Europe's Losing Battle For Recovery

Nick Andrews

The wobble in world markets continues, with stock indices across all time zones down steeply in recent sessions. Investors are not only realigning their exposure in anticipation of tighter liquidity conditions as the US Federal Reserve finally brings its asset purchases to a close later this month (see More Fools Than Money?). Ahead of today's European Central Bank (ECB) meeting they are also looking nervously at the magnitude of the task facing eurozone policymakers. And they appear to be coming to the conclusion that generating a rebound in growth may be too tough a job for Europe's leaders to accomplish in the near term.

With France and Italy—the eurozone's second and third biggest economies—either stagnating or contracting, to achieve a convincing recovery will require policymakers to press home their attack on three fronts: structural reform to increase economic flexibility, fiscal easing to stimulate activity, and monetary expansion to support credit growth. On all three fronts they face determined opposition.

- **Structural reform:** On Sunday President Francois Hollande's ruling Socialist Party lost control of the Senate to France's center-right Union for Popular Movement (UMP) party, a development which will only complicate the implementation of reform plans already facing staunch resistance from strikers in the transport, manufacturing and service sectors. Meanwhile Italy's three most powerful trade unions agreed on Monday to form a united front in opposition to Prime Minster Matteo Renzi's proposed Jobs Act. Worse, Renzi has failed to win over the left wing of his own party, which accuses him of slavish obedience to Berlin's policy diktat. Although the party's senior leadership pledged its support for the bill this week, a possible showdown in the Senate on October 7 could still see key reform proposals significantly watered down.

- **Fiscal policy:** In recent days both France and Italy have revised their deficit reduction targets. Yesterday French Finance Minister Michel Sapin rejected austerity, saying Paris will not bring its deficit below 3% of GDP until 2017, two years later than it earlier targeted. The Italian government this week also pushed back the date when it expects to balance its books, postponing its target by a year. The two governments face an uphill struggle in selling their delayed targets in Brussels and Berlin, however. The recent appointment of France's former finance minister, Pierre Moscovici, as Europe's economics and financial affairs commissioner with the key role of approving national budgets had raised hopes that France and Italy would be given greater flexibility in

Checking The Boxes

Our short take on the latest news

Fact	Consensus belief	GK Research reaction
US private employment rose by 213K in Sept, from 202K (according to ADP estimates)	Better than the expected 200K	Encouraging, during a month when some of the other growth data has softened
US Institute for Supply Management mfg Purchasing Managers Index slowed to 56.6 in Sept, from 59.0	Worse than the expected 58.0	Auto sales, consumer conf, and Purchasing Managers Index have all softened in latest reading, but trend is still positive
German Purchasing Managers Index fell to 49.9 in Sept, from 51.4	Lower than 50.3 flash estimate; below 50, joining France at 48.8 & Greece at 48.4	German trading partner woes abound (Russian sanctions, weak growth in China, France & Italy...)
France announced 3% budget target will not be met until 2017; postponed from 2015	Budget deficit to hit 4.4% in 2014, 4.3% in 2015, 3.8% in 2016 & 2.8% in 2017	Based on optimistic growth forecasts & risks confrontation with Germany over austerity

meeting fiscal targets. But in a surprise move this week Commission President Jean-Claude Juncker curbed Moscovici's powers, appointing hawkish Latvian commissioner Valdis Dombrovskis to oversee and sign off Moscovici's budget approvals. The move was widely seen as aimed at placating opinion in Berlin, where Chancellor Angela Merkel is uneasily watching the rise in popularity of anti-European political part, anti-euro party (AfD). Although AfD is still small, the threat of losing voters to Germany's Euro-skeptic right will only encourage the chancellor to take a tough line with France and Italy over fiscal policy, especially in the absence of significant progress on structural reform.

- **Monetary policy:** Investors are looking to ECB president Mario Draghi to announce details of a major program of asset-backed securities purchases at the central bank's meeting today. However, given the insistence of the Bundesbank that the ECB should only buy superior quality investment grade securities and the reluctance of the German and French finance ministries to back ECB purchases with government guarantees, there is a clear risk that markets will find Draghi's program deeply underwhelming. To make things even more difficult, on October 14 the European Court of Justice is set to rule on the legality of the ECB's proposed Outright Monetary Transactions program of secondary market sovereign bond purchases. A decision against the program would effectively rule out the possibility of full-blown quantitative easing in Europe.

With efforts to procure a European recovery belabored on all three fronts, and prospects for eurozone corporate earnings set to disappoint, it should be no surprise that investors are jittery. The only bright spot for Europe at the moment is the weakness of the euro, which has fallen nearly 10% against the US dollar since May; a decline that will both help to support eurozone exporters and to ease disinflationary pressure. As the US moves closer to tightening monetary policy and with European policymakers facing an uphill struggle in their efforts to generate a recovery, the decline in the euro looks set to continue.

Test Your Knowledge

The governor of Argentina's central bank resigned yesterday after drawing fire from president *CristinaFernandez de Kirchner for failing to halt the slide of the Argentinian peso. So far this year the peso's official exchange rate against the US dollar has depreciated by 22.9%. How much has its black market rate fallen?*

a) It's actually risen by 10%
b) It's flat
c) It's fallen by 60%

Answer: b) At the end of the first half of this year, the peso's black market rate was more or less flat against the US dollar, after a steep slump in December 2013, which anticipated the peso's official devaluation. The relative stability of the peso's unofficial exchange rate will be a little comfort to Argentina's beleaguered president, however, given that at the end of June, the currency's black market exchange rate was trading at a discount of some 35% to the official rate. At such a deep discount, the peso's black market rate implies that Argentina's annual inflation rate is running at more than 50%, a far cry from the 15% rate announced by the government for the first half of the year. Find an analysis here.

To subscribe to the Daily, please email lhall@evergreencapital.net