Eurozone On The Brink?

*Prepared: August 16, 2011*

**Executive Summary**

Just over a year ago, readers of *The Wall Street Journal* saw a shocking photo of policemen under attack in a street riot. But what was really shocking, was that the photo wasn’t taken in the streets of Cairo, Damascus or Tehran — it was actually shot in Athens, Greece. And the root cause of the violence being depicted wasn’t due to politics, religious tension, or sectarian strife — it was caused by economics.

With origins that date back almost sixty years, the formation of the European Union (EU) represents one of the most significant political and economic developments of our time. Yet today, some analysts contend that a portion of the EU — the eurozone — is on the brink of falling apart. And with events unfolding daily, the future is hard to predict. However, given the importance of the eurozone to the global financial system, there are many thoughts and observations to consider about what might lie ahead.

**Background**

The formation of the EU began in 1952 with trade agreements, primarily around coal and steel, between Belgium, Germany, France, Italy, Luxembourg and the Netherlands. In 1973, Denmark, Ireland and the United Kingdom entered the fold, followed eight years later by Greece, and 13 years later by Spain and Portugal.

Since that time, another 15 countries have entered the Union. Today, there are 27 members, with additional countries (such as Turkey) seeking to join. In terms of major countries, only Norway and Switzerland still lie outside the EU.

Along the way, a very important development of the European Union was the creation of a European Monetary Union centered around a common currency — the area commonly referred to as the eurozone. And in 1999, the euro was born. At present, 17 countries have retired their local currencies and adopted the euro. Gone is the German deutschmark, the Italian lire, the French franc and 14 other European currencies. Today, even the Vatican issues currency denominated in euros.

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*Important disclosures provided on page 4.*
Not all countries have adopted the euro. Switzerland and Norway still issue their own currencies, as do the United Kingdom, Sweden and Denmark. Nevertheless, the creation of a common currency has been a tremendously important development in global financial affairs.

As mentioned, there are currently 27 members of the European Union. In terms of a variety of metrics — such as population, gross domestic product (GDP), exports and savings — these countries combined rival equivalent measures for the United States. And, in every case, exceed those of Japan which is the world’s third largest economy. This makes the EU a critical component of the global economy and a source of tremendous pride to many Europeans.

**Characteristics of the Euro Area**

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<th>€-17</th>
<th>EU-27</th>
<th>U.S.</th>
<th>Japan</th>
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<tr>
<td>Population (millions)</td>
<td>331</td>
<td>501</td>
<td>309</td>
<td>128</td>
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<tr>
<td>GDP (PPP, € billions)</td>
<td>9.0</td>
<td>12.5</td>
<td>11.2</td>
<td>3.3</td>
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<tr>
<td>GDP per capita (PPP, € thousands)</td>
<td>24.1</td>
<td>24.9</td>
<td>36.3</td>
<td>25.6</td>
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<tr>
<td>Share of world GDP (PPP, %)</td>
<td>15.1</td>
<td>21.3</td>
<td>20.4</td>
<td>6.0</td>
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Source: European Central Bank; 2010 figures shown
€: symbol for euros
€-17: 17 countries in EU using the euro; EU-27: all 27 countries in the EU
GDP: Gross Domestic Product; PPP: Purchasing Power Parity

**What has gone wrong?**

Europe is struggling with a monetary union without a fiscal union, each of which implies very different, albeit interrelated challenges.

Within the greater EU is the Economic and Monetary Union (EMU). With the euro serving as the centerpiece of common currency, the goal of the EMU is to converge the economies of its participants in terms of monetary goals. This includes such things as price stability, interest rate parity, currency exchange rates, and public finance discipline (meaning fiscal policy aimed at controlling budget deficits and spending).

**Can you spare a dime?**

Like individuals, when governments take in less than they spend, trouble lies ahead. And spending beyond their means is what some countries in the eurozone have been doing for quite some time. These issues have now brought the eurozone to the brink of a full blown crisis.

It is in the area of fiscal policy discipline (or the lack thereof) that problems have been building for some time. These issues have now brought the eurozone to the brink of a full blown crisis.

