HindeSight

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December 11

Should I Stay or Should I Go?

"There is no example in history of a lasting monetary union that was not linked to one State."

Ottmar Issing, Chief Economist, Bundesbank and ECB, 1991

"He played a blinder. I think David Cameron has done very, very well to assert Britain's interests, to defend London and British industry to put a line in the sand."

Boris Johnson, Mayor of London (Conservative Party)

"It's a black day for Britain...David Cameron has made a very bad mistake...he has shot himself in the foot."

Lord Oakeshott (Liberal Democrat peer)

"Bye Bye Britain."

Der Spiegel

The year 1981 was an auspicious year. It was the year all Greeks may wish never happened. It was the year their mother country entered into the European Community, which later became the European Union.

It was the year Ronald Reagan succeeded Jimmy Carter as the President of the United States and promptly instigated a group called the Gold Commission. They found that the US Treasury owned no gold at all and that all the Fort Knox gold remaining was being held as collateral by the Federal Reserve bank against the national debt. It was also the year the socialite and heiress Paris Hilton was born - a young lady that symbolises the vapid emptiness of our "I want more money" culture.

It was, however, an even more remarkable year for the English punk rock band *The Clash*, who released from their album 'Combat Rock' their first and only UK number-one single. It was emphatically titled 'Should I Stay or Should I Go' - immortalised in Rolling Stone's 500 Greatest Songs of All Time. Some 30 years on it could be considered an emblematic anthem of the dilemma that faces members of both the European Union (EU) and the European Monetary Union (EMU) alike.

On December 9th, 2011 David Cameron, the UK Prime Minister solved his dilemma when he effectively exited the UK from tighter European control. At the EU Summit he vetoed the proposed Treaty changes which would enshrine new rules leading to greater fiscal integration between member states. He had earlier intimated at a speech at the famous City venue, Mansion House, that he wished to see powers ebb back to Britain rather than flow away. Depending on one's point of view it's tempting to say 'Cameron you (*punk*) rock'.

It is not the purpose of this piece to debate Cameron's decision or even his diplomacy skills; we were not party to the discussions, and cannot be too swayed by a cacophony of conflicting views on the subject. Has he scored a huge own-goal or the European Final winning penalty? Time will tell. Cameron's veto garnered more attention than whether or not the EU Summit put together any initiatives that can actually prevent a disorderly break-up of the union.

The purpose of this piece is to re-examine the viability of the European Union one full year on from when we wrote our HindeSight Letter December 2010 - The Euro Brady Bunch. It would be fair to say that you could sum up that piece with the quote we gave from the economist Herbert Stein, "If something cannot go on forever, it will stop."

So this is where we still stand today. We believe the structural integrity of the eurozone is broken irrevocably, as a complex web of cross-border funding of sovereign nations vis a vis each other and also their respective banks has imperilled their viability and (?). Something has to give and the question of to exit or not to exit may well be rephrased as "How Will I Go and When Will I Go?"

The self-reinforcing feedback mechanism brought about by austerity will lead to a higher debt burden which mathematically predisposes several if not many European member states to undergo a hard default. This outcome is more likely should member states try for, and then fail, at greater fiscal integration. We suggest when push comes to shove the very 'power of the purse' - the very core of national sovereignty - will not be relinquished for greater fiscal harmony. The very basis of the EU inception to unite Europeans against a repeat of the awful events of two world wars could well lead to greater disunity and conflict.

The original Treaty of Rome, from 1957, was a vision of classical liberalism for Europe. The Treaty delivered four basic liberties: free circulation of goods, free offering of services, free movement of financial capital and free migration. Slowly but surely these liberties have been marginalised as a new Socialist vision has emerged, that of a centralised state with ruling technocrats in Brussels. This Socialist web has now even entangled individual nations as Greece and Italy have appointed technocratic governments.

The pursuit of a supranational state is now in the ascendancy, as is evidenced by the Euro Summit on December 9th - Statement by the Euro Area Heads of State or Government. In essence a framework for a fiscal compact, with automatic sanctions for miscreant countries breaching enhanced Stability and Growth rules was announced.

