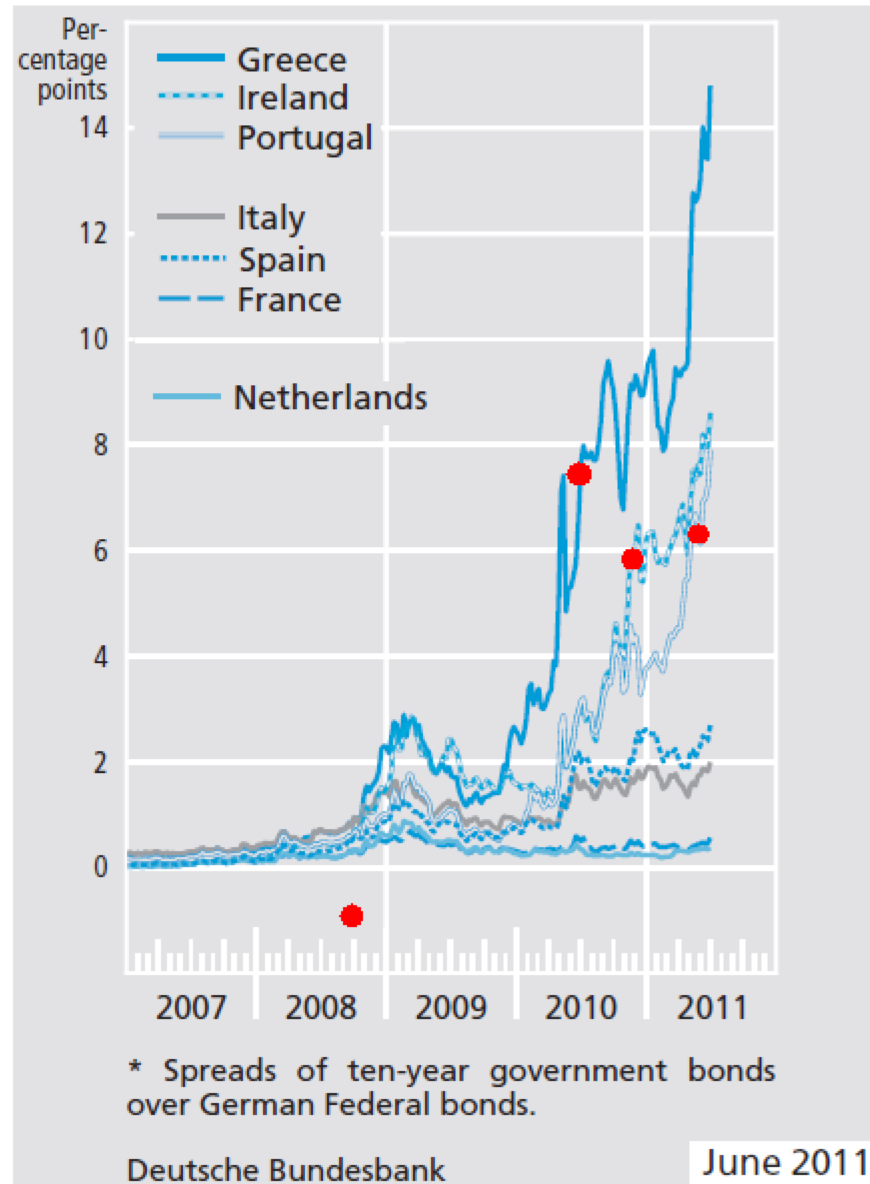
Eurocrisis
How does it end?

There are only two forces that unite men: fear and interest.

Napoleon Bonaparte

What's happening?

- September 2008, **Lehman Brothers collapse; economic recession unfolds**
- May 2010, **Greece gets 110 billion euros**
- November 2010, **Ireland gets 85 billion euros**
- May 2011, **Portugal gets 78 billion euros**
- February 2012, **Greece gets 130 billion euros, and defaults on 100…**



Why is it happening?
Myth 1

- The Euro (currency) is in crisis

Between January 2002, when the euro became “tangible”, until December 2011, the USD **lost** 31% versus the Euro, the British Pound **lost** 27% versus the Euro.

