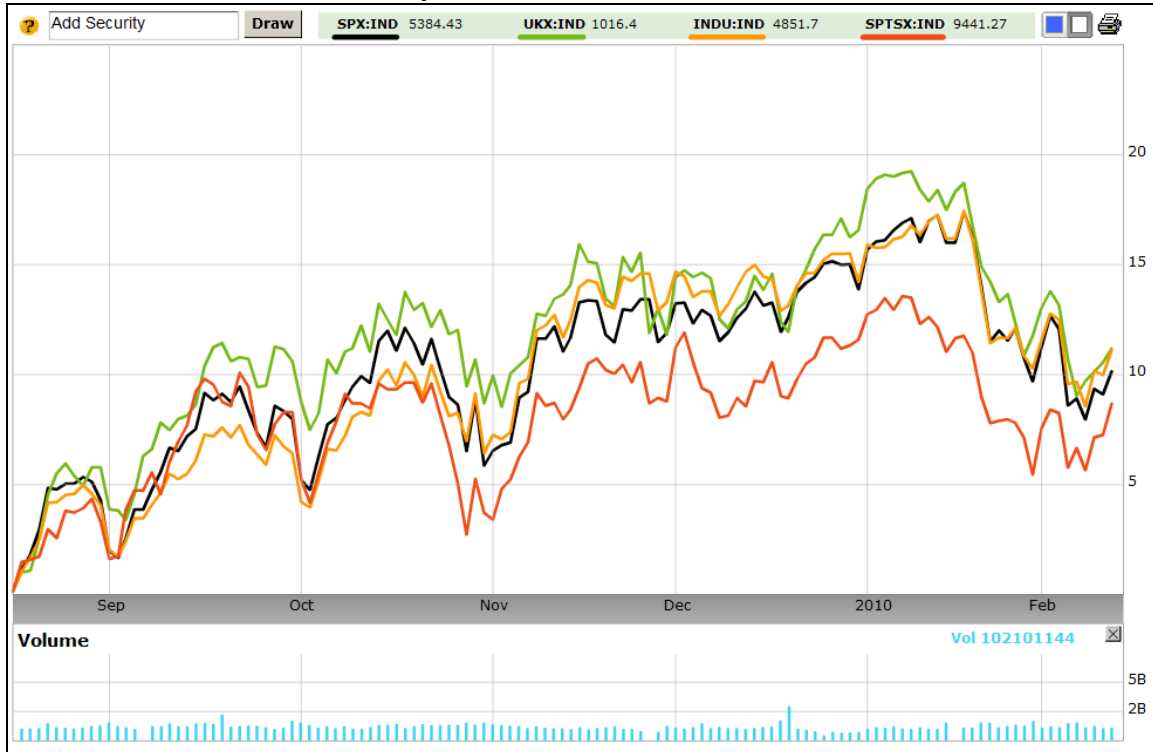


## The fate of the euro

### *Canadian markets a safe haven*

February 12, 2010 – The big North American and European stock indexes have followed pretty much the same pattern over the past six months. This includes the recent slide from January highs and last week’s mini rally as eurozone leaders pledged to take some type of undefined action, “if needed, to safeguard financial stability in the euro area as a whole.” Stock markets, being an instant reflection of investor mob mentality, presumably took this to mean that France and Germany, the eurozone’s two largest economies, will guarantee Greece’s sovereign debt, and by implication, Greece’s teetering economy, thereby saving the European monetary union. Cue the ironic chuckling from the econosphere.

#### Main market indexes in lockstep



Courtesy Bloomberg LP

That's because the fate of the European Monetary Union currently hangs in the balance. What happens over the next week or two will quite literally determine the fate of the European monetary experiment, and determine the viability of the European Union altogether. There are really only two paths ahead.