Its acceptance is so far seemingly uniform, excepting the UK for now as a means to preventing an economic Armageddon. Although question marks hang over 3 other EU members.

In our opinion the summit was yet again an unparalleled farce. The UK veto has forced the rest to embark on adopting a new 'Stability union' without any EU legal framework. This demonstrates that EU permanent non-members, like the UK, who are not part of the monetary union but are full participants in the Treaty, does not work. We now have not only the question of the EMU survival but quite possibly of the EU itself. You’re either in or you're out of both unions. They cannot co-exist as the legal framework has proven to be inflexible.

Even allowing for legal changes - remember the protracted dealings of the Lisbon Treaty - this amendment to the Rome Treaty took over 10 years before the final ratification was given. So today we imagine legal trickery will be employed to try to make a new Growth and Stability pact stick. The new pact proposed is about as original as a newly elected French President being found to have a mistress. In the 1993 pact both France and Germany subsequently broke the 'golden rules'. So even if this gets past the proverbial 'starting gate', we suggest countries will always breach these rules in the interest of their national electorate. Clearly this is something that explains the seeming intransigence of member countries throughout this crisis.

Other proposals from the Summit included bringing the European Stability Mechanism forward to July 2012, bolstered by €500bn (but funded by who remains a mystery). Similarly €200bn will come from the IMF, allegedly lent by eurozone members. The UK has now deferred on contributions to this for a later date. Who is next? Most we imagine. This is the point. They do not have the money. But 'Merkosy's' point is they want to create bogus reality that they do, but we know they don't have it. We recap the realities here with a salient overview of the eurozone debt situation.

Eurozone Debt Overview

The sources of the European debt crisis are remarkably simple. Most economies in Europe suffer from the same economic disease as does many other parts of the world; the accumulation of too much debt and too many future liabilities in the context of a too generous welfare state. However two factors make the European situation unique.

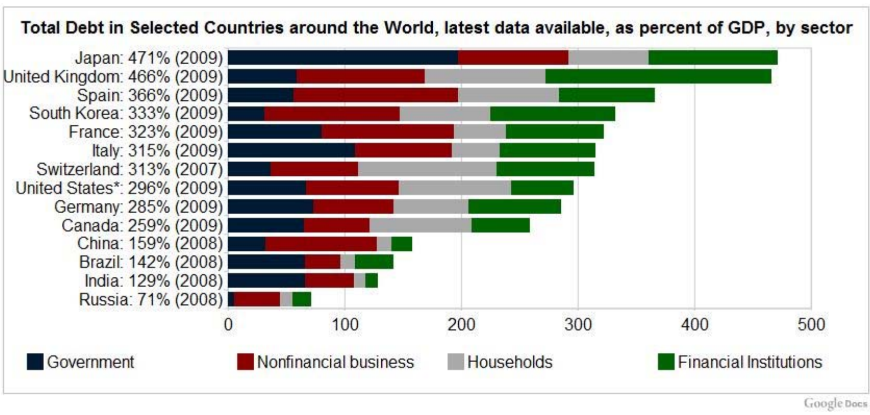
Firstly, the institutional setup makes it impossible for the weakest economies to correct through nominal devaluation which puts immense pressure on the society as a whole to undergo a painful internal devaluation and austerity.

Secondly, ageing populations and declining trend growth means that even with an optimal institutional setup, it would be very difficult (if not impossible) for many European economies to avoid considerable private and public debt restructurings.

One concept worth emphasizing here is that of the debt snowball and how it relates to the difficulties of correcting a large debt level from within a currency union with no means of devaluation or independent monetary policy. The path which Greece, Spain, Portugal et al have to take in the context of monetary union involves either deflation or significant reductions in nominal GDP growth (or both). This almost certainly means that the level of nominal growth in GDP will be lower than the interest rate they pay on their debt and thus the debt snowball rolls. We know now that market dynamic assures this as sluggish growth itself prompts international investors to demand more for holding debt from these economies, and herein lies the *catch 22*.

