



### EUROPE: THE NEVER-ENDING STORY

*By Ford Scudder, CFA and Wayne Winegarden, Ph.D.*

#### Summary

- The euro is likely to weaken against the U.S. dollar with continued volatility until policies that are more credible and permanent than the recent EU fiscal pact are agreed upon and enforced.
- The ECB will likely print euros to spread some of the austerity costs around Euroland through higher inflation, also leading to a weaker euro.
- The full impact of euro depreciation will be partially offset by a combination of increasing U.S. monetary base and European deleveraging, which will likely include foreign asset sales.

#### Summary and Conclusion

In light of the recent volatility and policy developments in Europe that culminated in the EU fiscal summit on December 9<sup>th</sup>, this paper offers our views on the dollar-euro exchange rate over the next 12- to 18-months.

Until the recent European sovereign debt crisis, the excessive supply of dollars created by the U.S. central bank weakened the dollar vis-à-vis the euro-dollar exchange rate down to around 1.60 dollars per euro at the height of the crisis, eventually forming a volatile range between 1.30 and 1.50 dollars per euro. This dollar weakness reflected both a reduction in the relative attractiveness of investment in the U.S. due to anti-growth economic policies and the excessive supply of U.S. dollars created by the Federal Reserve.

The recent market turmoil in Europe represents an inflection point in this relationship that investors are watching carefully, and rightly so. Our takeaways from the December 9<sup>th</sup> Finance summit and recent Central Bank actions, including another 25 basis point interest rate cut, are:

- The euro crisis has always been, and remains to be, a straightforward solvency issue that requires fiscal remedies;
- While we are skeptical that the best fiscal reforms will be adopted, ideally these fiscal remedies will involve spending cuts and pro-growth tax reforms that broaden the tax base (perhaps raising more euros in doing so) and reduce the high marginal tax rates across Europe, but especially in the countries with the largest solvency issues;
- We anticipate that, ultimately, Euroland will do what is necessary to ensure the euro survives due to the high costs of unwinding the currency union;
- This fiscal conference's results were less than satisfactory: the more stringent budgetary rules and the 0.5 percent of GDP deficit limit is necessary, but at this point remain mere promises and there is still no clear path established that will both resolve the current fiscal crisis and ensure future fiscal crises will be minimized;
- Despite the less than satisfactory results from the fiscal conference, debtor countries, most importantly Italy and Spain, will ultimately follow through with their fiscal austerity plans and bear a large share of the costs; however, some parts of the austerity programs—higher wealth taxes in Italy—are ill advised;
- Despite the recent bearish language from the ECB that it will not buy large amounts of debt, this language is likely political posturing and ultimately we believe the ECB will monetize some of this debt; and
- While ill-advised, by printing euros the ECB will spread some of the austerity costs on to other nations of the euro area via higher inflation—a likely political necessity at this juncture—that will hit Germany particularly hard.

As described below, the result from these actions, all other things equal, should be a weakening euro on net with continued volatility that will not be resolved until the fiscal solvency issues are adequately addressed. Based on the current behavior, this process looks to drag on for at least 3 months, which pushes the limit for how long this process can continue without

resolution. However, we believe the euro devaluation against the dollar will be offset somewhat because the Federal Reserve will expand the U.S. monetary base.

### A Monetary Exchange Rate Framework

The dollar-euro exchange rate is simply the dollar price of a euro (or alternatively the euro price of a dollar). Like any other price, the dollar price of a euro reflects changes in market supply and market demand. Consequently, the key factors that determine changes in the dollar price of a euro are:

1. Changes in the supply of dollars and changes in the supply of euros as created by each currency block's central bank;
2. Changes in trade flows; and,
3. Changes in the after-tax rate of return of assets within each currency block.

Understanding the direction of exchange rates requires an understanding of these three points.