Despite the media hype in 2011, the euro as kept its stability (low volatility) status intact. 2011 high and low in the USD/EUR is roughly 14% apart, and 8.5% for the GBP/EUR pair.

The Euro matters. But right now, other things matter more

Why is it happening?
Myth 1

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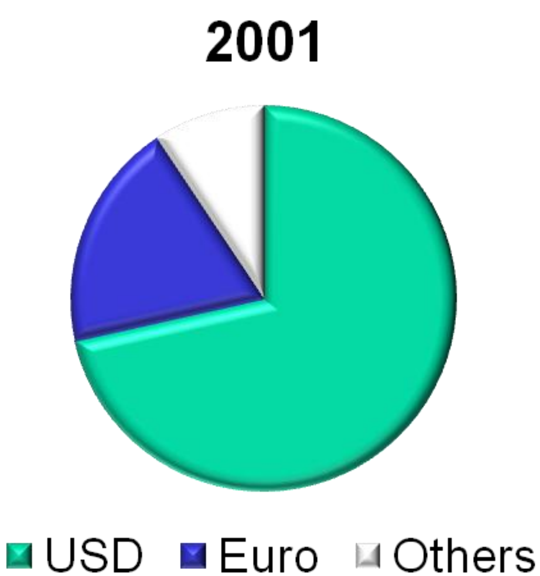
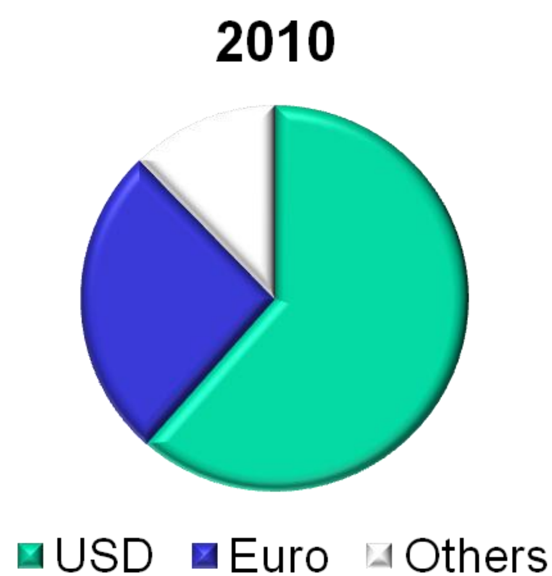


Total of official holdings of foreign exchange



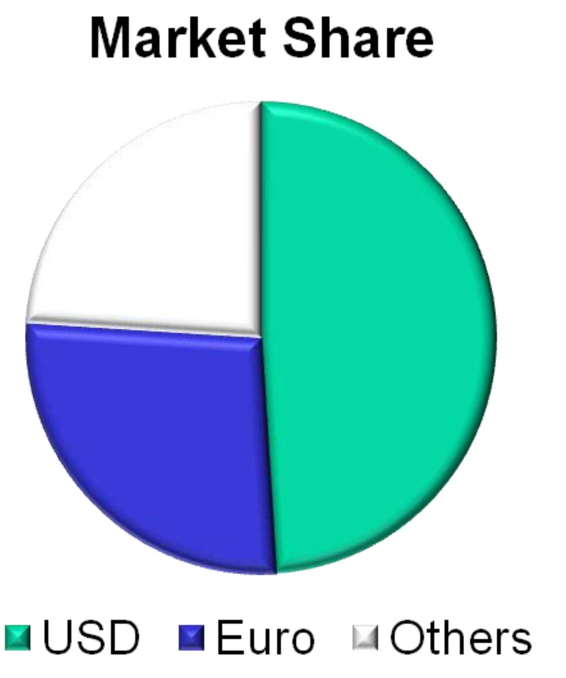
The Euro is a de-facto alternative to the USD

Why is it happening?
Myth 1

- The Euro (currency) is in crisis

At the end of 2011, the ECB estimated that from the total stock of debt securities issued in a foreign currency (for instance, Singapore government bonds issued in USD), 27% is in Euros and 49% in USD.