Although it would appear simple, it is not straightforward to calculate the total debt to GDP levels for a country. Different data sources will include different measures of debt and analysts may choose to exclude or include certain measures of debt depending on the query in question.

In a widely cited report, McKinsey comes up with the following figures for the major economies which show the magnitude of the problem even if the numbers may differ from analysis to analysis. Note this does not include social security and other such long-term liabilities, which balloons debt to GDP ratios significantly.

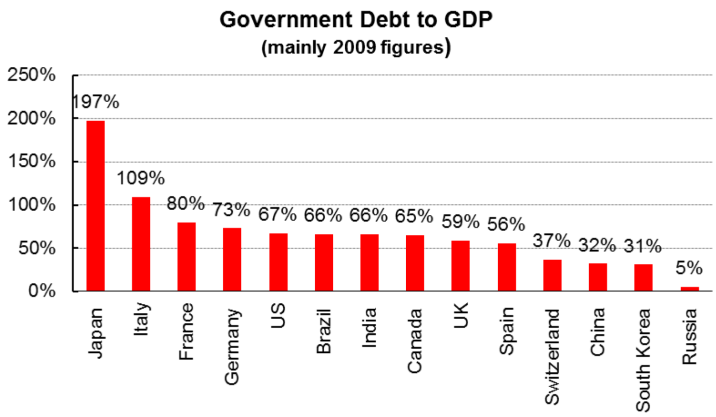


Source: McKinsey (if asset backed securities are included, US total debt to GDP increases to 350% of GDP)*

While the headline number may certainly be important in itself, the break-up of debt across sectors as well as the amount owed to foreigners (external debt) are important to begin to understand why growth and debt dynamics may differ across countries.

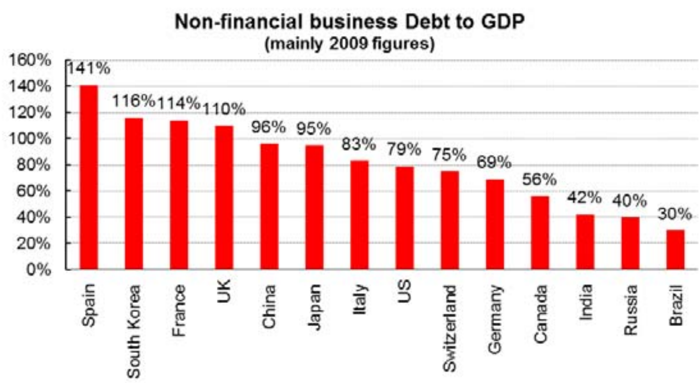
In the charts below, we have broken up the figures into subsectors and in the following sections we investigate the extent to which debt in Europe is held by sovereigns or the private sector, as well as how much is external debt.

Government debt to GDP:



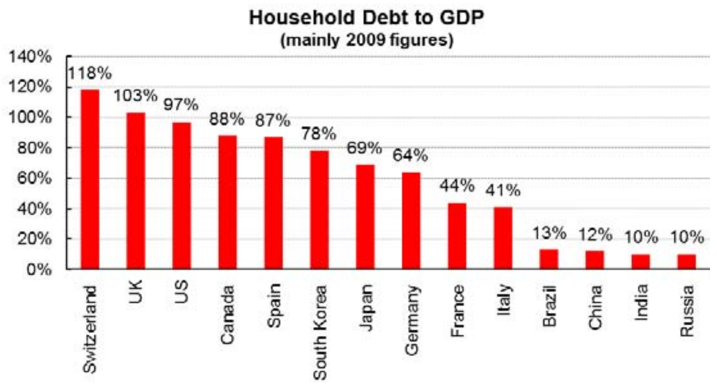
Source: McKinsey

Non-financial business debt to GDP:



