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BREAKING UP IS HARD TO DO

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Breaking Up Is Hard to Do

"The eurozone is not going to break up. For Ireland to leave the euro would be like for Texas to leave the dollar area or for Cornwall to leave the sterling area."—Brian Lenihan, Irish Finance Minister

"The reports of my death have been greatly exaggerated."—Mark Twain

Could the euro break up? This question has plagued the common currency for more than a decade; indeed, some voiced worries about such an outcome prior to the euro's 1999 launch. In our opinion, such concerns are unlikely to be validated anytime soon. While it is true that the euro is relatively unique in its political construct (i.e., it was concocted by politicians rather than evolving naturally via market forces, as have virtually all other currencies), a euro breakup seems a remote possibility at present. This is largely due to the fact that the majority of countries in the European Monetary Union (EMU) benefit more from staying than they would from leaving. The country most able to go its own way (Germany) seems highly unlikely to leave for a variety of reasons, including the havoc that such a move would wreak on German trading partners, as well as the country's history as the central player in European politics and economics.

Further, conditions among member countries today are less divergent than they were in late 2008, as the global economic downturn has pulled down *all* countries. As a result there is broad agreement among members at the moment regarding the "correct" direction of interest rates (lower is better). Thus, while it is certainly legitimate to see bond pricing that reflects worries over individual country risk (e.g., exceptionally wide yield spreads between debt issued by strong and weak countries—Table A), this should *not* be viewed as a sign that the euro is in imminent danger of fragmenting. However, the euro does seem at risk of *weakening* given rapidly worsening economic conditions and a mushrooming crisis in the banking sector, both of which will almost certainly lead to more central bank easing/unconventional measures (i.e., attempts to create inflation).

What Is a Euro, Anyway?

The euro is a curious construct, designed as it was by government officials and economists. Further, as with all fiat currencies, euros have no *intrinsic* value (as does, say, a gold coin), and have worth only to the extent that people judge *others* will accept them as payment. (Governments, of course, help this process along by requiring citizens to use currencies for payment of taxes.) All that said, any argument that the euro will "break up" (defined as the splintering of the currency bloc and return of participant countries to individual currencies) must explain why potential defectors would prefer such an arrangement to the status quo. This is a difficult argument to make.

Consider the case of Italy, which some have pegged as the country most likely to leave the EMU. It is certainly true that Italy's financial position leaves much to be desired—total government debt is more than 100% of annual GDP, and the country is running budget and trade deficits of about 3% (Table B). Further,

Italian competitiveness has plunged in recent years, with unit labor costs rising more than 20% over the past ten years, according to the OECD, while German labor costs *fell* more than 10%.

The question, then, is whether Italy would benefit from exiting the EMU and thus being freed to pursue a course it has frequented in the past—namely, devaluing its currency to make exports more competitive. In our opinion, the answer is a resounding no. As fund manager Absolute Return Partners put it in a recent note, "bond investors would demand double digit returns on a Lira-denominated bond to compensate for the dramatically increased devaluation risk. Already in a precarious fiscal position, Italy could quite simply not afford that."

Of course, the fact that Italy is unlikely to leave the euro of its own accord does *not* mean it could not be forced out, to say nothing of the possibility that the country could default on its debt and/or come under European Union (EU) administration (thus ceding control over certain decisions [e.g., wage levels] in return for some sort of EU bailout).[1]

Indeed, there are several options available to deal with a country on the verge of default:

1. The country in question could attempt to issue more debt, albeit at punitive rates. Such an outcome might or might not be viable, depending on the specifics of the situation, although it would also be possible for the European Central Bank to purchase the debt if private buyers did not emerge (essentially the "quantitative easing" currently employed by the Federal Reserve, Bank of England, and Bank of Japan).

2. Other countries (likely France or Germany) could bail out the country and/or its banking system. While neither country has given any indication it is even considering such a step, and would likely face strong internal resistance to the idea, we cannot rule out this possibility.[2]

3. The International Monetary Fund (IMF) or some other international organization could bail out the country. Indeed, the recent G20 decision to triple the organization's lending capacity to US$750 billion makes it much more likely such a bailout could become reality.

4. The country could opt out of the euro.

All of the above are certainly possible in coming years, if not for Italy then for another highly indebted member such as Greece or Ireland. However, the important point is that *none* of these eventualities

[1] The prospect of a troubled country coming under EU administration should not be dismissed out of hand. While at first blush such a scenario seems anathema to the target country, it might actually provide political cover for the local government. Most politicians, for example, would almost certainly prefer to let the EU force painful cuts in wages (rather than doing it themselves) in order to get unit labor costs back in line.