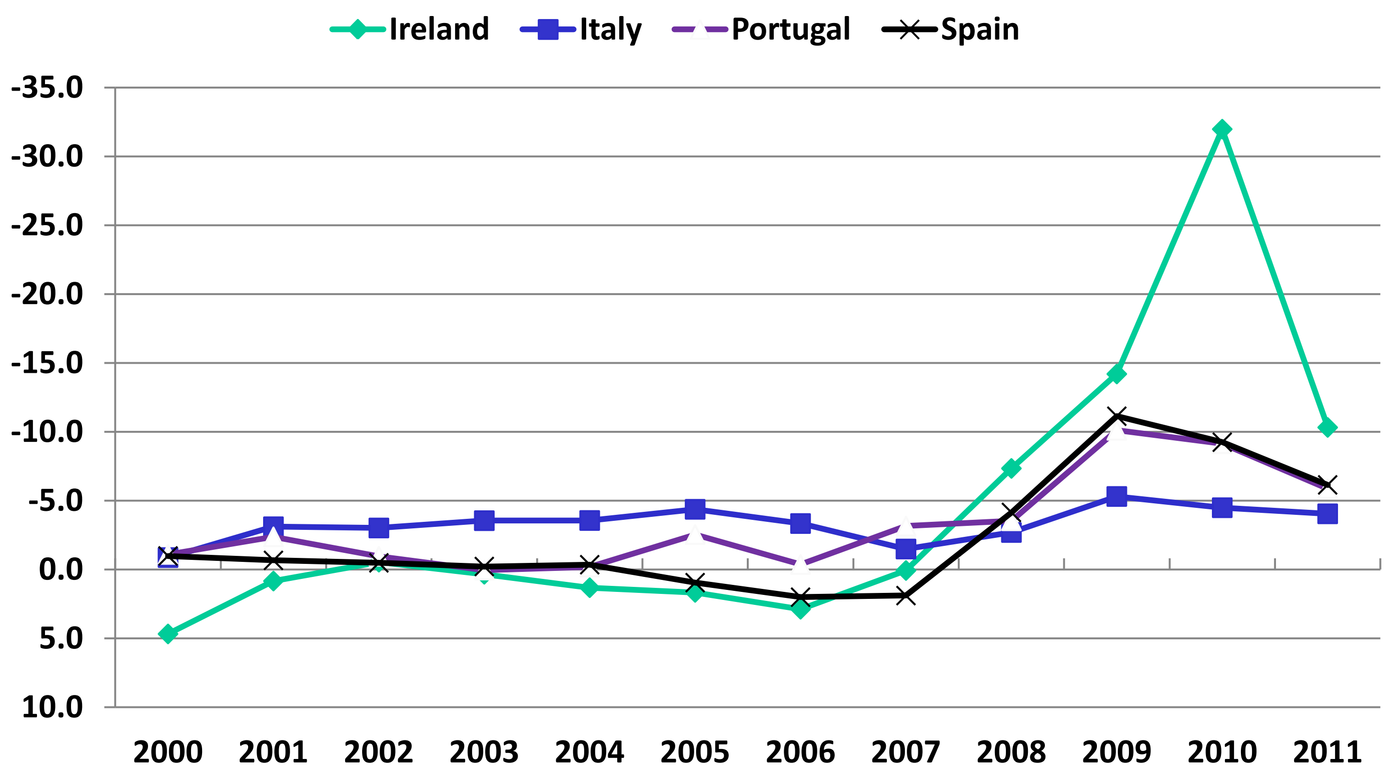
Is this a currency in crisis?



Why is it happening?
Myth 2

- Excessive borrowing

The debt-burdened countries (except Greece) actually had modest budget deficits or surpluses before 2008's recession.