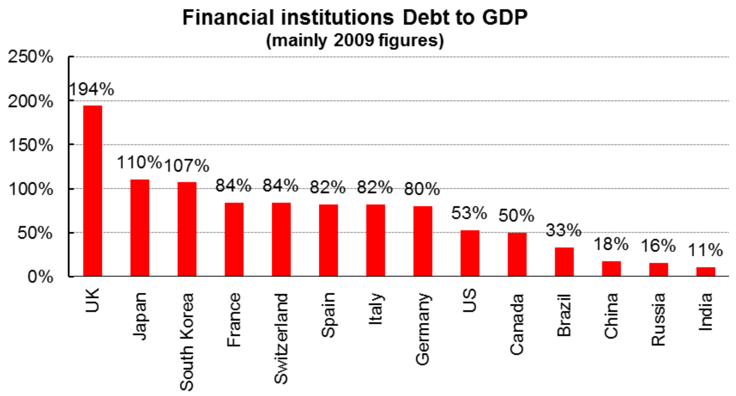
Source: McKinsey

Household debt to GDP:



Source: McKinsey

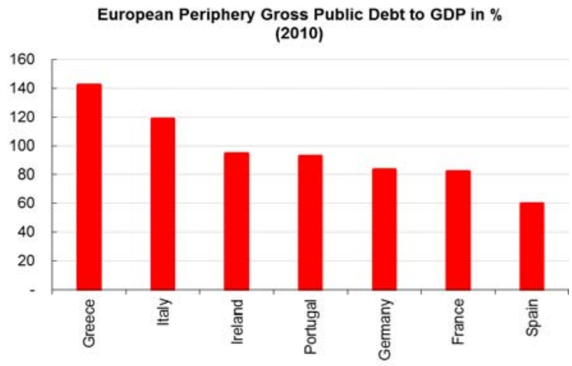
Financial institutions debt to GDP:



Source: McKinsey

Private and Public Sector Debt in Europe

In Europe, there are notable distinctions between the countries that are collectively said to face a debt/growth crisis or perhaps even a significant risk of debt restructuring.



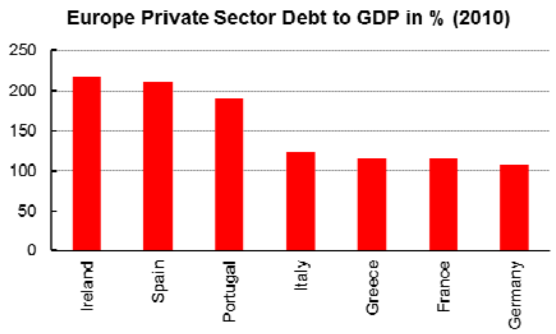
Source: Bloomberg

The problem in Greece and Italy is primarily a sovereign debt issue. The new government in Italy headed by Mario Monti is now trying to pass burdensome austerity measures on public finances to avoid the Greek fate, where a deteriorating economy means that the debt/ratio continues to increase despite efforts to reduce the ongoing deficit.

The Greek sovereign is now effectively in default with private creditors looking to lose anything between 50% to 100% of face value on their Greek sovereign debt holdings.

Spain on the other hand has a relatively small level of government debt and has mainly remained in the market's spotlight due to its high level of private debt (see below). Ireland provides a good example here as the country's government debt rose from 25% of GDP in 2007 to almost 100% in 2010 due to government's full guarantee and backstop of the banking system. In this sense Spain is like Ireland where the need to either recapitalise the banking system or guarantee debts in the property sector may mean that the private debt is transferred to the government balance sheet. The UK underwent such a socialisation of private sector losses, and yet financial institutions' debt is still too high relative to GDP.

Outside the eurozone, Australia and Denmark are similar examples with low government debt but high levels of private debt and over levered banking sectors which may ultimately need to be bailed out by the government.



Source: World Bank

Spain and Ireland are the economies in Europe with the largest private sector leverage closely followed by Portugal which has remained suspiciously outside of the limelight despite the fact that the economy has both a high private and government debt/gdp level.

In theory, the main distinction between high levels of private and public leverage resides in the debt dynamics. In the former case (Greece and Italy), the link between market prices (yields) and the deterioration in growth and public finances is more continuous than in the latter case (Ireland and Spain) where a government can essentially go bankrupt overnight as a result of having to backstop the domestic financial system. In addition, how authorities choose to deal with private sector defaults matters too. In Spain, for example the attempt to postpone the realisation of losses in the property market has given rise to the illusion of muddling through even if the fundamentals might merit a full blown crisis.