On the one hand, a bailout of Greece by other eurozone members, primarily France and Germany, through debt guarantees attached to stringent conditions designed to ensure the Greeks return to a state of fiscal rectitude. This implies a degree of political oversight to ensure the Greeks do not continue to cook the fiscal books as they have so many times in the past. But political oversight is not part of the European Monetary Union's mandate. To make it so would require a unanimous endorsement of a European political constitution applying equally to all members, an outcome which to date has remained deeply controversial and highly elusive. It would be rejected outright by the U.K., which is not, wisely it seems, even a member of the monetary union.

On the other hand, Greece may reject political oversight as a condition of sovereign loan guarantees and step out of the eurozone, reinstating the drachma, which it can then use to monetize its debt, devalue its currency, and inflate its way out of trouble, all without that pesky political meddling from Berlin and Paris. But what's good for the Greeks, of course, may well also suit the Spaniards, the Italians, and the Irish. In that case, the unravelling of the euro would be complete, as the old regime of a European currency unit is reinstated, or even a complete regression to multiple European currencies occurs. The Swiss, of course, never a part of the eurozone in the first place, simply sit back in their mountainous redoubt say, "I told you so," and offer the franc at market rates.

So which way will things go? The euro is only 11 years old, and plenty of political and economic capital is tied up in the monetary union. One thing's for certain: It will not go gently into that good night. So warnings of a calamitous unwinding of the euro are premature to say the least. More likely, Greece's (and Spain's, and Italy's, and Ireland's) debts will be guaranteed by some Rube Goldberg-like financial contraption consisting of special drawing rights from the International Monetary Fund backstopped by complex special debt issues by the eurozone's largest members through some loophole-type arrangement with the European Central Bank. All this to get around the intractable issue of overtly "political" control of member states' individual fiscal policies while still attempting to apply some external discipline to a member state. In other words, a typically European mash-up. It'll be a temporary fix and will last for only as long as it takes for the next crisis to flare up.

So the euro may well be on a long, slow decline into oblivion. For the time being, however, it's likely to be business as usual. Unfortunately, eurozone business was not all that good in the fourth quarter of last year. Gross domestic product grew only 0.1% from the previous quarter, which in turn recorded only a 0.4% increase. Germany's GDP stalled at 0.7% in the quarter, while Italy posted a 0.2% drop.

Still, with emerging Asian economies India and China leading the growth parade, weak European domestic demand may well be offset by a growing tide of exports. The weaker euro, incidentally, won't hurt that trend one little bit.

In the meantime, US Federal Reserve Board Chairman Ben Bernanke, once again set the stage for the Fed's easy-money exit strategy, describing to a Congressional committee how the Fed might begin to stanch the record flow of credit and "normalize" lending. These include moves to raise interest on bank deposits held by the Fed and raise the Fed's discount rate, well before moving on to increases in the benchmark fed funds rate. He didn't set a timetable for all this, saying only that low rates are needed for an "extended period" and monetary policy must remain "highly accommodative."

Markets were presumably happy with these developments, more or less ignoring the euro-shambles as a regional currency issue that is unlikely to materially affect the global recovery, and seeing Bernanke's comments as a renewed commitment to keeping a relatively easy monetary policy while economic recovery gathers momentum.

Markets yo-yoed around last week, as the problems besetting the eurozone caught investors' attention for a bit. But that settled down when European leaders made appropriate mollifying noises. Then China stepped in late in the week to cinch bank lending by upping reserve requirements for the second time this year in an effort to deflate a growing real estate asset bubble, following fourth-quarter GDP growth of 10.7%.

Toronto's S&P/TSX Composite Index closed Friday with a 2.2% week-over-week advance as buyers emerged from the woodwork in search of bargains in the resource sector late on Friday. Neither euro-zone fiscal problems nor China's overheated economy caused much concern, as investors' optimism for Canada's resource and financial issues remained undiluted.

New York's Dow Jones Industrial Average, however, eked out a 0.9% weekly gain, as investors were rather more subdued about the outlook for the big global industrials, given those same events in Europe and China. Ditto for the S&P 500 Composite Index, which advanced an insipid 0.8% on the week.

For now, Canada's market remains in the cat-bird seat as a desirable investment for international money seeking safe harbour. That can only contribute to the upside potential for TSX issues as the year progresses. ■

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