Greece outright lied about the budget situation

Why is it happening?
Myth 3

- Saints & Sinners – Core & Periphery

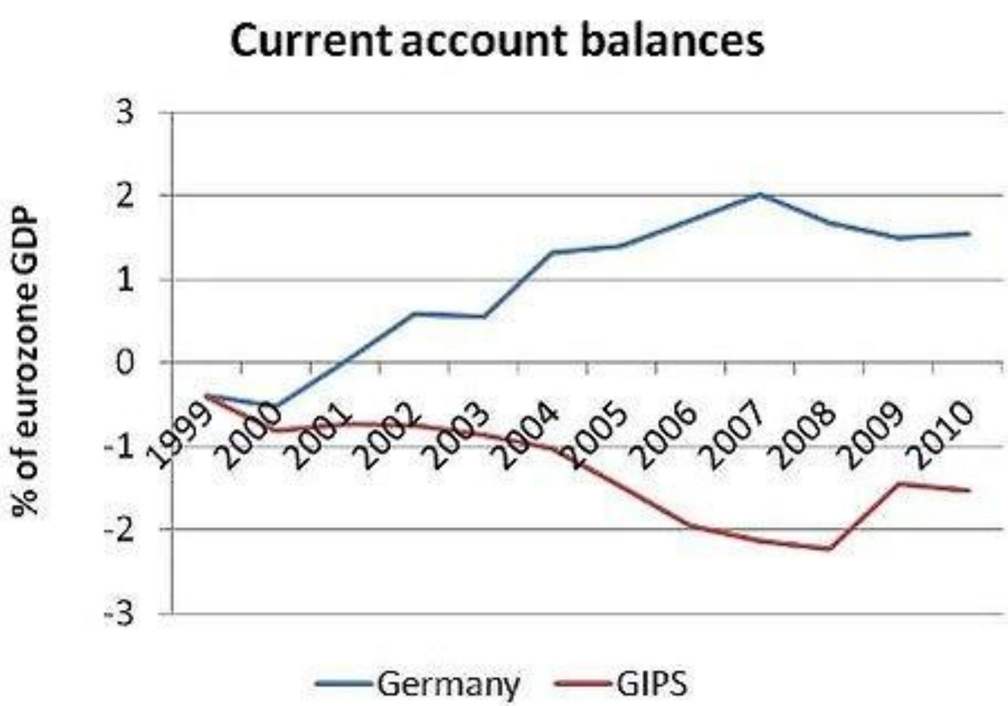
The eurozone crisis is as much a tale of excess bank leverage and poor risk management in Germany, Netherlands, Finland, Austria, Luxembourg Belgium and France (i.e. the **core**) as of excess consumption and wasteful investment in the **periphery.**

The conduits for the capital that flowed from core to periphery were banks, and these were more highly leveraged in countries like Germany and the Netherlands than they were in the periphery.

This is not a simple story of sinners and saints

Why is it happening?
Myth 4

- All can do like Germany



What the "core countries" are in effect saying is that everyone should run huge trade surpluses.

That poses an arithmetic problem.

The Current Account of the EU27 is zero

Why is it happening?
Myth 5

- Solvency is *the* question

Whatever the size of a government's debt, what matters is how does it compare to the revenues (i.e. taxes) available to service it.

Maybe Debt to GDP is the wrong ratio to analyse?