In the present crisis, this is evidenced by the more constant market focus on Italy and Greece whereas the situation in Spain (while steadily getting worse) has been the subject of on/off focus even if government yields in Spain are now also at levels which are too high for the government to live with. This may have something to do with markets' preoccupation with outstanding government debt levels. Italy is a stand out, with €1.9 trillion worth of government debt.

External Debt in Europe

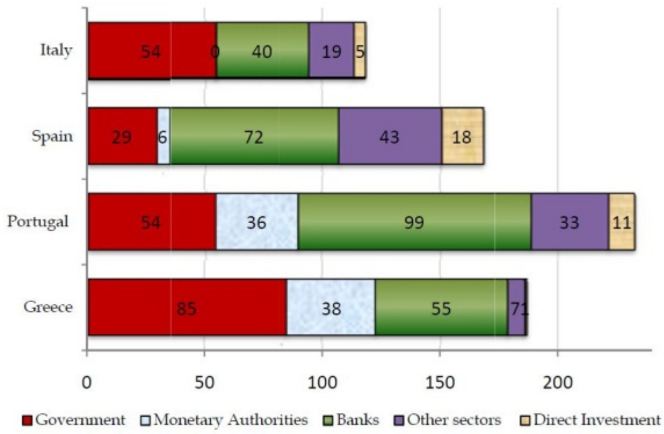
If the total debt to GDP across all the economy's constituents is difficult to calculate it is considerably more difficult to pin down the level of external debt. One of the reasons for this is the importance of net external debt and thus the relationship between assets held abroad by domestic citizens assets held domestically by foreigners (the net international investment position, NIIP).

It follows from here that if your investment position is considerably negative you may be likely to run a current account deficit as the income earned by foreigners on assets held in your country exceeds the income you earn on foreign assets. Deductively, it follows that running a consistent and large negative current account deficit is associated with net external debt.

Japan is a good example here. Measured on total debt to GDP and in particular government debt to GDP, Japan is by far the world's most over levered. However, because the debt is primarily owned by domestic economic agents and because the economy has a large external surplus (strong net foreign asset position), the transmission mechanism from high debt to higher bond yields and financial stress is considerably different than in Europe.

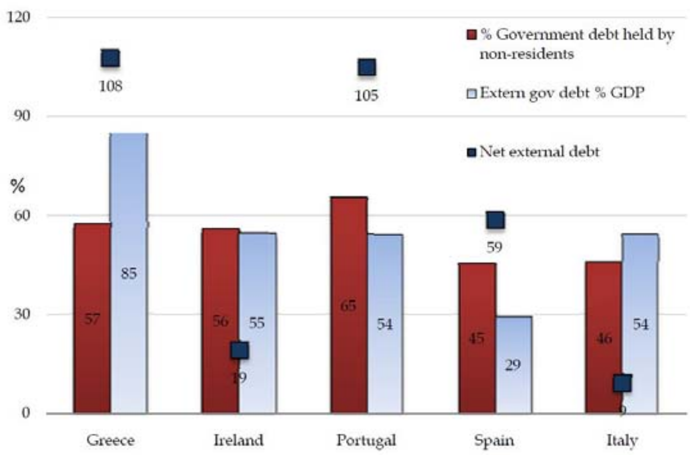
The external debt of the European periphery is significant. Estimates from the end of 2010 by Daniel Gros and Cinzia Alcidi from the CEPS suggests that peripheral eurozone economies have well over 100% in gross external debt.

Figure 4. Gross external debt (as % of GDP in 2010q3) and its breakdown by sector



Source: Gros and Alcidi (2010)

More importantly is the net external debt and specifically the share of government debt held by foreigners which is a key determinant for the propagation of financial stress throughout the European banking system (through cross country holdings of debt).