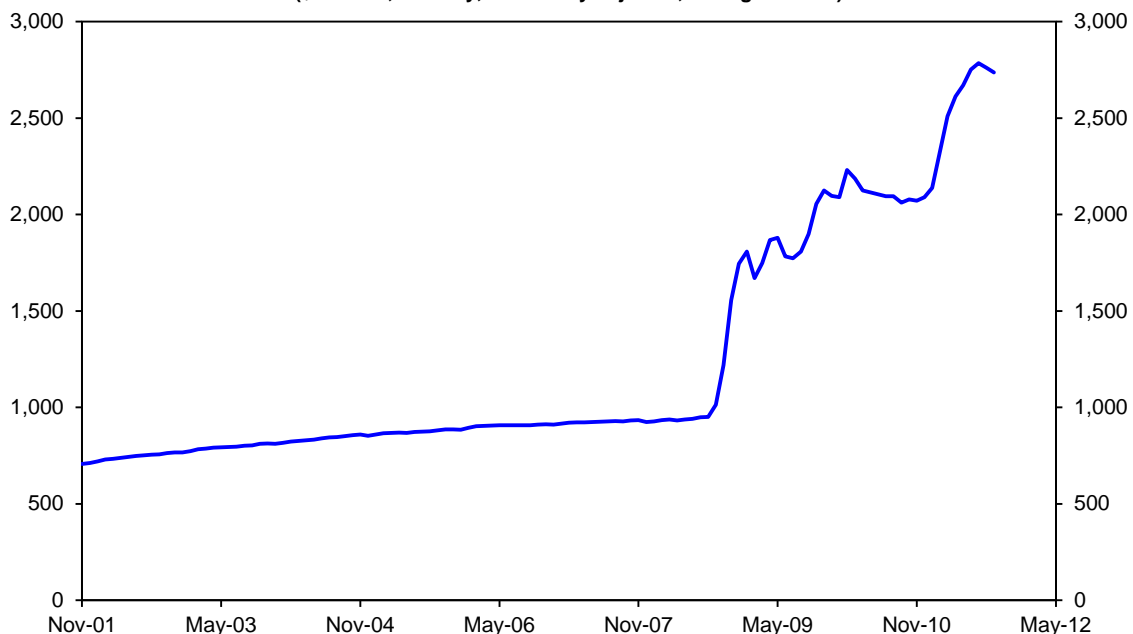
### Inflation and Monetary Policy in the U.S. and Europe

The first point asserts that the overall U.S. price level has been and is determined by actions of the Federal Reserve. Likewise, the euro price level is the consequence of the actions of the ECB (European Central Bank). With both euro and dollar price levels being set independently of the foreign exchange markets, the dollar/euro exchange rate then represents the price of U.S. goods and services relative to those in Euroland. A devaluation of the dollar means U.S. companies become more competitive, i.e. U.S. goods and services become cheaper.

In the foreign exchange market, for every winner there's a loser. The dollar's rise is the euro's fall. The limitation on how far the value of the euro can fall is determined by the demand for and supply of the euro relative to the dollar. U.S. dollar prices are not an arbitrary number picked out of a hat, but instead are the consequence of deliberative and purposive Fed policy and have been thus for a quarter of a century.

