

Eurozone Crisis “Part Deux”: The Big One

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In June when we suggested that the European Union (EU) efforts to prevent a collapse in the eurozone had the potential to succeed, we cautioned that a few caveats remained. The main condition was that the proposed contingency fund should not actually be used, as tapping into this financial source could be enough to bring about its own demise.

The other caveats were as follows: the European Central Bank (ECB) needed to continue to provide a significant amount of liquidity at cheap rates; the European economy needed to continue its economic recovery; and if the euro were to be a weak currency during this transition, then this would be beneficial.

Unfortunately, these conditions have not been met, and the eurozone is now under significant threat. For the first time, we even suggest that it could be broken up. This still remains a low-probability outcome, but we believe these murmurings, now started, will continue.

Before examining the possibility of a break-up, we should point out what we think has gone wrong. First, it seems to us that the core of Europe (mainly Germany) believe that once the European Financial Stability Facility (EFSF) was in place, the ECB short-term liquidity program would not be required. This approach has forced Ireland, and possibly Portugal, to seek aid through the EFSF program, which we believe is a dangerous move and a mistake. We believe the beauty of the ECB funding is that it helps the banks directly without influencing public opinion, as it largely occurs behind the scenes. In our opinion, once such funding acquires public prominence, the delicate web of coalition governments within Europe may start to lose public support, leading to the risk that slim majorities are overturned. A likely fear is that these coalition governments could lose fiscal control, and that fiscal policy would then be set by the core European countries. Such a loss of sovereignty, in our view, would not be tolerated at a time of severe economic hardship.

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¹ Please see disclosures at the back.

Naturally, all this uncertainty is likely to lead to a weakening of the euro. This has only just started to materialize, having been held back initially by what we see as US currency debasement efforts. So far, the only countries that are benefiting from this currency decline have been those in the core, and those that are focused on exports.

We believe the second mistake was to talk about the response to the next crisis before having fixed the current one. For example, public comments in Germany about bond haircuts beyond the years when the EFSF will have ended have spooked holders of existing debt. This may produce a further hazard, as it raises the borrowing costs of those countries and of the banks that need very low rates to offset the fiscal austerity measures.

Meanwhile, the economic recovery in the peripheral markets is insufficient to keep tax-receipt growth positive. Disappointing economic data from Greece and Ireland is worrying investors that these countries' efforts to turn their deficits around are not going to work. So, the combination of higher borrowing costs and uncertainty about the security of borrowing, accompanied by the simultaneous withdrawal of cheap liquidity, is bringing the euro to a crisis that may be greater than the previous one in May. The tenor and timing of the comments coming from the core governments and the hawkish response from the ECB suggest that a two-speed Europe has clearly emerged, with what we regard as an inarticulate official policy response.

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Could there be a connection? We could make more of this hawkish response from Germany causing a euro shock, were it not for the idea that many German and other core European banks have significant holdings of peripheral government debt. Due to a lack of transparency, this can only be a theory, and furthermore, these peripheral debt-holding banks could have protected themselves significantly, and may consequently be more able to withstand PIIGS (Portugal, Ireland, Italy, Greece and Spain) re-structuring and haircuts.

Until recently, the notion of one of the PIIGS countries leaving the euro seemed absurd. There would be little benefit for the exit as it would probably be accompanied by a significant currency devaluation, rendering its existing stock of euro debt prohibitively expensive to service. The idea of bond holders taking a haircut during a restructuring is one that we have anticipated with regard to Greece, but it has now become more likely for other countries following recent German proposals. We believe a combination of these two ideas leads to a plausible, if not possible, solution to the crisis.

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If the core European countries were to leave the euro and set up their own new eurozone (comprising Germany, Netherlands, Austria and Finland), then the likely devaluation of the old euro currency zone (Belgium, France and the PIIGS) can help those countries overcome some of their economic difficulties. The ECB, freed from German influence, could print money to support its bond issuance. At first glance, the bond holders may not like such an obvious devaluation of their assets but, as with many debt restructuring proposals, by the time an issuer reaches this point, all other options are largely exhausted and the only remaining alternative is default. At least domestic holders of the euro debt may not suffer, and would welcome the countries' increased potential to recover. The devaluation of the euro would be dramatic. This may not be what the German authorities desire as it would erode the country's export competitiveness, but forcing the PIIGS to pay high borrowing costs and endure deflationary fiscal adjustment may become too much for those democracies to bear. This type of scheme remains far-fetched, but something similar may feature in the contingency planning corridors of the European institutions. In the meantime, talk of such events is enough to keep the pressure on the euro, even if an actual breakdown of the eurozone is, politically, unlikely.

If Portugal tapped into the EFSF, the door would be closed to Spain, given the frailty of the EFSF structure. This would lead us to expect the ECB to support Spain via increased liquidity measures.

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