Source: Gros and Alcidi (2010)

On average, about half of government debt in the eurozone periphery is held by foreigners which represent significant cross-border holdings of debt in Europe at large. Here, it is interesting to note that despite significant differences in overall net external debt level, the relative high level of cross border holdings of government debt in the eurozone means that sovereign stress in one country is easily and swiftly transferred to the whole eurozone economy.

The problem of extensive external debt in the context of a weak economy and rising interest rate costs is not only a problem because foreign investors may be more swift to push up yields than domestic investors, but also because the interest rate payment, by definition, leaves the country.

Markets are increasingly concerned that the Greek debt crisis could spread to other eurozone countries including Portugal, Ireland, and Spain. This column notes that much of these countries' debt is held by non-residents meaning that the governments do not receive tax revenue on the interest paid, nor does the interest payment itself remain in the country. The solution lies with debt restructuring and rescheduling.

Ricardo Cabral, May 2010

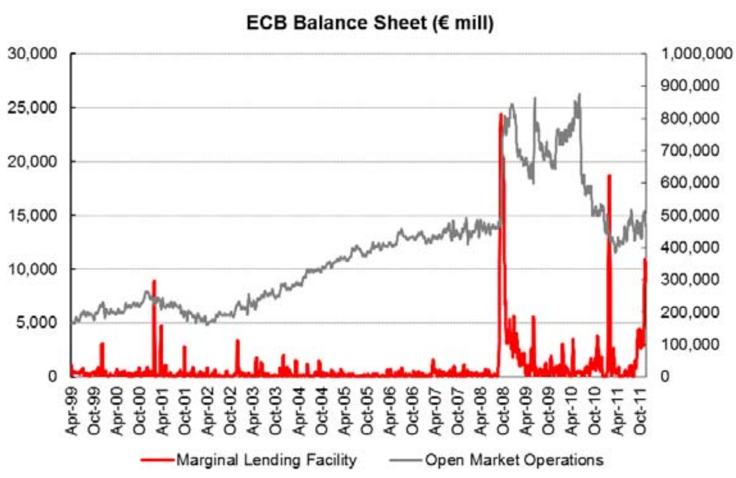
EU Banks, financial oppression and cross border lending

While the crisis in Europe remains a sovereign debt crisis, the main transmission mechanism to the real economy is through the European banking system which is facing structural headwinds in the form of deleveraging needs (and how to abide to new Basel III rules) as well as a choking liquidity and funding crisis. It is a circuitous problem.

A severe credit crunch is developing in Europe with estimates of the total shrinkage of eurozone banks' balance sheets ranging from €1.5 to €2 trillion. This is between 15% and 20% of eurozone GDP (2010 values).

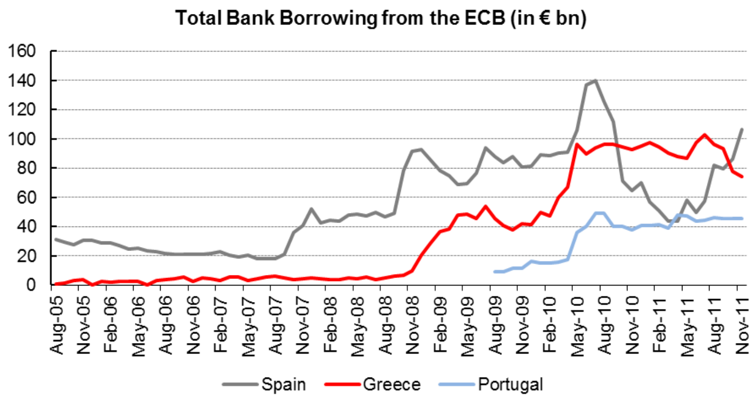
The ECB’s decision to provide liquidity on a full allotment basis is recognition of the grave issues facing the European banking system.