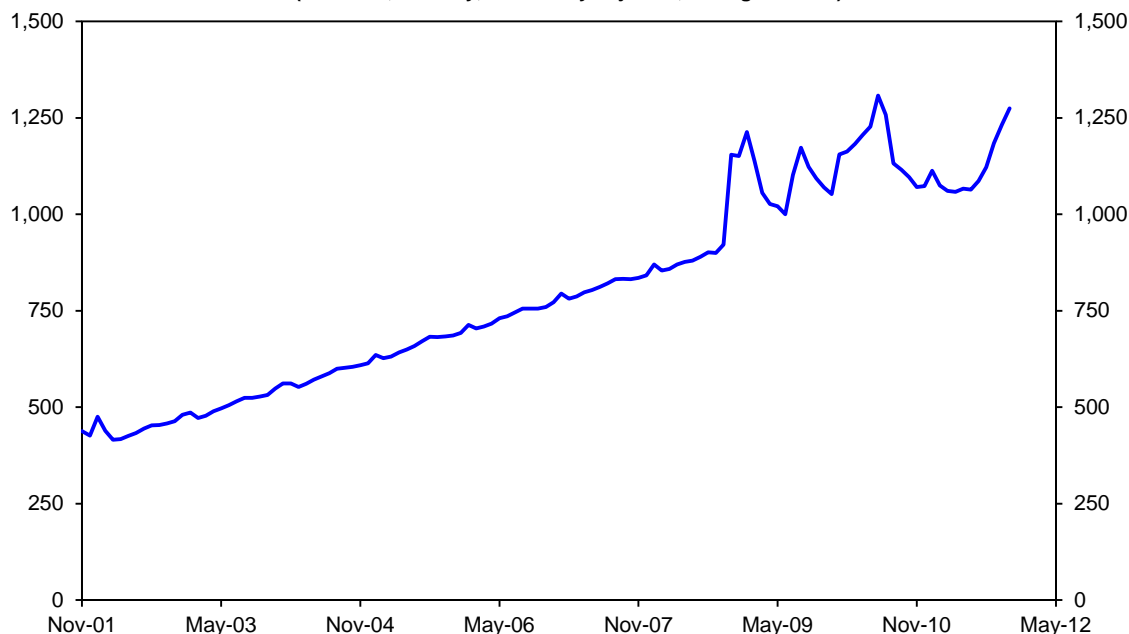
Despite years of solid monetary policy, the Bernanke Fed has been nothing short of a U-turn. In the ten years prior to 2008's massive increase, the sweep-adjusted monetary base rarely strayed from its remarkably consistent growth rate of 5.5 percent per year—the Fed never wavering in its resolve to maintain the prime objective of price stability. In response to the financial crisis, the Fed wavered. The sweep-adjusted monetary base exploded to an average 37.95 percent annual growth rate over the past three years.

**Figure 1**  
**Level of the U.S. Sweep-Adjusted Monetary Base**  
**(\$ billions, monthly, seasonally adjusted, through Nov-11)**



Source: Federal Reserve Bank of St. Louis

**Figure 2**  
**Level of European Central Bank Monetary Base**  
 (€billions, monthly, seasonally adjusted, through Nov-11)



Source: European Central Bank

European euro prices are also not an arbitrary number picked out of a hat, but instead are a conscious consequence of the policies of the European Central Bank. The ECB has not allowed (yet?) for its monetary base to explode to the same extent as the Fed has in the U.S. Thus you would expect a weaker dollar relative to the euro based on the pre-crisis levels based on the supply of dollars relative to the supply of euros.

When you consider the fact that dollar prices are determined by the Fed, and euro prices are determined by the ECB, then it follows that any change in the dollar/euro exchange rate is one and the same as a change in the price of U.S. goods relative to European goods. If the dollar price of the euro rises (i.e. the dollar devalues relative to the euro), then U.S. goods become relatively less expensive when compared to their European counterparts whether measured in dollars or euros; i.e. U.S. companies become more competitive. When the dollar price of the euro falls, then the dollar has appreciated against the euro and U.S. companies become less competitive. In this context the exchange rate is constrained by the prices of goods and services.

#### Trade and Investment Impacts on Exchange Rates

The second factor in determining exchange rates is based on the Ricardian framework of comparative advantage. The U.S. produces some products more efficiently than Euroland and some less efficiently. Those we produce more efficiently we export, and those we produce less efficiently we import. The equilibrium real exchange rate balances exports with imports.

Once we allow the real exchange rate to deviate from the equilibrium rate, we see that the weaker the dollar, the greater will be the U.S. trade surplus (i.e. the smaller the trade deficit) and *vice versa*.<sup>1</sup> Also, the further away from equilibrium the real exchange rate moves, the more difficult it becomes to move that currency even further away. There are natural, albeit fuzzy, limits on how far a currency can move from its central value.

In addition to depending on the level of the exchange rate, quantities of traded goods purchased and supplied also depend upon changes in the exchange rate. Decisions to buy depend not only upon price, but also upon where prices are expected to be in the near future. The trade responses to a weak dollar will differ dramatically depending upon whether people believe the dollar will get weaker still or will reverse trend and get stronger. And, to reinforce the point, there are definite trends in the movement of exchange rates, allowing rational market participants to forecast future changes in the exchange rate.

This is where the third point of the paper becomes relevant. Investors make their global allocation of capital based upon their perceptions of after tax returns. When investors shift their investments to a more attractive country, that country will experience a trade deficit and a capital surplus, while the less attractive countries will have trade surpluses and capital

<sup>1</sup> As an important point, this is not to say that a devaluation will by necessity improve the trade balance. As we have often written, it is unclear whether devaluations help trade. The difference is here we are speaking of the real exchange rate rather than the nominal exchange rate.

deficits. The important point here is simply that relative investment attractiveness determines whether a country has a trade surplus or deficit.