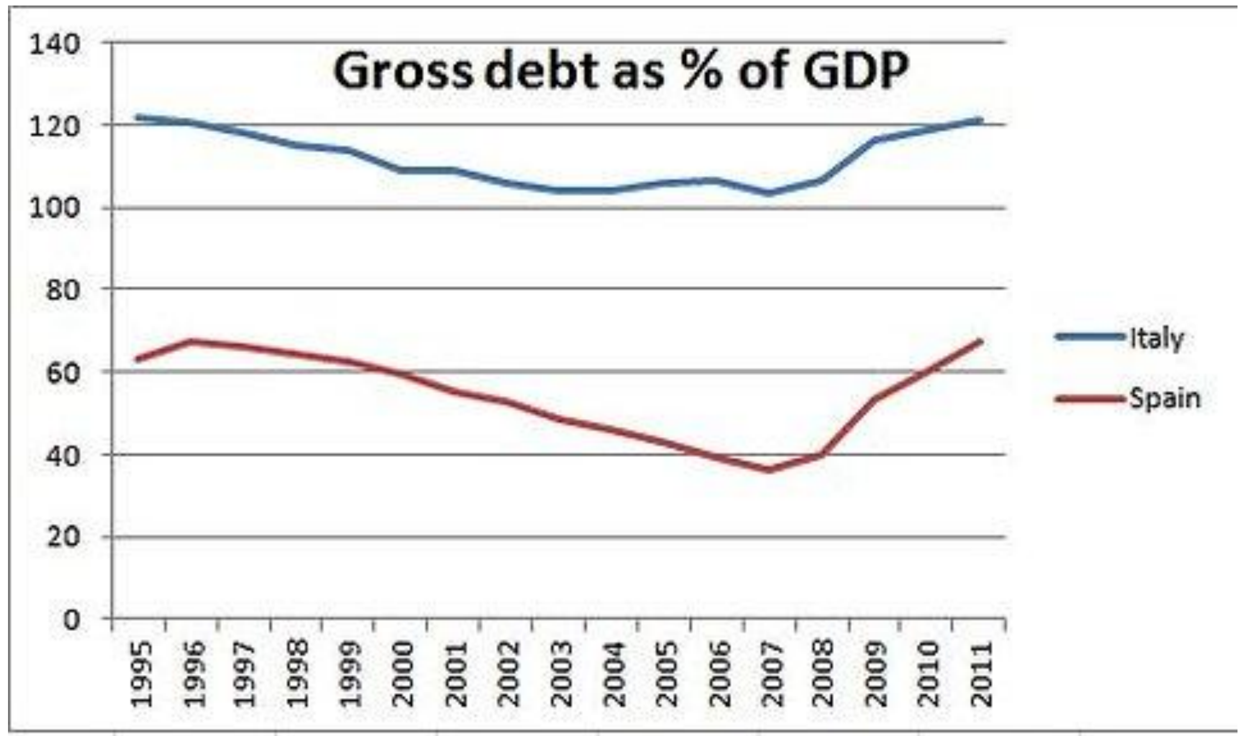
End of 2010 figures G6	**Government Debt / Revenues**
Japan	682%
Italy	253%
USA	247%
UK	244%
France	157%
Germany	122%

Governments can unilaterally increase their income by raising taxes

Why is it happening?
Myth 6

- Rising debt

Before the crisis Spain had low and declining debt. Italy had high debt inherited from the past, but it was steadily going down.