ECB Liquidity Provisions:



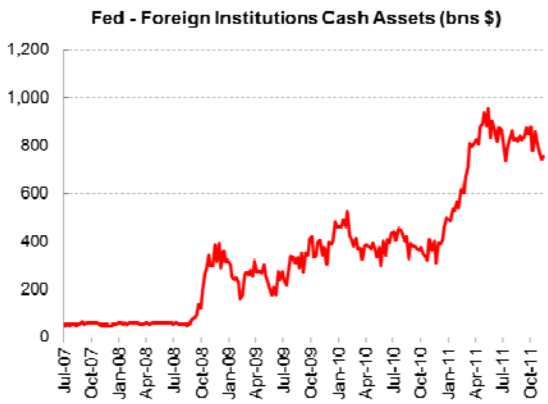
Source: ECB

Notably, banks in Spain are beneficiaries of this as they continue to ramp up their dependence on the ECB.

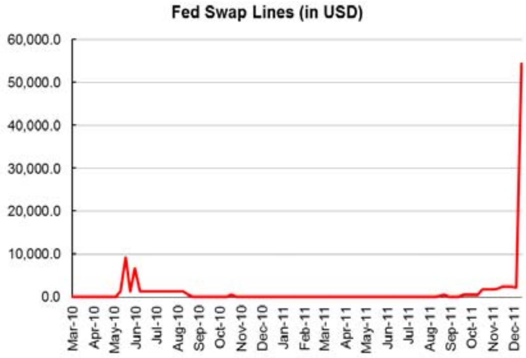


Source: Bloomberg

Another acute issue is the need for liquid dollar assets to settle short-term funding requirements which has prompted coordinated central bank action despite seemingly ample USD buffers owned by foreign institutions held at the Fed.

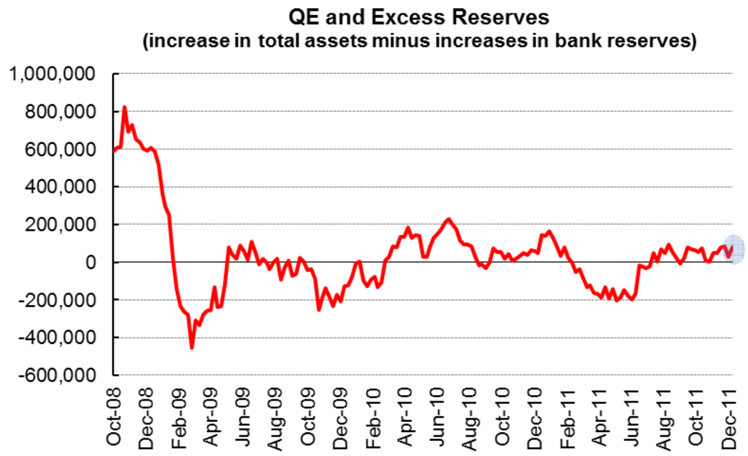


Source: Bloomberg



Source: Bloomberg

As before, central bank balance sheet expansion is spreading since the increase in the Fed swap lines constitute a de facto expansion of the Fed's balance sheet. In the week ending in the middle of December, the Fed's balance sheet rose, by $82 billion which is the highest weekly increase since the heights of the crisis in 2008/09:



Source: FRB

The main problem with the eurozone crisis lies in the contagion effect between struggling banks and sovereigns and how the former will even have to abide by stricter capital and liquidity requirements due to the implementation of Basel III. The components of the crisis are as follows;

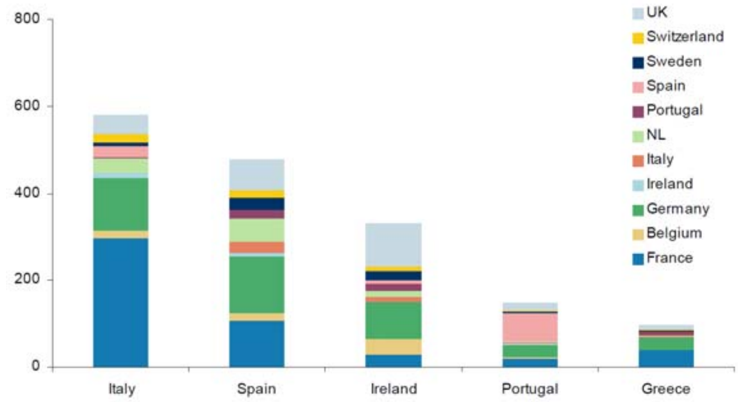
- Increasing sovereign funding costs make it impossible for local companies and banks to finance themselves in the short-term liquidity markets. Many European banks are essentially dependent on the ECB's liquidity window for survival.