Integrating all three points provides a perspective on future exchange rate movements. A country's trade deficit is determined by its capital flows, which in turn are determined by its domestic economic policies relative to those abroad. Real exchange rates then adjust to provide the trade deficit (or surplus) as determined by capital flows. Lastly, with domestic prices set by domestic policies, the nominal exchange rate becomes one and the same as the real exchange rate.

### The Dollar-Euro: Falling into the Abyss Together

The French phrase *Plus ça change, plus la même chose* says it all. Change ironically is the one constant.

The Appendix provides the historical backdrop to the current dollar-euro exchange rates. The current dollar-euro exchange rate reflects the interruption in the dollar-euro equilibrating process of the mid-2000s by the housing bust and global financial crisis of the late 2000s, and its aftermath.

Following the crisis, policymakers in the U.S. have worked the wrong policy model. As we have stated many times, no matter how hard you work the wrong policy model, it will always provide the wrong policy solution. Presidents Bush and Obama, in cooperation with the Federal Reserve, have been attempting to stimulate the U.S. economy with a combination of high spending and excessive monetary creation.

Policymakers continue to double (and even triple) down on the original mistake, despite the lack of evidence current policies are improving the economy. In the name of jumpstarting economic growth, President Obama is seeking tax increases on the rich to further enable more spending. The Federal Reserve continues to leverage its unprecedented balance sheet to further distort interest rates in the U.S. economy in the hopes of increasing output by:

- Increasing exports;
- Decreasing borrowing costs, leading to higher investment ; and,
- Reducing the stock of unwanted assets—either mortgage-backed securities or, now, sovereign debt.

The U.S. has also instituted anti-growth fiscal and regulatory policies, most notably Dodd-Frank and “ObamaCare”.

These policies are the polar opposite of the types of policies that should be implemented as represented by the Mundell-Laffer hypothesis that spurred the Reagan and Thatcher economic revolutions.<sup>2</sup> Based on the Mundell-Laffer Hypothesis, the Federal Reserve should be restraining monetary growth, not printing money like mad, in order to create a stable monetary system.

Economic growth should be stimulated, on the other hand, by reversing the adverse fiscal and regulatory policies implemented and creating a more pro-growth tax system. The correct fiscal stimulus would repeal “ObamaCare”, repeal Dodd Frank, return federal government spending back to at most 20 percent of GDP (if not lower), and stop the future tax increases coming down the pike. Ideally, the U.S. would also reform the current tax system and broaden the tax base, lower the marginal tax rates—especially the corporate tax rate—and significantly reduce the costs of compliance with the tax code that we estimate to be at least 30-cents for every dollar collected.<sup>3</sup>

Pursuing these policies would raise economic growth, increase investment, decrease the oversupply of dollars and (based on the framework discussed above) strengthen the dollar. Because the U.S. is not creating sustainable economic growth via a pro-growth policy reform, the U.S. economy is currently weak, and will remain weak, precisely because the wrong policies are being implemented.

In Europe, excessive government spending has already led to fiscal crises and may have already pushed Europe's economy over the precipice. Certainly the sovereign debt crises in Europe, and the associated capital flight from euro-denominated assets, have exerted pressure on the dollar to appreciate against the euro over the past year. But, the ECB has not yet instituted the same policy mistake as the Federal Reserve; and, here is the key.

The weak U.S. and European investment climates and weak economic growth prospects in both regions have offsetting impacts with respect to the dollar price of the euro (or the euro price of the dollar)—the investment and trade impacts on the exchange rate are poor in both regions. However, due to the unprecedented expansion of the U.S. money supply the scales have been tilted in favor of a weaker dollar relative to its value 5-years ago or 10-years ago (see Figure 3 below).

