



Daily Themes

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Euro-zone: make or brake

Over time there have been many currency unions that, despite their initial success and longevity, ultimately haven't survived. Only a few years ago, the idea of a euro-zone breakup was generally considered absurd and only seriously discussed in academic circles. Now some commentators are arguing that this is the most likely outcome of the euro-zone's debt crisis. We see two ways this could happen; either some of the weak members leave and the euro continues with its strong members, or one or more of the core countries go and the euro breaks up completely. We believe that the probability of a euro breakup is only 10% for the next two years, although this increases with time. The euro-zone muddling through the crisis in its current form is the least likely scenario in our view. On a 5-year horizon we see a 30% probability that at least one member will leave the euro-zone. But this is outweighed by what we see as a 50% chance that the euro-zone will emerge from the crisis closer to a political and fiscal union. This is a requirement if it is to survive in the long run.

Academics have warned for some time that the euro is a sub-optimal currency union, as it lacks a single fiscal authority that can distribute wealth and risks among the euro members. Milton Friedman warned: "The euro is going to be a big source of problems, not a source of help. The euro has no precedent. To the best of my knowledge, there has never been a monetary union, putting out a fiat currency, composed of independent states. There have been unions based on gold or silver, but not on fiat money—money tempted to inflate—put out by politically independent entities." This became very obvious during the recent recession. Absence

of a bail-out mechanism to support the weaker euro-members and lack of co-ordinated communication among the various authorities have seriously harmed the euro-zone's credibility. As a result, the euro has lost more than 10% versus the dollar this year and yields on euro-periphery bonds have increased dramatically.

Past currency unions in Europe, Latam

Incident	Duration	Year of dissolution	Causes of the break up
Austro-Hungarian krone	26	1918	Hyperinflation and instability after WWI
Yugoslavian dinar	50	1994	Hyperinflation and members leaving the federation
Czechoslovakian koruna	48	1993	Dissolution of the Czechoslovak federation
The Soviet Union ruble	32	1993	Fall of Soviet Union
Latin Monetary union	61	1927	Political tensions and WWI
Scandinavian monetary union	41	1914	Outbreak of WWI

Source: Coutts

Going to great lengths to avoid a breakup

Markets have forced European authorities to give a clear signal that they won't allow a euro-zone breakup. The European Union and the International Monetary Fund put together a €110bn rescue package for Greece and a €750bn support mechanism for all euro-zone members, while the European Central Bank started buying sovereign bonds. In the end the euro-zone is a political project and the political capital that has been put behind it is perceived to be more valuable than the economic cost of maintaining a sub-optimal currency union.

Enormous costs in leaving EMU

The costs for the any country that leaves the euro-zone would also be enormous. For example, if a weak country like Greece leaves it would result in an immediate default on its debt. Exclusion from the credit markets would increase the cost of borrowing dramatically. The inability to borrow would force the government to immediately reduce its deficit to zero, implying a fiscal consolidation

Carl Astorri

Head of Economics & Asset Strategy

James Butterfill

Equity Strategist

firstname.lastname@coutts.com

Alan Higgins

Head of Investment Strategy UK

Henry Lancaster

Senior Investment Analyst

Jean-Maurice Ladure

Head of Investment Strategy Europe

Julien Seetharamdoo

Bond Strategist

Norman Villamin

Head of Investment Strategy Asia

Georgios Tsapouris

Investment Strategist

around three times larger than the one currently in place. A surge in borrowing costs and extreme fiscal squeeze would put the country into a much worse and longer recession than currently expected. Benefits from the devalued new currency would be trivial, as the export sector accounts for only 7% of GDP, while the social unrest would harm important economic sectors, such as tourism.

The cost would be significant even if a strong country like Germany were to leave the euro-zone. A safe new deutsche mark would attract large amounts of capital and appreciate dramatically, hitting exports significantly. The additional loss of business confidence and disruptions in the banking sector would probably tip the country back into recession. To these would be added the significant cost arising from the unprecedented legal hurdles of leaving the euro. The process of re-denominating contracts to the new currencies would be cumbersome and expensive.

Considering the existing strong political will for a united Europe and the economic and social costs that the leaving country would incur, we believe that no mainstream politician wants to be perceived as taking a strategic decision to leave the euro.

Willing to stay in, but are they able?

However, a decision to leave the euro-zone would be easier if it was seen as inevitable. Argentina, having tried various remedies for its debt crisis, decided to unilaterally default in 2002. This was not part of a strategic plan, but rather a reaction to the fact that the cost from social unrest surpassed the benefits from maintaining its peg to the US dollar. Euro-zone nations are aware that if they would leave the euro now they would incur enormous costs. However, the balance changes over time as it becomes increasingly more expensive to stay in. As the peripheral countries go deeper into recession in the years ahead, the pain of remaining in the euro will also increase. But by then, fiscal deficits are expected to be lower, making defaulting and going to a balanced budget relatively less painful for these countries.

At the same time, if the debt crisis continues to spread and core euro-zone nations are called on to bailout more of the weaker members, dropping out would become an increasingly attractive option for the fiscally fit.

As the costs of staying in increase through time, increasing unease from domestic populations could meet with less strong political will from the members' leaders to remain part of the euro-zone. Today's politicians are already much less committed to the idea than their predecessors, who lived through WWII and saw a united Europe as a means of securing peace and prosperity.

Eventually political parties that are willing to take their countries outside the euro may come to power. If one or more of the weak countries are forced, or decide, to go the euro could continue as a currency. If a strong country or countries abandon the euro, we believe the euro-zone would break up entirely. Even if these strong currencies decided to create a new monetary union, the new currency would be significantly different from today's euro.

At the moment Greece has secured its funding for the next 18 months and we therefore believe that the probability of the euro-zone breaking up is low for this period. Markets should instead be more focused on the risks arising from the implementation of the measures already announced and the co-ordination hurdles that European leaders have to overcome.

After this period though, the risk that at least one country leaves EMU increases to a significant 30%. Even if the support packages to the weaker countries are extended and defaults are avoided, the cost of staying inside the euro-zone will increase significantly for the peripheral countries. We therefore believe that the euro-zone cannot continue in its current form forever. In the long run it has to move closer to a fiscal and political union that will make the euro-zone a more optimal currency area. Even with fewer members a closer union is necessary, or the euro-zone will fail.

Carl Astorri
Head of Economics & Asset Strategy
James Butterfill
Equity Strategist
firstname.lastname@coutts.com

Alan Higgins
Head of Investment Strategy UK
Henry Lancaster
Senior Investment Analyst

Jean-Maurice Ladure
Head of Investment Strategy Europe
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Bond Strategist

Norman Villamin
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Georgios Tsapouris
Investment Strategist

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