[2] While EU rules technically prohibit countries from bailing each other out, few expect this to be an insurmountable hurdle. As EU Economic and Monetary Affairs Commissioner Joaquín Almunia said in March, "If a crisis emerges in one euro area country, there is a solution…Before visiting the IMF, you can be sure there is a solution and you can be sure that it is not clever to talk in public about this solution."

would be expected to threaten the existence of the euro. As noted above, benefits outweigh costs for the vast majority of participants; in other words, it is in everyone's interest to maintain the EMU. The question thus becomes whether a euro breakup could happen *in spite of this*. While such an outcome is certainly possible, it seems unlikely to occur anytime soon.

What Unity?

It is true that all Eurozone members "want" a cheaper currency at present; however, stark economic differences remain. For example, consider the European banking system, which according to the IMF has written down a mere 25% of its estimated US$1.2 trillion in bad debt.[3] (And given the fate of prior estimates, as well as the pace at which the global economy has been deteriorating, this number seems far more likely to rise than fall.) Not only are write-downs of this magnitude problematic, but there is significant dispersion among countries. France and Germany, for example, are likely to be able to "afford" a bank bailout if necessary; the same cannot be said for Austria and Ireland, whose bank liabilities are far greater than total GDP (Table C).

Property markets in Ireland and Spain, meanwhile, are in far worse shape than those in other member countries, while Austria and Greece (along with Germany) are most exposed to the ongoing collapse in Eastern Europe. (According to the BCA Research, Eurozone bank claims on Eastern and Central Europe total €1 trillion, of which nearly 40% is at risk of restructuring or default.)

Said a different way, while all members may favor a cheap currency, underlying differences in economic conditions are likely to manifest at some point. Indeed, if banking sector problems are not resolved in some meaningful way, the gap between Eurozone members could grow quickly once the global economy hits bottom. Nevertheless, all these problems are in a sense variants of the debt issues discussed above, and thus should not be considered serious threats to the euro for the foreseeable future.

However, the euro does have long-term problems that will need to be addressed at some point. Most notably, capital flows (both economic and human) between member countries remain halting, a situation that has potential to worsen given the protectionist urges stirred by the global downturn. Thus, given the divergent economies across member countries, interest rates will almost always be too loose for some countries and too tight for others. Unless and until this disparity can be addressed through "normal" channels (e.g., workers relocating from low-wage countries to high-wage countries, as happens across states in the United States), such pressures will only grow more acute, and are likely to someday threaten the euro's existence.

[3] This number includes the United Kingdom, and was calculated as 5% of the US$23.8 trillion in assets held as of April 2009.

