

# The end of the eurozone

## Economic perspective

6<sup>th</sup> June 2011

This is the third note in a series of notes outlining the backdrop for global markets financial markets in the coming 18 to 24 months. A key part of this outlook is the belief that the global economy will continue to experience semi-regular shocks; perhaps quite as large as the shocks experienced in late 2008. The second crisis is obviously European, and the possibility that the current eurozone will not survive.

The focus of financial markets seems to be on, perhaps not unsurprisingly, financial solutions. How can Greece and the other peripherals maintain liquidity? There is a belief that if trouble can be staved off to 2014 crisis will be averted. By 2014 austerity will have worked and a return to market-based financing possible. This is a false belief, in my opinion. Both economically but, more importantly, politically these austerity measures are unsustainable.

***I think there is a greater than 50% chance of a politically driven collapse in the eurozone.***

Last year, as the crisis gathered pace, an analyst made the comment “*those who are negative about the euro fail to understand that it is about optimising the political, not the economic outcome – the euro will be supported because it stops a European war*”. Initially, I believed this to be true. But on consideration, I believe it ignores the history of the first half of the 20<sup>th</sup> century in Europe. The peace must be relatively equitable and this euro peace is quite obviously not equitable; the pain is not shared. The lack of economic equity will lead to political instability.

### **Austerity to date**

It's useful to remind ourselves of the pain some are feeling in Europe already. Unemployment rates have spiked (Spain 8% to 21.5%, Ireland 4.5% to 15%, Portugal 8% to 12% and Greece 7% to 16%). This pain can only increase as austerity bites.

Consider just the original Greek bailout terms from 2010. The new bail out provision requires a further 6.4 billion euros in cuts, just this year:

- 8% reduction in income for pensioners from cutting some holiday bonuses
- Wages at state run companies will see wages cut by 3%
- Postpone the solidarity bonus to the poorest 2.5 million Greeks
- Cut public investment by 500 million euros
- Increase sales tax rates
- Raise cigarette, fuel and alcohol taxes.

These terms have led to a 10.7% decline in GDP from its Q3 2008 peak and it is expected things will only get worse with unemployment in Greece and elsewhere trending up again. But, the new bailout terms are not only financially tough, they may be even worse if the Greeks agree to international supervision of tax collection. This would be a breach of Greek sovereignty.

## **This pain represents the political problem. It's not fair.**

I was told early on in life that it's not fair but it's hard to not have some sympathy with those that think the bailout conditions hit them harder than others.

Look at Greece – unemployment has nearly tripled yet wages are down just 1.7% from their peak. Remember the Greek Railways; they make 100 million euros a year but spend 300 million euros on wages alone; surely job and wage cuts here are as necessary as they are in the private sector. A combination of an inflexible labour market and little change in the public sector mean the burden is spread unevenly across the unemployed, particularly as they are also paying higher consumption tax rates.

The same story seems to exist across much of peripheral Europe. There has been a substantial increase in unemployment yet for many wages have not fallen. It seems only natural that some, the unemployed and those in the private sector who have seen falling wages, would feel politically excluded.

Another way of looking at this is in the import data. In the Asia crisis, imports fell dramatically; in Thailand, Indonesia and Korea US\$ values declined by over 30% and for a period of between two and two and a half years. In Europe the steepest declines were less than 30% and shorter than two years and some of the decline is more associated with the financial crisis than austerity. While there were also winners and losers in Asia, every citizen experienced a dramatic decline in global living standards through the currency decline (the Indonesian Rupiah depreciated 85% against the US\$.) The crisis was a shared experience; it's not being shared in Europe.

This pain manifests itself politically in the protest movements observed currently in Athens and Madrid. But it's not just the periphery nations. Indeed, there seems to be greater political organisation amongst those outside the political mainstream in the northern European economies. The most obvious examples are the True Finns in Finland, the Party of Freedom in the Netherlands, the National Front in France and the Northern League in Italy. These are Tea Party equivalents with, perhaps, different platform positions but broadly the same complaint – exclusion from decision making, a lack of jobs and a perceived inability to access the fiscal support that others are granted. They are becoming big enough to influence political decision making.

One letter in the Financial Times recently pointed this out. The FT's editorial had laid into the National Front (NF) in France, suggesting France should ignore the party and its policies; exiting the eurozone, exiting Nato, ending or controlling immigration and bringing back the death penalty. The letter writer made the point that if a referendum were held today it is likely that France would vote for all these measures. Instead, of ignoring the National Front, he said the political establishment should better address the concerns of the NF's constituency. He went on to say that in next year's election, if the NF are ignored they will likely get 20% of the vote and their leader, Marine LePen, will go to the second round Presidential runoff, meaning the other candidate must explicitly address these issues, probably through populist pandering.

It's also seen in the decision of Angela Merkel to end nuclear energy production in Germany by 2022. Merkel has suffered a number of electoral defeats, largely due to European issues. Her lack of political success has required a more aggressive stance; faced with the choice of a more anti-European agenda or cutting 24% of Germany's power generation, she chose power generation. The price of maintaining the political consensus for a eurozone bailout in Germany is rising dramatically.

Finally, there's the True Finns. In 2011 they won 19.9% (and 39 seats, five seats behind the largest party) of the vote at national elections compared to 4.7% of the vote in 2007. They won this vote, partly, on an anti-European platform and it's not hard to see why. As Finland stumps up for a eurozone bailout it must also deal with the decline of one of its biggest employers – Nokia. Nokia, facing substantial market declines due to its inability to create a competitive smart phone, has seen its share price fall to below \$7 from over \$40 prior to the financial crisis and must now cut jobs. The True Finns argument goes; why save Portugal when our own people are losing their jobs?

### Where does this lead to?

This is Europe's Lehman Brothers moment. Indeed, there is an eerie familiarity. Too Big to Fail by Andrew Ross Sorkin highlighted the way in which the Lehman Brothers CEO, Dick Fuld, repeatedly turned down offers to buy or re-capitalise his bank but each time he refused in the hope of a higher offer. I think Europe is in the same position. There have been opportunities for the European institutions to take the medicine and each time the problem has been kicked down the road. Each failure has handed more power to those movements that were once on the fringe at a time when the cost of bailing out is only going to rise.

Already there is momentum for Greece to exit the eurozone, prompting this comment from the European Union's Maritime Affairs and Fisheries Commissioner, Maria Damanaki, a Greek:

"The greatest achievement of post-war Greece, the euro and the European course of the country is at risk. The scenario of Greece being distanced from the euro is now on the table as are ways to do this...Either we agree with our creditors on a program of tough sacrifices and results...or we return to the drachma."

Furthermore, the idea that any failure in Greece, eurozone exit or default, can be quarantined ignores the experience of financial crises since the Asia Crisis. Contagion is an ever-present danger. A default or exit by Greece will have unknown consequences. Even if the next most likely candidates, Ireland and Portugal, behave themselves, it may be the smaller Northern European economies that accentuate the crisis. Each bail out must be agreed by all members of the EU, and increasingly, expecting further support from each country is becoming more of a stretch. Once an exit does occur, the incentives for others to leave will only increase.

And for those looking for the technical aspects of leaving a currency, good examples include Ireland from the UK's pound and the Czechoslovakian split.

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