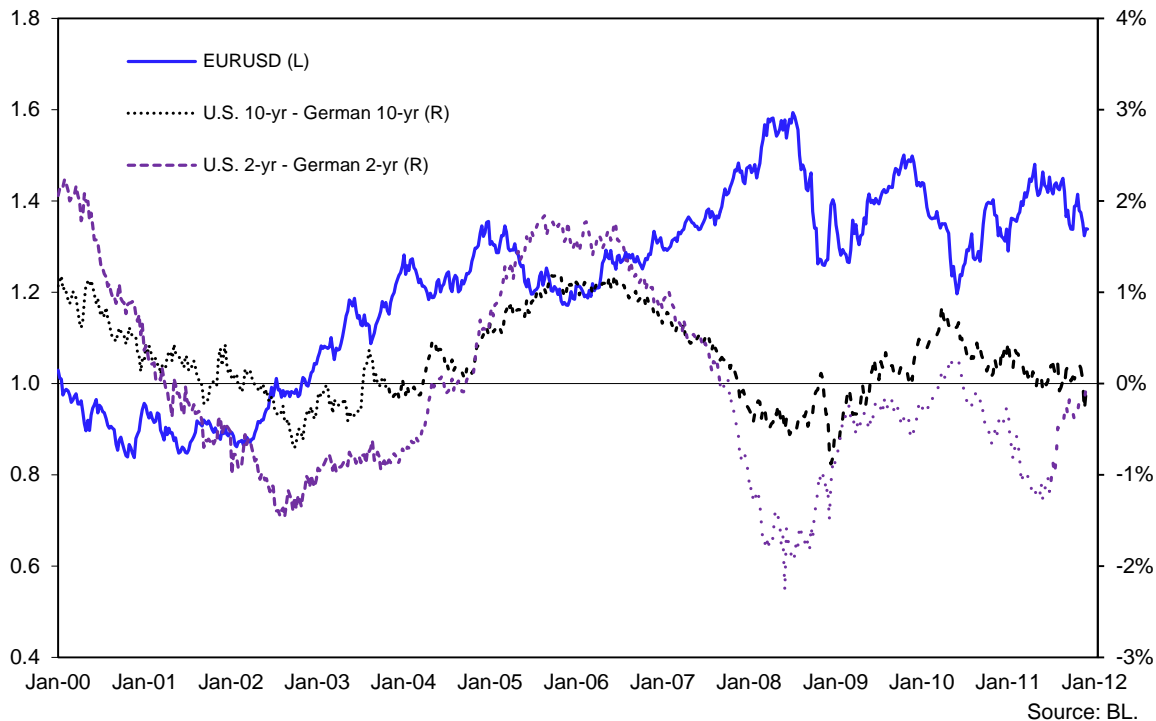
<sup>2</sup> Jude Wanniski, “The Mundell Laffer Hypothesis”, *The Public Interest*, Issue 39, Spring 1975, pp. 31-52.

<sup>3</sup> Arthur B. Laffer, Wayne H. Winegarden, and John Childs, “The Economic Burden Caused by Tax Code Complexity”, Laffer Associates, October 7, 2010.

The current consequences from excessive U.S. monetary creation relative to the diminished investment prospects in Europe appear to be priced into the current exchange rate. Figure 3 illustrates that while the dollar-euro exchange rate has been trading in a band, the extreme fiscal and economic uncertainty has created significant volatility as well.

It is important for us to note here that the market's view of the consequences from excessive U.S. money creation is not yet as dire as ours in the longer-term. We believe in the longer-term inflation in the U.S. will be much stronger than the current market inflation outlook; therefore, the longer-term outlook for the dollar is significant weakness. However, there can be divergence from this trend over a shorter timeframe.

**Figure 3**  
**EURUSD Exchange Rate and U.S.-German 2 Yr. and 10 Yr. Bond Yield Spreads**  
(weekly, through 12/09/11)



*Past performance does not predict future results.*

Source: BL.

Following the *unsuccessful* conclusion of the December 9<sup>th</sup> summit, further actions from the ECB have been delayed, but we still expect them to occur eventually. When it does, the ECB will step in with a massive QE program and expand its balance sheet significantly. Based on the current euro-dollar and interest rate relationships illustrated in Figure 3, if the Federal Reserve does not ease in tandem with the ECB, then the euro will weaken substantially against the dollar—with even greater exchange rate volatility.

