflation expectations.

Two years ago the euro area was in perpetual crisis. Three words from Mr Draghi and the downward spiral swung powerfully into reverse. Those who remember the late 1990s euro convergence trade got to see it all over again as the average 10-year sovereign spread for France, Italy and Spain hurtled in from more than 4 percentage points over Germany to less than 1 percentage point.

Funding markets reopened, bank balance sheets improved and economic growth returned. At one point the euro was up 15 per cent against the dollar and unhedged investors saw European equities outperform the US by a full 25 per cent.

In recent weeks it seems Mr Draghi’s spell has been wearing off. European lead indicators are weak. France is flat lining, Italy is back in recession and the conflict in Ukraine is hurting business confidence in Germany. There has been some derating of equity markets but it is the persistently weak relative earnings trend that has the Euro Stoxx 50 index making new lows against the S&P 500.

Gradual European underperformance is starting to look normal but a more intense phase could easily return. The euro crisis has been in remission while domestic growth has been strong and the global need for income has provided ready flows into high yielding bond markets.

However, the old feedback loop remains largely in place, with banks heavily exposed to their sovereign, legacy debt excluded from discussions on banking union, and a single deposit protection scheme elusive.

A downward shock to European growth or a steady rise in US interest rates could put upward pressure on peripheral yields, hurting banks, triggering asset price falls and pushing the more fragile economies back into recession when they are already on the verge of deflation.

Worse still, economic weakness would lead to calls for self-defeating austerity when the exact opposite is required.

Europe urgently needs policies that boost nominal growth, especially in the debt-ridden south. The ECB has fired its last shot on rates and its other policies may fail to reach credit-starved small businesses and property markets.

Abenomics in Japan was designed to address just this situation. It prescribes serious structural reform against a backdrop of sustained monetary and fiscal easing to raise inflation expectations and keep them on a higher path. This is hard to do in Japan. It is a gargantuan task in Europe's fragmented economy.

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Structural reforms take time and a level of political commitment that is hard to maintain in some of the countries in Europe's periphery. An equally heavy political responsibility rests with the core. The capacity for sustained fiscal expansion lies almost uniquely in Germany, but Berlin does not seem to appreciate its pivotal role.

German inflation is running below 1 per cent when it needs to be 3 per cent or 4 per cent if the rest of Europe is to regain competitiveness without prices and wages falling in nominal terms. It is time to abandon balanced budgets and go for growth.

In the long run, a single currency needs a single government with democratic accountability and the authority to make fiscal transfers. It was 85 years from the formation of the US until full fiscal and monetary union, and it took a civil war to overcome objections to the pooling of sovereignty that the introduction of Abraham Lincoln's greenback entailed.

Europe is starting from the other end, with the single currency coming first. Political and fiscal union remain unfinished business. Tensions with Russia could galvanise fellow feeling but Europe still lacks the defining event to bring it together or indeed break it apart.

The current generation of investors is likely to see the euro crisis come and go several times. The euro area is not invulnerable while internal divisions remain.

With growth weakening once more it is time to dust off the old euro crisis playbook: short the euro, short the periphery, long Germany.

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