Neither country was being profligate

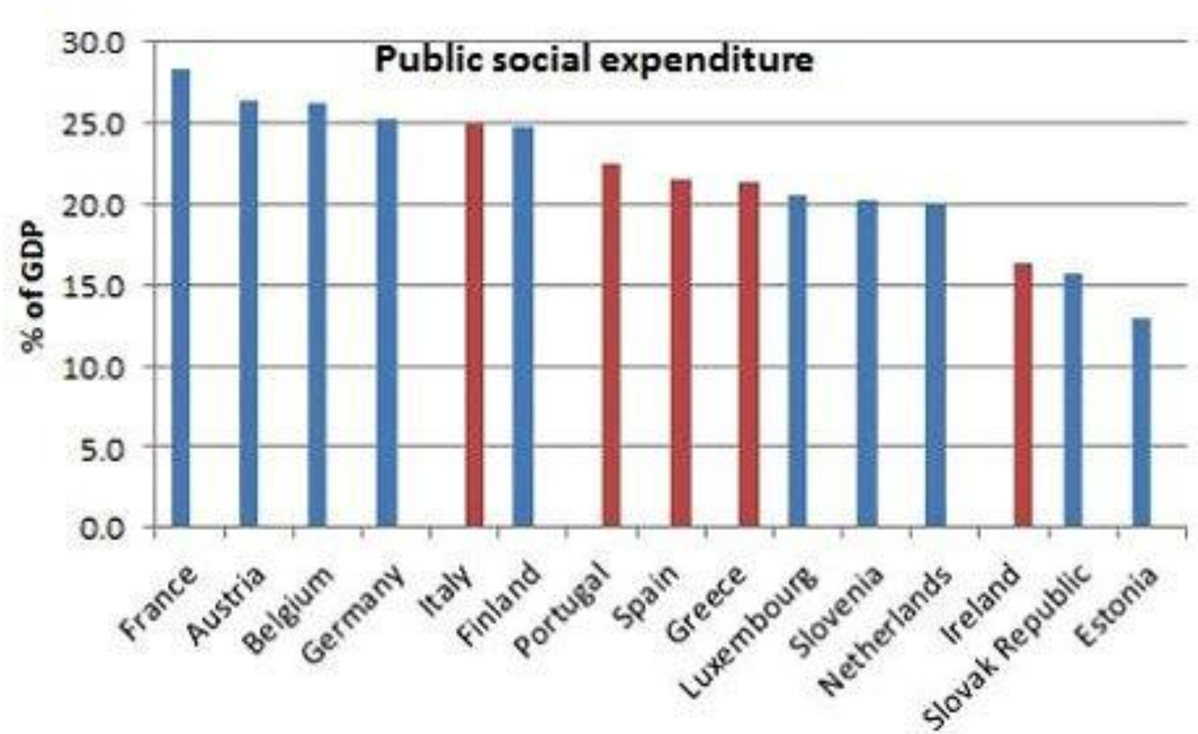
Why is it happening?
Myth 7

- Welfare

Europe's woes are being caused by the **burden of the welfare state.**

The numbers show something different.

Total public social expenditures as a share of GDP in 2007



Only Italy is in the top five — and Germany's welfare state was bigger

Once upon a time…

A monetary union was born

Critics: worried that it was inherently unstable. A monetary union could not work outside a fiscal (and hence a political) union.

Proponents: believed that a currency union could survive without a fiscal union provided it was held together by rules to which its member-states adhered. This was the view until October 2011.

Proponent cynics: assumed that if a rules-based system proved insufficient to keep the monetary union together, the resulting crisis would compel politicians to take steps towards greater fiscal union.

And discussions have started…

“Britain will join the monetary union in 1997” – Helmut Kohl, Maastricht 1991

Why is it happening?
Facts

- Absence of a fiscal union

The absence of a fiscal union explains why some eurozone members face sovereign debt crises, while states in the US do not. Unlike federal states in the US, members of the eurozone :

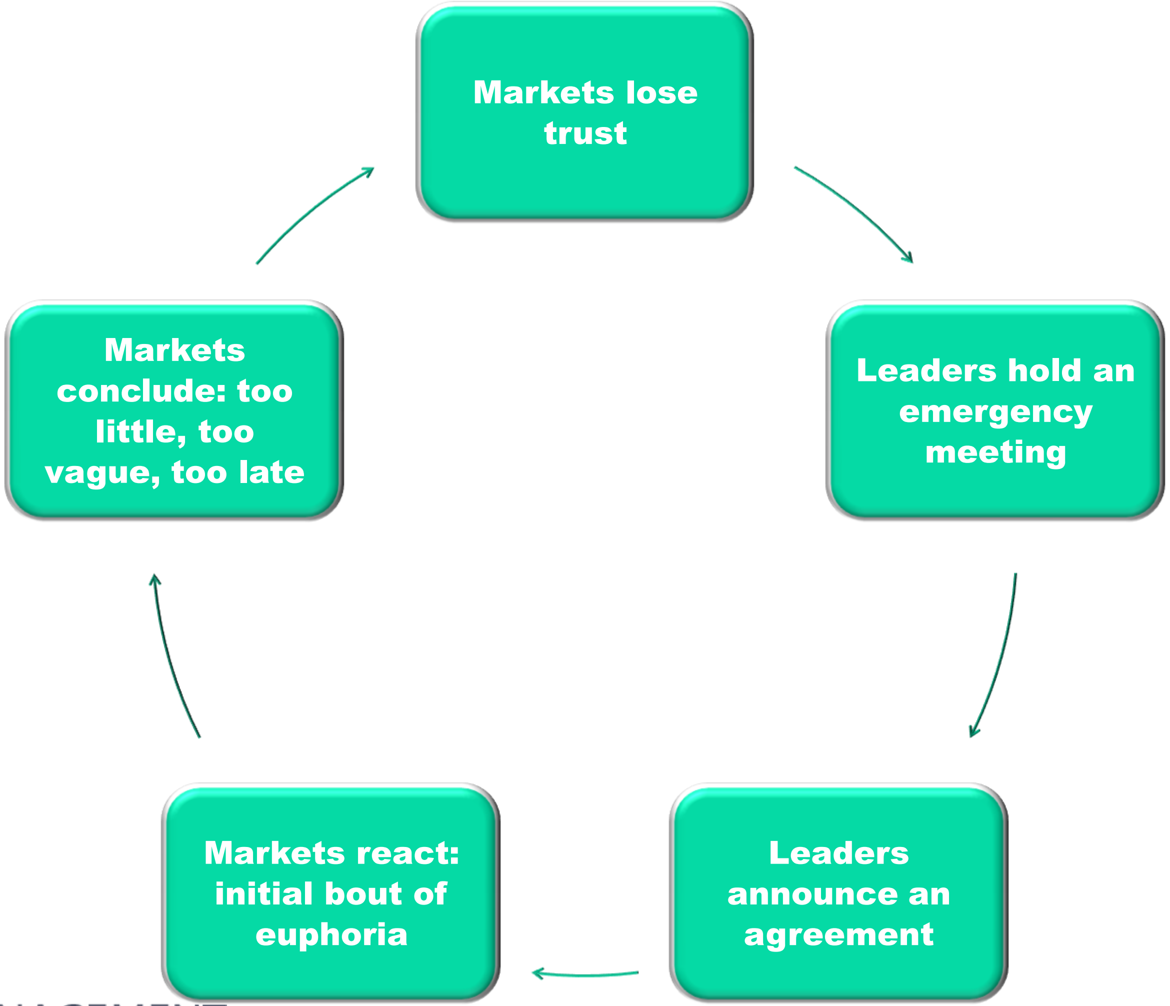
- did not assume joint liability for rescuing banks (i.e. **each country as it's own deposit insurance scheme**)