Returning to our framework for the value of a currency, the main effects on the dollar-euro exchange rate will be through the quantity of money and after-tax return on assets, our points one and three. The first point is that the quantity of euros are set to increase with the ECB stepping in as the “dark knight”.<sup>4</sup> The euro will thus depreciate against the dollar and the larger the commitment to increase the monetary base, the more the euro will fall.

Turning to point three, however, the immediate effect of a binding agreement on austerity will be a positive for the EU, halting the movement out of euro-denominated assets, and would suggest an appreciation of the euro. The devil is in the details, though, as austerity brought about by increasing marginal tax rates is much different than austerity via reduced government spending accompanied by pro-growth reforms.<sup>5</sup> Moreover, there will remain questions of whether any reforms requiring Maastricht Treaty changes or voter approval will ever truly be implemented. The more pro-growth the austerity measures and the more likely they are to actually be implemented, the more fiscal changes will cancel out the weakness in the euro brought on by monetary policy.

<sup>4</sup> Kenneth B. Petersen and Scott Vaughn, “The Dark Knight, Defending the Euro: A Job Left to the ECB”, Laffer Associates, August 16, 2011.

<sup>5</sup> Arthur B. Laffer and Ford M. Scudder, “Global Austerity: The Good, The Bad and The Ugly”, Laffer Associates, August 12, 2010.

Thus, looking at the changes in Europe in isolation, we anticipate a weakening euro. Yet the EU and ECB are not the only actors on this stage.

Longer-term, we do not believe that the Federal Reserve will sit idle while the ECB significantly expands its monetary base. Instead, we fully expect the Federal Reserve will also expand the U.S. monetary base under the guise of “ensuring adequate dollar liquidity” for the European financial system in order to “stave off another global financial crisis”. Indeed, the Fed has already seen large use of the swap lines recently extended to European banks. At present, it looks like the ECB will be the more egregious printer this go-around, but with this FOMC that is never a guarantee.

Unfortunately, these actions on the aggregate will not dampen the currency volatility. The actions of the world’s largest central banks are negatively affecting global economic growth via their extreme behaviors which are not conducive to stable currency values.

## **APPENDIX**

### The Late 1970s / Early 1980s

The U.S. economy and politics of the late 1970s and early 1980s were at a crossroads. At this crossroads, God shed his grace upon America. In 1978 alone U.S. capital gains tax rates were slashed (Steiger / Hansen), California property tax rates were more than halved (Proposition 13) and Paul Volcker was appointed chairman of the Federal Reserve. All in all it was a very good year. But not to be outdone, in 1980 Ronald Reagan was nominated and elected President of the United States and promised tax rate cuts, deregulation, freer trade and a sound monetary policy. Compared to the late 1960s and all of the 1970s, this was a 180 degree turnaround.

Virtually everyone in the world was optimistic about America and for good reason. Americans took advantage of the policy changes through appreciating asset values and higher profits. The only way foreigners could avail themselves of the greater opportunities in the U.S. was to invest more net in the U.S. And, to do that they had to generate a dollar cash flow by selling more goods to the U.S. and buying fewer goods from the U.S. The trade surplus generated by foreigners was one and the same as the foreign capital deficit. Symmetrically, the U.S. trade deficit was the U.S. capital surplus.

If the emerging and continuing trade deficits were a result of indulgent consumption-driven overspending by Americans financed by “credit cards,” then clearly the dollar should have fallen in the foreign exchange markets. It didn’t. Not only did the dollar not fall, but from late 1978 through February of 1985 the dollar increased in value by more than 50 percent versus the average of all foreign currencies. The changes wrought in the global economy resulted from an increased demand for dollars rather than an increased supply of dollars. That’s “Econ 101”. The U.S. trade accounts went further and further into the red and the dollar just kept getting stronger and stronger. By the end of the Reagan/Volcker era, the U.S. trade deficit/capital surplus remained high, but the dollar witnessed a sharp decline. In fact, it wasn’t until the dollar had fallen mightily that the trade balance even started to turn around. But, then again, people won’t buy goods from the U.S. any more than they have to if they believe U.S. goods’ prices will be even lower in the near future.

