

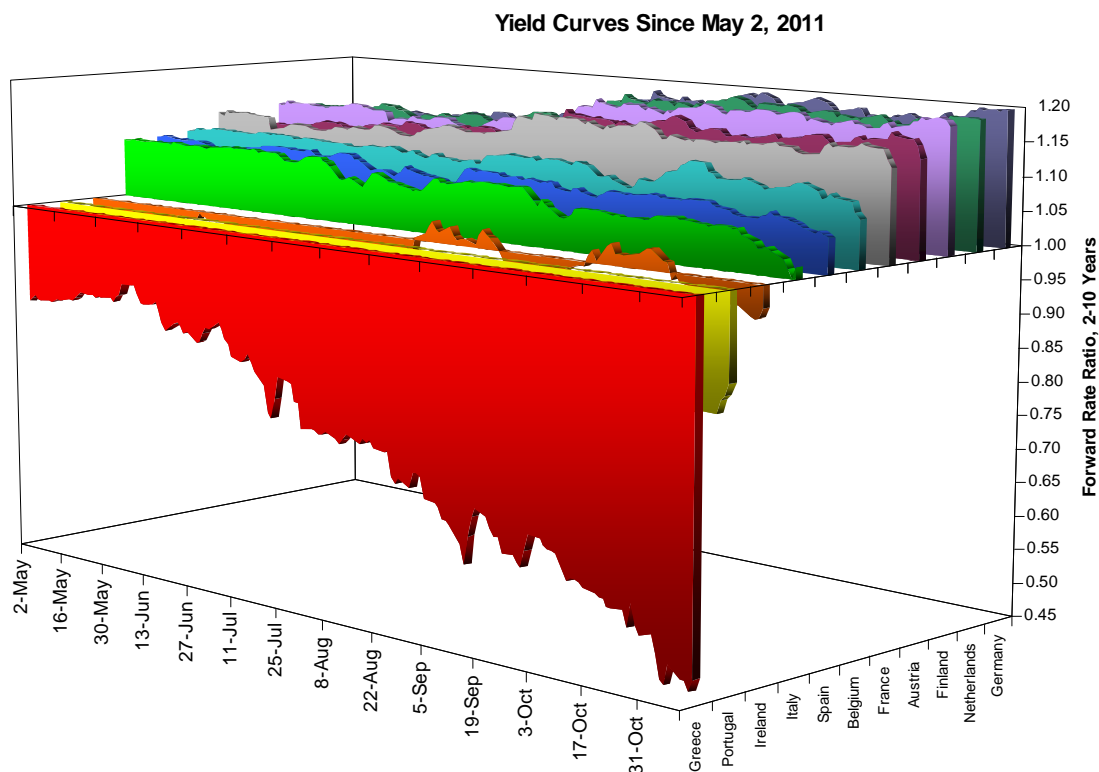
Revisiting The Cost Of Being Europe

Perhaps it is the result of growing up during the Vietnam War era, the first time Americans really got a taste of wars far easier to start than to finish, but whatever the reason I have internalized the concept war is the natural state of human affairs and peace is something you have to work very hard to achieve and even harder to preserve. As an aside in this regard, ten minutes after the last American soldier leaves Afghanistan, it will be as if we never were there: Their lowest energy state is clobbering each other.

So it is with the cost of European monetary union sans European fiscal union. Their natural state of affairs appears to be wildly divergent paths of inflation, growth, taxation and pretty much whatever other politico-economic metric you care to invent, such as currencies.

A point I noted back in May 2010 in [The Cost of Being Europe](#) was the single currency can be restated as a set of national currencies whose exchange rates are fixed. As a country can fix its interest rates or it can fix its currency but it cannot fix both simultaneously. The U.S. follows the path of fixing its short-term interest rates and allowing the dollar to float with the occasional nudge to one side or another; China follows the path of minimal exchange-rate adjustment and de facto swings in interest rates executed by large-scale capital exports. The Eurozone, with its fixed exchange rates, has to allow short-term interest rates to float.