Conclusion

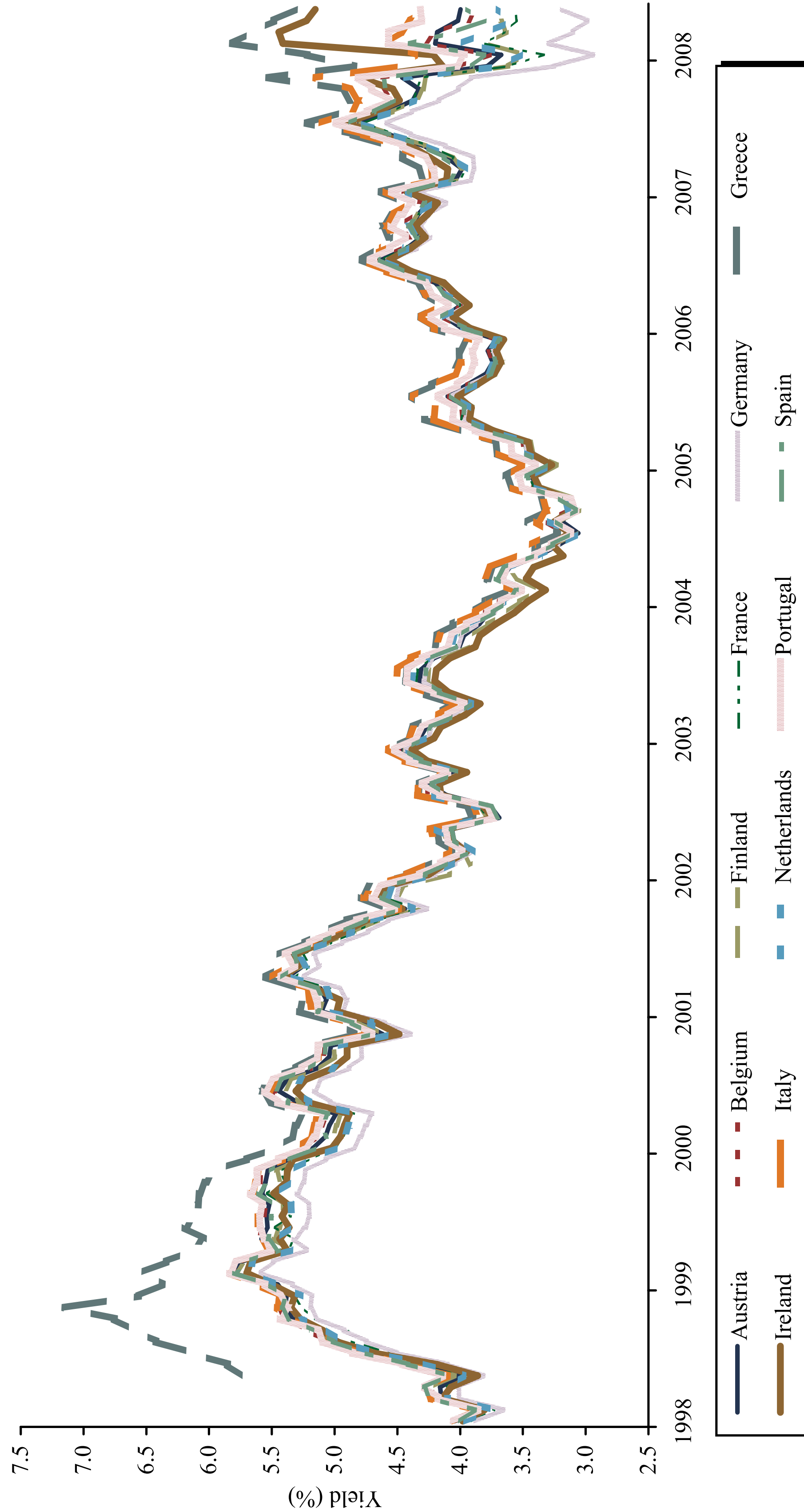
Despite all its trappings of "success," the euro remains very much a work in progress, and its long-term survival is anything but guaranteed. However, as membership in the common currency remains a net benefit to most countries (at least for the moment), we do not expect the euro to break up anytime soon. Indeed, the synchronized global downturn has likely *decreased* pressure on the euro for two (related) reasons. First, since everyone wants a cheap currency right now, there is little disagreement over where to set interest rates. Second, the global credit crunch has restricted access to funding for all but the most worthy credits; although countries such as Italy and Spain do need to pay higher rates than Germany to attract investors, they might well be shut out of capital markets were they on their own. Further, Eurozone membership confers intangible as well as tangible benefits. So while it is debatable whether France and Germany would be willing to bail out Greece, for example, such a discussion would never take place were Greece on its own. Similarly, the IMF is probably more likely to bail out a Eurozone member than a country not in the "club" due to systemic risk concerns, whether real or imagined.

The bottom line is that for all its flaws, the Eurozone is currently proving more beneficial than costly to member countries, and thus there is no substantive constituency that supports a breakup. While continued failure to address capital flow issues would likely threaten the common currency's survival down the road, such an eventuality is far too long term and speculative for us to venture a guess on its likelihood, much less the investment implications that would ensue.

Table A

TEN-YEAR BENCHMARK BOND YIELDS DIVERGE

December 31, 1998 – April 30, 2009



Source: Thomson Datastream.

Note: Data for Greece start on April 30, 1999.

Table B

SELECT MACRO INDICATORS

Country	Current Account as % of GDP		Foreign Currency Reserves (US$ mm)		Govt Debt as % of GDP		Govt Deficit/Surplus as % of GDP	
	1998	2008	1998	2008	1998	2008	1998	2008
Austria	-2.5	3.2	20,918.0	8,244.0	64.8	62.5	-2.5	-0.5
Belgium	5.2	0.6	15,763.0	7,767.0	117.1	89.6	-0.9	-0.9
Cyprus	3.1	-12.9	1,343.6	585.5	58.6	49.1	-4.1	1.0
Finland	5.6	3.6	8,508.2	6,397.6	48.2	33.4	1.7	3.4
France	2.5	-2.0	38,753.0	30,382.0	59.4	68.0	-2.6	-3.2
Germany	-0.6	6.2	64,133.0	38,557.0	60.3	65.9	-2.2	0.0
Greece	-2.8	-14.4	17,188.3	158.7	105.8	97.6	-2.2	-3.7
Ireland	0.8	-3.3	8,622.0	609.0	53.6	43.2	2.3	-6.6
Italy	1.6	-2.9	25,447.0	35,303.0	114.9	105.8	-3.1	-2.9
Luxembourg	---	---	---	258.4	7.1	14.7	3.1	0.0
Malta	-6.0	-8.3	1,555.7	288.3	53.4	64.1	-10.2	-4.2
Netherlands	3.2	6.3	17,536.0	9,369.0	65.7	58.2	-0.9	1.0
Portugal	-7.0	-12.1	15,067.0	1,022.0	52.1	66.4	-3.4	-2.4
Slovakia	-8.9	-6.1	2,867.1	17,804.9	34.5	27.6	-3.8	-2.3
Slovenia	-0.7	-5.8	3,572.9	809.9	23.6	22.8	-0.9	-0.6
Spain	-1.2	-8.1	52,490.0	11,540.0	64.1	39.5	-3.2	-3.6

Sources: FactSet Research Systems and Thomson Datastream.

