MONEY TALKS: Euro's Gain Contains Seeds Of Its Next Crisis

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NEW YORK (Dow Jones)--With the euro at a six-month high near $1.38, it is hard to believe that three months ago, when it was beneath $1.20, the consensus was that it was headed to parity.

Such is the unpredictable, two-way nature of foreign exchange markets.

Indeed, just as the euro seems a one-way bet right now, there is an equally strong chance of another reversal. The seeds of it lie inside the same fundamental story now driving the euro higher: the striking gap in policy intentions between the European Central Bank and the Federal Reserve.

On the face of it, the logic behind the euro-dollar trade is clear.

The Fed is openly willing to launch further "quantitative easing" asset purchases to avoid the threat of deflation, with New York Federal Reserve President William Dudley directly stating Friday that further Fed stimulus action is "likely." By contrast, the ECB is letting its own extraordinary liquidity facilities expire and is sounding far more steadfast over tight policy.

In short, there will be more dollars injected into the financial system and fewer euros. Along with the one-percentage-point differential in favor of the ECB's reference rate over the Fed's, this creates a strong incentive to sell greenbacks and buy the European single currency.

But how on earth is a country like Ireland supposed to survive such tighter monetary conditions?

In case people hadn't noticed, Ireland announced this week that its final bill for bailing out the country's banking system could run to EUR50 billion, taking its fiscal deficit to an eye-popping 32% of gross domestic product. Weighted for GDP, it is as if the U.S. committed $4.3 trillion to rescue its banking system, rather than the $700 billion earmarked in the Troubled Asset Relief Program in 2008.

Ireland, which has already been through a painful fiscal adjustment, is surely facing even more austerity ahead. The last thing it needs is a stronger euro, which will undermine its competitiveness even further.

The same goes for Greece, which expects its austerity program to shrink its economy by 4% this year, as well as for Spain and Portugal. All of these peripheral countries need monetary relief when the ECB is giving them hardship.

The reason for this countercyclical policy lies within Germany, which is growing rapidly, as manifest in an unexpected drop in its unemployment rate this week. Add to this the ingrained hawkishness of the ECB--which it inherited from the Deutsche Bundesbank--and you have a bias toward monetary tightening.

When euro skeptics talk about the problem of one-size-fits-all policymaking, this is what they mean.

This wide gap between center and periphery can't persist forever. Without the outlet of a softer currency to offset the fiscal austerity at home, the weaker economies will keep deteriorating, making it even harder to service debt.

Meanwhile, the euro zone's banks remain at risk, notwithstanding the recent bank stress tests. Although they have gotten through the roll-off of ECB lending facilities without crisis, rates are rising in the interbank market as the excess liquidity dries up.

And who really believes that the banks' portfolios of Irish, Greek, Spanish and Portuguese bonds are no longer at risk?

For now, the backstop of the EUR440 billion European Financial Stability Fund is giving investors confidence to buy the debt of troubled sovereigns' debt in auction, preventing their bonds from wholesale collapse. But this hasn't stopped Ireland's credit default swap spread from blowing out toward 500 basis points. In fact, talk of Ireland tapping the stability fund has been cited as a reason for nervousness in the secondary market.

Many worry about what will happen in January 2013, when the stability fund expires and when Greece's EUR110 billion bailout program ends. Unless Ireland and company can quickly shift from austerity-led contraction to austerity-led growth, the euro-zone leaders will face enormous pressure to find a more permanent fiscal union-like solution.

German voters aren't going to be happy about that, reviving the political tension that was at the heart of the recent crisis. That challenging political showdown gets more intense the stronger the euro gets.

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