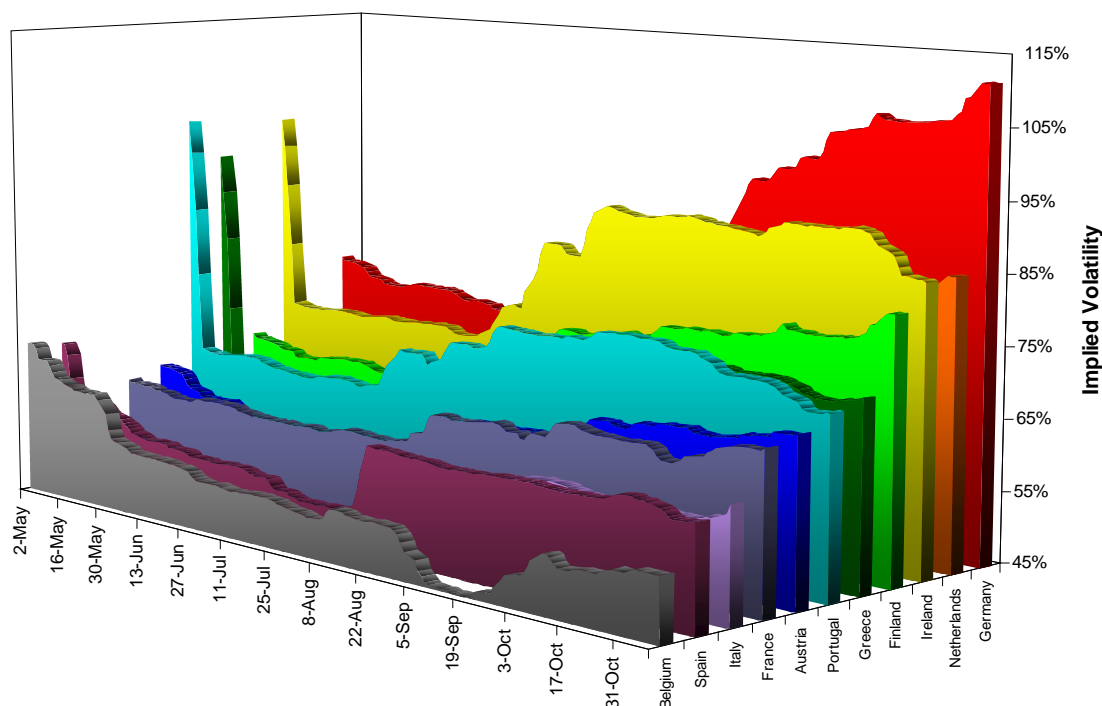
While attention was focused on the rise in long-term bond yields, particularly in Italy, last week, the real costs come in the form of much higher short-term interest rates. These are the yields required to induce creditors to assume sovereign debt risk. If we step beyond the money-market yield curve and head to the coupon yield curve as measured by the forward rate ratio between two and ten years ($FRR_{2,10}$), we can see the costs of staying in the European Monetary Union. The $FRR_{2,10}$ is the rate at which we can lock in borrowing for eight years starting two years from now, divided by the ten-year rate itself. The more this ratio exceeds 1.00, the steeper the yield curve is.



Please note in the chart above how the five members of the PIIGS quintet have the flattest yield curves. Those for Ireland and Portugal are inverted; the one for Greece is incredibly inverted. No one in Greece can afford to borrow short and lend long until there is some sense long-term interest rates are about to fall. Restated, investment is going to be on holiday in Greece.

If we turn to two-year zero-coupon volatility, we see another and different set of victims. The highest volatilities belong to Germany and the Netherlands, with Finland in fourth place. As funds flow from the low-quality credits into high-quality credits, they push short-term interest rates lower. This is an unstable situation, one that can reverse literally overnight. Investors have to buy protection.

Two-Year Zero-Coupon Implied Volatility Since May 2, 2011



This higher volatility adds to the cost of doing business in the high-quality credits and deters long-term investment. Investment takes another holiday.

Everyone frets about the euro breaking apart; this is all well and good as apparently we need something to fret about at all times in this business. The incredible answer is the fragmentation has been occurring in the interest rate world; we have hidden it in the exchange-rate world.