Will the Euro Survive? (Oct 2011)

by John Hutchinson

The storm clouds have gathered over the summer over the future of the Euro and the Euro-zone as one epicentre of the continuing global financial crisis.

We have George Osborne, the Chancellor of the Exchequer, making a recent declaration that there are only six weeks to save the Euro with his mind on the G20 summit in November.

In this discussion, we will attempt to unravel some of the complexities of the Euro. First, it is necessary to recap some of the history. The whole European project was forged out of the destruction and chaos of the Second World War. Whatever the economic outcomes of the current crisis, there is a fundamental, enduring commitment to European political union, particularly from founder members such as France and Germany, in terms of ensuring the peace, stability and economic integration of both the Eurozone's 17 member states and the 27

nations of the EU.

Germany, especially, despite the huge cost of the absorption of East Germany into West remains overwhelmingly committed to the European project in which the Euro is implicit. Euro scepticism, surprisingly, has little hold in the industrial powerhouse of Europe, even though Greece and Southern Europe are blamed for their public sector profligacy.

The UK, of course, learnt its lesson when it abandoned the ERM (Exchange Rate Mechanism), the forerunner of the Euro on September 16th 1992 when the Bank of England was forced to raise interest rates to 15% in a desperate attempt to maintain the value of the pound within the mechanism. The Bank lost billions, notably to speculators such as George Soros, and dramatically the government suspended the UK's involvement in the scheme never to return. Within months, the pound had fallen some 20% in value and it was exports, boosted by making products and service so much more competitive, which became the motor of growth, leading the UK out of recession.

It would be much more difficult for any country, such as Greece, in the Euro-zone to exit and return to the original currency without a lot of difficulties in current circumstances as we shall explore.

The nature of the recession is much more profound and systemic now than in the early 1990s as we are threatened with a further collapse of the banking and financial system due to the debt crisis which David Cameron has described today (Sunday) as "a threat not just to itself but also a threat to the UK economy, and a threat to the world economy" in a BBC interview.

And on cue, the spectre of collapsing banks has manifest itself with fears that Dexia, a large Belgian bank, which has been brought to its knees by the paralysis in the inter-bank lending markets and heavy exposure to Greek debt. This feels like a replay of 2008 although we are not quite staring into a precipice in the way that we were in September/October of that year yet.

There is a conspiracy of indecision and inaction within Europe, mirrored by the extreme volatility of the world's stock markets. German and French stocks have fallen by some 25% since the end of June and the F.T.S.E is down by 13.7% in the last quarter.

So what are the possible routes out of this mess? Most economists appear to agree on the prognosis if something is not done to shore up Europe's financial systems and the Euro-zone periphery of Greece, Portugal and Ireland. The problem is that this periphery of small nations is

rapidly engulfing the large economies of the Euro 17-Spain, Italy and even dragging France and Belgium into the whirlpool of debt and default. It is the diagnosis and hence the remedy which economists cannot agree upon, showing their true colours as professors of “the dismal science”.

Is it systemic, based on forces beyond the control of central banks and governments? Or is it actually entirely the individual responsibility of each country in terms of control of public sector spending and debt?

The answer is probably a combination of both. The Euro 17 nations are tied into the euro as a currency which means that smaller inefficient, debt ridden and top heavy public sectors in the peripheral countries have no room for manoeuvre and cannot benefit from devaluing their currency or allowing it to depreciate. In the case of Greece, particularly, there seems to be no prospect of growth returning as a culture of austerity seems impossible to impose and the need for further loans and bail-outs only feeds the hand that strangles its citizens. Catch 22.

Are there valid means of insuring government debts in the form of bonds or loans against default? There are instruments such as credit default swaps (CDS) so that for example a bank that lends to Greece can hedge its loan by buying CDS protection on Greece. The bank will make regular payments to the CDS seller. If Greece defaults on its debts, the CDS seller must buy their loans back at their full face value. However, these can also be bought by investors who speculate on the likelihood of a country defaulting on its debts and can be a way of “shorting” the market. Catch 22 instruments.
Could the Euro collapse entirely? This could be precipitated by events if markets take complete fright, although governments will be able to act very rapidly in concert if necessary to reassure them. Its effects would be catastrophic as they would imply an implosion of the Euro 17, including France and Germany and the ensuing financial tsunami would drown large areas of most developed countries from which Britain would not have immunity.

There are some speculators betting on this as an outcome and have bought credit default swaps on countries such as Greece on the expectation that the countries will inevitably default, in which case they will make enormous returns.

Could individual countries exit the Euro-zone? Again this would be fraught with danger-supposing that Greece did so and its government would not want to do so as it sees far more long term benefits within the euro-zone than without, despite the immense pain and domestic unrest, practically it would be very problematic to return to a very minor currency like the drachma, as this would imply default. Even if a substantial amount of its debt were to be written off, the remaining debt would be denominated in Euros and the drachma would plummet making it difficult to pay off any residual debt.

It would also be likely to precipitate a complete collapse of the Euro-zone in its own right in

current conditions which in turn brings in a domino effect on the Western banking/financial system effectively.

However, two scenarios may emerge eventually-either some of the smaller, weaker nations, that is the likes of Greece, Ireland and Portugal may exit the Euro ultimately or we may see a division into a North and South Euro (with Ireland finding its way into the South).

The economic consequences of the collapse of the Euro-Zone will impel Euro-zone governments (and the G20 and world financial institution) to shore up the banking system, just as in 2008 as the alternative is too dire to contemplate.

However, the political fault-lines for either a one speed or two speed Euro may equally be impossible to bear as the only way that the Euro will survive is through increasing convergence of its economies which means common fiscal policies and increasingly common political policies set by the dominant economic power, Germany. That may generate tensions which endanger the whole European project anyway.

The global financial system with its esoteric and incomprehensible world of derivatives and credit swaps has become divorced from the real world of meaningful and measureable transactions. The balance of risk and responsibility is out of kilter and demands fundamental realignment to make the global financial system substantial again.

Some background readings

http://www.bbc.co.uk/news/business-15141423
http://www.bbc.co.uk/news/world-europe-14934430
http://news.bbc.co.uk/onthisday/hi/dates/stories/september/16/newsid_2519000/2519013.stm
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