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Why The Euro May Fail

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As the 1.25$/€ limit was taken out recently, it is likely the deterioration in the Euro will continue for some time.

As a reminder, the Euro was launched at 1.18 $/€ in January 1999 and at its low reached 0.82 $/€ in October 2000. Present levels, therefore, are by no means 'oversold' in the long-term scheme of things. Any intervention by the authorities in the near term is unlikely. However, there is evidence to suggest that through the mechanism of currency swaps, back door support is an option for the central banks.

In the light of recent events, the likelihood that the Euro (at least, in its present form) will not survive has risen dramatically.

From the start, the structure and basis for this 'experiment' in unity were flawed. At the heart of the failure is the lack of labor mobility within the European structure which cannot adjust for the inevitable differences in competitiveness between countries. So as one economy becomes less competitive and unemployment rises, labor is unable (or unwilling) to geographically move to where employment exists. The result is a rise in joblessness and an inevitable requirement for financial support from the more prosperous regions of the Union. Unfortunately, this can only go on for so long. Furthermore, if the perception is that a country is overindulging at the expense of others (retirement at 80% of salary, pension at age 55!), resentment quickly grows. This is the position Europe is in today.

The cultural differences between the countries remain significant and in many areas, irreconcilable. Add to this, the fact that going back to the late 1990's, the motivation for European Monetary Union was almost entirely political. The EMU was not hugely popular with the electorates and rejected by many voters. This implies that since the EMU's inception, the momentum for its success has largely been driven by Brussels and not the popular vote. Now that the chickens are finally coming home to roost, it is the voters that will ultimately be needed to approve and inevitably pay for its flaws. It is becoming a tall order for the European politicians to sell to the voters.

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The beginnings of the unity process can be sourced back to the 1957 Treaty of Rome that sought to establish trade links between 6 core European countries. Subsequently, it is really quite difficult to pinpoint the motivation behind a full drive to unity, with the best reason on offer being that after two World Wars (both originated in Europe) economic unity would somehow preserve peace in the region. Much of that drive came from Germany and it's former Chancellor, Helmut Kohl (the father of the Euro), who even today questions why there is not more support for the Greek bailout.

What motivation does a hard-working European taxpayer have to pay for the indulgences − sometimes created by political differences − of its neighbor? Ultimately, the answer is none. Any politician trying to promote a bailout is liable to be voted from office, as recent German elections have shown. This is especially the case if their own domestic economic landscape remains challenging, as is the case in much of Europe where many countries are likely to enter a double-dip downturn after the 2008 financial crisis. Both Italy and Spain are forecast to experience negative GDP growth in 2010 by some economists.

In addition to the labor mobility problem mentioned above, the unworkable combination of multiple fiscal policies and only one monetary policy governed by the Frankfurt-based European Central Bank is all too evident. The original notion that all countries would be bound by the economic limits of the 1991 Maastricht Treaty was, at best, optimistic. The 'Stability Pact' laid down a set of economic rules by which all countries were supposed to behave (limits on inflation, budget deficit as % of GDP, etc.). The problem was that it was unclear how any country would be punished if they broke the rules, although 'penalties' were clarified in 2005. (See note 1.) Add to this, almost immediately, Germany and France − the supposed 'deep pockets' of the Union − broke the stability pact terms, as their budget deficits exceeded the 3% limit in 2003. At the time, critics charged that the Pact was too rigid, implying that in times of economic stress, governments should be allowed to increase deficits as a way of reversing a downturn.

It is also noteworthy that in 2009, none of the 10 largest EMU countries were in compliance with the Stability Pact as all the budget deficits of the major countries exceeded 3%. A rule is a rule. That all members are in breach of the rule gives the Greeks some justification for their predicament. Herein lies one of the many flaws with the present Euro structure.

The problems for the global markets are many. Similar to the period after the Lehman bankruptcy, lack of confidence among European banks is growing. European banks hold much of the Greek debt likely to be renegotiated in any settlement. If Greece is bailed out or defaults, the fear is that a larger country such as Spain or Italy follows hard on its heels. Unemployment in Spain is presently a staggering 22%, compared to Germany's 7.5%. If any country does default, the very existence of the Euro is called into question. (See note 2.)

The best case scenario is that should Greece comply with the IMF/EU package, the required cuts and tax increases will likely decimate that economy for the foreseeable future and require significant changes to the Greek 'way of life.' The problem is that the same scenario could just as easily play out for Spain, Portugal, Ireland and possibly Italy. In any event, any bailout package will be a tough sell to the more prosperous voters of Europe, especially as their economic landscape is likely to deteriorate further. Even German Chancellor Merkel admitted recently that the package only "buys time." The question then becomes: buys time before what?

So at 1.23 $/€ dollar (the US $ once again looks like the World's undisputed reserve currency), the Euro is 4.2% above its launch price of 1.18, and 50% above its 0.820 all-time low. Given the lack of technical support and the huge uncertainties it faces, the potential for further deterioration seems inevitable.

Notes:

1. The main language for "Out of Compliance," or Excessive Deficit Procedure (EDP) for the Euro area was written in 1997 under the Stability and Growth Pact (SGP), and basically has two main criteria which each member state must respect:

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a. An annual budget deficit no higher than 3% of GDP.

b. A national debt lower than 60% of GDP, or approaching that value.

2. During the nineties, sovereign spreads of the member countries converged as investors perceived that credit risk would be severely reduced for peripheral countries under the umbrella of the EMU. Clearly, this notion has been reversed as CDS spreads have widened substantially and investors realize that the possibility of a default is real. Some saw these rules as too harsh and the rules were never enforceable by the Council of Ministers. (Large countries like France and Germany ran excessive deficit for years.) In March 2005, EMU relaxed the rules, but maintained the 3% budget deficit and 60% public debt rule. The decision to declare a country in Excessive Deficit is now a more drawn-out process, in that the Commission issues an early warning before the excessive deficit has occurred. The EDP procedure will only move forward if the excess of the government deficit over the 3% GDP threshold is considered NOT TEMPORARY NOR EXCEPTIONAL, and the deficit is FAR from the threshold. The punishment for worst-case is stated to be financial sanctions: "If the Member State fails to comply, the Council can decide to move to the next step of the EDP, the ultimate possibility being to impose financial sanctions."

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