

## Quotable

“Any idiot can face a crisis - it's day to day living that wears you out.”

Anton Chekhov

## Commentary & Analysis

### The International Monetary Fund Cries Uncle: Euro goes lower...

This week we witnessed an intellectual revolt by the International Monetary Fund (IMF), the key partner involved in this European crisis with the European Commission and European Central Bank aka the Troika. It validates my long-term euro bearish view.

First, we saw the warning that European banks needed to raise a cool \$4.5 trillion in capital...Ouch. That would represent a massive deleveraging and I think especially exposes emerging Europe—Eastern and Central Europe—who depend to such a large degree in bank funding. Secondly, and this is where the cry uncle comes into play, the IMF concluded, finally, that austerity measures are squeezing the life out of the Eurozone economy.

Most of the economies imposing strict austerity are fading fast, they include: Greece, Portugal, Spain, and Italy (Ireland may be the lone exception—they didn't give up that tax advantage...Did they?). The idea a country can cut spending, in a massive welfare state, and raise taxes at the same time, and expect to grow the economy to produce more tax revenues is sadly mistaken about how the real world works. This was the policy path seemingly endorsed by the IMF until its about face this week.

The IMF has finally realized the path of austerity and tax increases leads to a viscous downward spiral of lower growth, lower tax revenue, more cuts, lower growth, lower tax revenue...etc. It is what many have been saying for a long-time and why most have predicted a Great Depression era settling over the zone.

I think this about face by the IMF exposes the primary flaw facing the Eurozone—it is a structural competition problem.

All countries locked in the straightjacket of one monetary policy and one currency—the euro—are forced to by the market to compete against one another based on the efficiency

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of their respective economies. For example, granted a simplistic one, but to the point: If goods in country A can be produced more efficiently than similar goods by B, then A wins. In the real world, even if country B's manufacturing industry is not as competitive (depending on the good itself) the country's currency, by virtue of a less efficient economy, could fall in value relative to country A's currency, thereby making B's goods relatively attractive even though its labor efficiencies lag; thus, given country B a chance to create some wealth in its competition against country A.

But the example in the above paragraph cannot play out in the Eurozone—with Germany as country A, and weaker countries representing country B. Instead of using the currency, weaker countries must find a way to deflate domestic wages. This is what austerity has been all about. The theory makes sense. But politically and economically thus far it has been devastating. And given estimates this process may take a decade or more to pan out seems daunting given the level of social unrest and growing resistance among those distributing wealth

So, the IMF steps in with an intellectual life line of sorts, but it stretches only so far.

The idea of more spending will not do the trick. If that were the winning strategy, seven years of borrowing and spending between 2000-2007 by the weaker Eurozone countries', at near German interest rates, didn't help their relative competitiveness. Labor efficiencies, based on wage rate productivity moved further out of line i.e. the gap for German competitiveness widened during the time weaker Eurozone countries has all the access to capital they needed.

When credit is flowing freely and consumers are spending wildly (thanks to rising debt levels and not real wealth production) everyone is happy and the structural competition problem remains effectively hidden. But when you look at the numbers during the Eurozone consumer boom, you see that Germany filled a massive amount of this demand and it is why Germany's current account surplus was soaring during this period, while the other countries were—surprise-surprise—recording increasingly bigger deficits.

The key point is this: In one sense it is good the IMF is finally acting like a grown up and pointing out that austerity is killing the Eurozone. However, more spending by governments will not solve the core competitiveness problem. If the weak countries cannot create real wealth on their own, this game will end—the euro will break apart in time.

Based on our daily research, it seems more and more multi-national companies and analysts are coming around to the idea that there will be a breakup. The big companies—international and European based—are actually sweeping their cash accounts each night into what is perceived as stronger countries banks, and then bringing the cash back in the morning for operating capital. Many firms have either formed committees to monitor the ongoing breakup risk in the zone in real time or have drawn out strategic contingency plans to deal with a breakup, defining risks and costs.

An idea JR and I have floated before, which was a bit out of the box a year ago, and seems to be gaining some traction among analysts, is that if Germany leaves the Eurozone, everyone would be better off, including Germany.

This growing belief of the zone being better off implicitly validates:

1) countries competing with Germany cannot compete using the same currency, and if Germany leaves and the D-mark rises in value against the remaining currencies, as most suspect it will, then those still using the euro will be able to compete on final goods exports, and even on a foreign direct investment basis as their assets, in a much devalued euro relative to the D-mark look cheap, and;

2) the incentives for Germany to remain as the paymaster within the Eurozone are fading fast. German taxpayers are grumbling and the country's central bank—the Bundesbank—is not happy. Because of the way the payment system is structured in the Eurozone between the ECB and Bundesbank, Germany takes on a huge risk, now estimated at around €900 billion and rising. And as the Eurozone craters down into another deep recession, the zone loses its captive export market appeal for German manufacturers.

So, I believe this week's admission by the IMF that austerity is the wrong policy to correct what ails Europe is a damning admission. It says to the world that to date, those up-teen number of summits designed to impose just the right amount of austerity to trigger recovery and confidence the single currency was "here to stay" was nothing more than a massive waste of political, and more importantly, economic capital. Plus, it was a waste of the a very pressure commodity for the Eurozone—time.

So now what for the Eurozone? Two potentialities...

1) A new round of massive fiscal spending, which by the way will push debt to equity ratios even higher from an already very lofty perch, may stabilize the zone and reduce social unrest. But it is an admission the welfare state cannot be dismantled anytime soon. And from a pure supply and demand standpoint, it will mean a much bigger supply of euro will be thrown onto the market. That alone should lead to a lower price for euro relative to all currencies.

2) Leaders in key countries come to their senses and realize if they had control of their own currencies and monetary and fiscal policies, they could design economic policies better tailored for their own needs to help their industries compete on their own terms. If that conclusion is reached by a critical mass of countries, based on the implicit and unintended backing of the IMF, this thing called the euro would unravel quickly.

Our most probable choice is idea number one: a massive amount of euro will be thrown on the market by the European Central Bank and increased fiscal spending. The law of supply and demand would then take over and the euro falls of its own weight.

We remain solid long-term euro bears. Here are a couple of charts to prove it.

## EUR/USD Weekly:



## EUR/USD Daily:



Jack Crooks

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