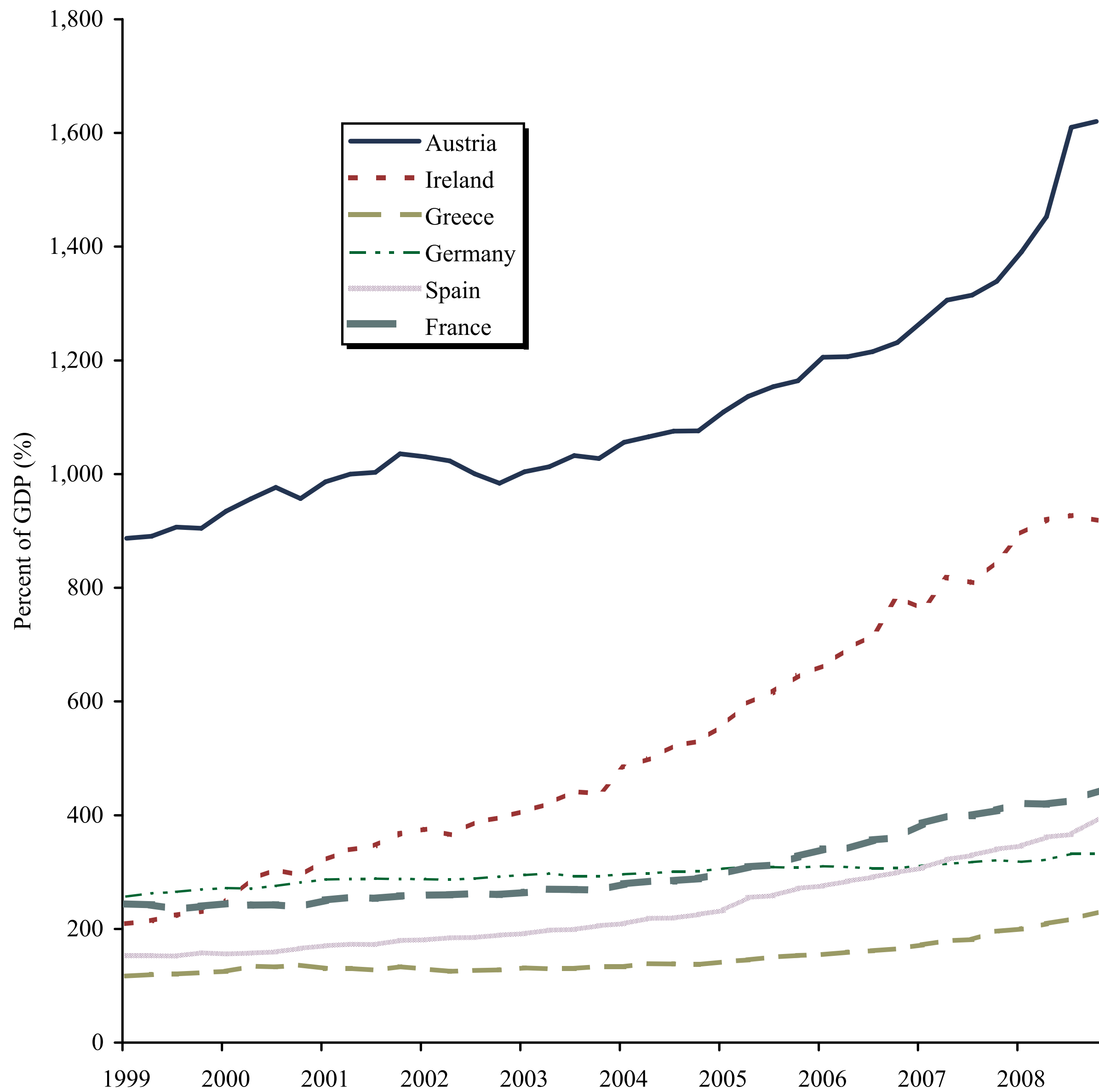
Notes: Years with "---" indicate data were not available. Percentages may not total due to rounding.

Table C

BANKING SECTOR LIABILITIES

March 31, 1999 – December 31, 2008

Monetary Financial Institution Liabilities as a Percentage of GDP



Source: Thomson Datastream.

Note: Total liabilities exclude capital and reserves.