- or rescuing each other (i.e. **each country issue its own sovereign bonds**)

US Federal law prohibits states from declaring bankruptcy

What has been done?

Autism, until October 2011



What has been done?

Austerity, until October 2011

- Austerity is the **only** way

But there are 7 ways to reduce debt:

- **Austerity (cut spending)**
- **Partial default (don't pay)**
- **Growth (increase productivity)**
- **Increase revenues (raise taxes)**
- **Inflation**
- **Printing money**
- **Currency devaluation**

Only for governments

"The idea that austerity measures could trigger stagnation is incorrect" said JC Trichet in 2010, and raised interest rates twice in 2011

What has been done?
Since November 2011

- 1) "New" European Central Bank

Much like the US Federal Reserve, the Bank of Japan and the Bank of England (struggling economies) the ECB is now engaged in so-called **"money printing"**, insulating Italy, Spain, France from contagion.

In late December 2011 the ECB lent **490 billion Euros** to eurozone banks at 1% per annum for a 3 years term. In late February **520 billion Euros**. Banks are now buying sovereign bonds at 4% or more and pocketing the difference.

Interest rates were cut in November and December

What will be done?
Medium-term, in discussions

- 2) Bank deposit insurance scheme

A euro in a Greek bank is today no longer the same as a euro in a German bank.

In this situation, there is the risk of a run on a national banking system. This is what the federal government has prevented in the USA.

What will be done?
Medium-term, in discussions

- 3) Debt mutualisation

The European Financial Stability Facility (EFSF), a beginning of an eurobond?

Investors do not know what they are buying when they purchase an Italian bond – is it backstopped by the eurozone as a whole or not?

Maastricht Treaty fixed the ratio to government debt at 60% of GDP

What will be done?
Long-term, in discussions

- 4) Bye-bye Greece?

The EU, ECB and IMF do not have much confidence that their 2012 agreement with Greece will avert a new default.

Instead they are apparently trying to delay its eventual default to late 2013 or 2014, allowing Portugal, Ireland, Spain, Italy and France to put their “house” in order.

In nature there are neither rewards nor punishments; there are consequences

What if…

- Payment in euros: contracts in **“Euros from Germany”.** Germany recently sold 1-year government bonds at -0.6% per year (minus).
- Bank account in a “core” **healthy** country: Germany, Netherlands, Austria, Finland, Luxembourg.
- If one or more countries leaves the eurozone, the above “new” currencies will gain in value.

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To invest successfully over a life time does not require a stratospheric IQ. **Warren Buffett**