Currently, a number of countries in Europe are running budget deficits that as a percent of GDP are simply too high. Although a country can get away with this for a while, ultimately there is a price to pay in that these deficits must be financed by issuing debt. In the case of countries within Europe, such as Greece, Italy, Ireland and Portugal, budget deficits have become uncomfortably high.
The problem isn’t just that this debt must be repaid, but it must also be serviced — meaning interest payments on it must be made. And if these payments are not made, you have a country in default. This can be catastrophic, not only to the country in question and its business community and citizens, but to the global financial system.

What makes the situation in the eurozone so unstable today is that there isn’t just one problem to solve. There are actually three problems. All three are interconnected and, in the short term, attempting to fix one problem may make the others even worse.

The first problem relates to the question of the fundamental solvency of certain countries in terms of budget deficits and outstanding debt. The second problem is the fact that the eurozone relies far more heavily on its banking system for financing than countries like the U.S. This means that if one or more countries in Europe were to default on their debt, the impact on the region’s banks could seriously impair their balance sheets. In turn, this could likely put a huge damper on growth within not only Europe, but globally, as well.

The third problem is faced by Greece, in particular, and to a lesser extent, Portugal, Spain and even Italy. The economies of these countries have become uncompetitive. To put it bluntly, these countries don’t produce enough of the things that people in other countries want to buy.

When combined, these three problems mean that countries, like Greece, could be caught in a debt trap. In order to reduce budget deficits and pay down debts, they need to cut spending. However, in cutting spending, they further reduce growth. And, in reducing growth, tax receipts also fall. Thus, a trap may form — which can be very difficult to escape.

What lies ahead?

In commenting on a dilemma during the civil war, Abraham Lincoln was said to have described it as “holding a tiger by the tail. You don’t like it, but you don’t dare let it go.” The situation in Europe today seems to be much like this.

On one hand, there isn’t a lot of sympathy for countries, like Greece, who have gotten themselves into these difficulties in the first place. On the other hand, no one dares contemplate the implications of the alternative — either by allowing Greece and other countries to default on their debt, or by the far more radical step of pushing them out of the European Monetary Union altogether.

Accordingly, in an effort to stave off either of these outcomes, over the past year various measures have been taken, including:

- Outright emergency loans via so-called “bail-out” packages to Greece, Ireland and Portugal by the European Central Bank (ECB) and the International Monetary Fund (IMF).
- The announcement of the creation of a €440 billion ($635 billion in U.S. dollars) European Financial Stability Facility (EFSF) with the authority to raise funds to loan to countries in financial difficulties.
- New policies wherein the ECB has intervened directly to drive interest rates on debt down via the open market purchase of the debt of countries such as Spain and Italy.
As to whether these measures alone will be enough to stem the crisis of confidence gripping the eurozone, the outcome is yet unknown. Until resolution is reached, the days and weeks ahead are likely to continue to be challenging. For example, recent ECB intervention in the Spanish and Italian debt markets does seem to have been successful in driving down interest rates to more affordable levels. Nevertheless, The Financial Times of London estimates that Spain and Italy, on a combined basis, will need to return to the bond markets for an estimated €813 billion ($1.15 trillion in U.S. dollars) in financing over the next 18 months. Should the interest rates demanded by investors to purchase this debt again rise much beyond present levels, the cost of these financings may not only become prohibitive, but could overwhelm the current resources of the ECB.

One proposed solution is the creation and issuance of “Eurobonds.” In essence, a Eurobond would be a debt obligation backed by the joint credit and several guarantees of members of the European Monetary Union. Were such bonds to be issued, it is likely they would also carry with them some form of mandatory compliance by members in terms of fiscal discipline. As to when or if we might see the issuance of Eurobonds, time will tell. At present, the political will does not seem to exist in Europe to take this bold step.

**Conclusion**

As mentioned, we believe the essential challenge facing the European Monetary Union is the fact they have created a *monetary* union based on a synchronization of currency and interest rates, but have failed to create a *fiscal* union based on a synchronization of spending and taxation. How this can be accomplished without compromising the political sovereignty of the countries in question is presently unclear. Perhaps the issuance of Eurobonds may be an answer. Or perhaps, absent that, some orderly way needs to be found for countries to leave the monetary union altogether.

Whatever the outcome, the European Union will remain a vitally important component of the global financial system and bears close observation and analysis in the weeks and months ahead.