### The Late 1980s / Early 1990s

The decline in the dollar followed later by the reduction in the trade deficit /capital surplus fully reflected the change in U.S. investment prospects as the curtain fell on both Ronald Reagan and Paul Volcker. Optimism continued to fall right along with the capital surplus and the dollar. President H.W. Bush had raised taxes and had backpedaled from Reaganomics. President Bill Clinton’s first two years in office weren’t much better. First, there was the 1993 tax increase and then Hillary’s Health Care scare. Yikes! The dollar stayed weak and the capital surplus and trade deficit stayed low. Investors were far less enthusiastic about the U.S.

### Another Turnaround

But then came the 1994 election with its “Contract with America.” The Democrats lost the U.S. House, the U.S. Senate and the state governorships. It was a political route of Biblical proportions. Clinton did an about face and became more Reagan than Reagan. Robert Reich was out and Dick Morris was in. It was a new era with a born again, pro-growth Democrat President—shades of JFK.

President Clinton reappointed Reagan’s Fed Chairman twice, pushed NAFTA through Congress, signed into law Welfare reform, cut government spending as a share of GDP by 3.5 percentage points, left office with budget surpluses and signed the biggest capital gains tax rate cut in our nation’s history. The U.S. was back with an ambitious supply-side agenda.

The period starting in the first quarter of 1995 on through the second quarter of 2002 was not only a period of U.S. supply-side economic policies, however. It was also a period when the rest of the world, with a couple of notable exceptions, was

recaptured by the *dirigiste* policies of income redistribution and demand management. Ping-ponging back and forth between Alain Juppé, Jacques Chirac and Lionel Jospin, France raised its VAT by two percentage points, instituted its notorious 35 hour workweek and sank into the quagmire of pro-union, anti-growth rhetoric. Gerhard Schröder, Oskar Lafontaine and the rest of the redistributionist crowd did all they could to hobble business in what was once a proud Germany. Wim Duisenberg was a disaster at the ECB and Prime Minister Yoshiro Mori could not have been worse for Japan. Carlos Salinas was replaced by Ernesto Zedillo in Mexico and Jean Chrétien reigned supreme in Canada. It was a sad day for the non-US world. Everyone wanted out of their asset positions in the non-US world and into assets in America. Capital was lined up on the U.S. border trying to get into the U.S. And into the U.S. capital came.

The U.S. capital surplus once again soared. Or, if you are captured by the deep root canal theorists, the trade deficit skyrocketed, ultimately to a figure close to 6 percent of U.S. GDP—the highest figure ever recorded for the U.S.

#### The Early- to Mid-2000s: Everyone Improves

Policies across the non-U.S. world changed for the better in the 2000s. Jean Claude Trichet took the reigns at the ECB and maintained a very strong euro policy. In France, the highest marginal corporate and personal tax rates were cut by 2.8 and 5.6 percentage points, respectively, the 35 hour work week was repealed, and Lionel Jospin was nowhere to be found. Germany, Luxembourg, Netherlands, Portugal, etc., all cut either personal or corporate tax rates. In Asia, China was a miracle of supply-side reforms. China's huge move away from state run enterprises and into private industry and pro-growth stable monetary policy of pegging the yuan to the dollar created annual real growth rates in excess of 10% for some 25 years. Japan was even a little better under Junichiro Koizumi than under Mori, but the operative word is "little." Japan, unfortunately, is a laggard.

The U.S. was still great, but the rest of the world went to the edge of the precipice, looked down, saw death, realized its mistakes and embraced limited supply-side economic policies. Investors were fully aware.

With the change in expected returns, investors now wished to invest a larger share of their assets in some of the non-U.S. countries. A U.S. capital surplus of some 6% of GDP was no longer warranted. The excess demand function for capital shifted.

With this shift, as with any market shift, the initial impact is on price. Demand and supply curves, in the short run, are chronically inelastic. But in the long run they are amazingly elastic. As a consequence, the period since the early part of 2002 saw a dramatic drop in the foreign exchange value of the U.S. dollar with no noticeable effect on the trade accounts. But, then again, if you believe the dollar will be lower in the near future than it is today, you will defer buying dollars even if the dollar is dirt-cheap. Periods of rapid currency change are materially different than periods of stable currencies.

This period of rapid currency change was interrupted by the financial crisis which began in 2007. And so, the stage was set for our current period.