- Financial institutions in Europe need both liquidity and capital and the market is providing neither. Firstly, this means that they are forced to shrink their assets rather than raise new equity/debt because the latter is effectively impossible at this point. **This shrinkage of the asset side is the main transmission mechanism of the credit crunch to the real economy.** Secondly, it makes them reliant on the ECB for short-term funding.

- The two processes above lead to financial integration in reverse as cross-border lending is capped to the detriment of especially Central and Eastern Europe, but it is the same for all European economic agents with sovereign funding needs.

- Deposit and general funding flight from the weakest banks and countries. Essentially, the market can and will discriminate and the weak will get weaker.

French, German and UK banks have largest exposures to PIIGS:



Source: Morgan Stanley

One key question that needs to be addressed within this framework is the amount of capital that European banks require. As it turns out, this is a very difficult question to answer and also a question whose answer depends critically on how the crisis itself is managed.

The self-reinforcing loop of stress in sovereign funding, stress in bank funding and stress in bank solvency is likely to overhang European economic recovery and lead to material balance sheet shrinkage. We see the drivers as three-fold:

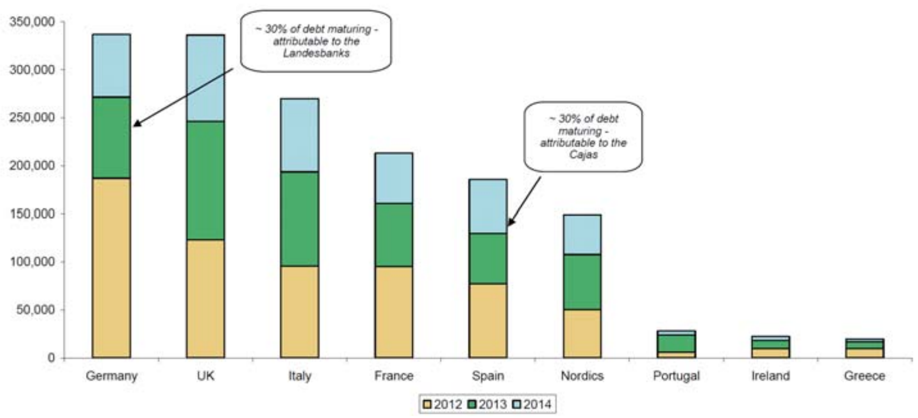
• the approach of Basel 3 shifting risk weights;

• the stress in bank funding ($ funding for euro-zone banks and unsecured term funding more broadly); and

• weakened balance sheets from the euro-zone crisis (and EBA recap simply adds to this).

Morgan Stanley estimates there is over €1.7 trillion of debt to roll across the core European banks, although of course ongoing deleveraging we discuss will reduce replacement needs.

Core Bank Debt Maturing:



Source: Morgan Stanley

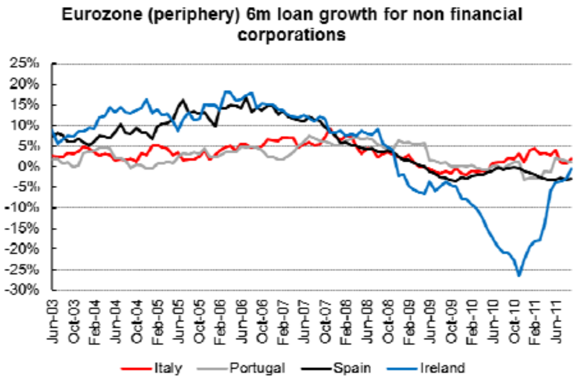
In this sense, the chief input to determining the need for banks at EU banks lies in the assumptions made on the need to provision against losses on sovereign debt and private sector defaults/write-downs.

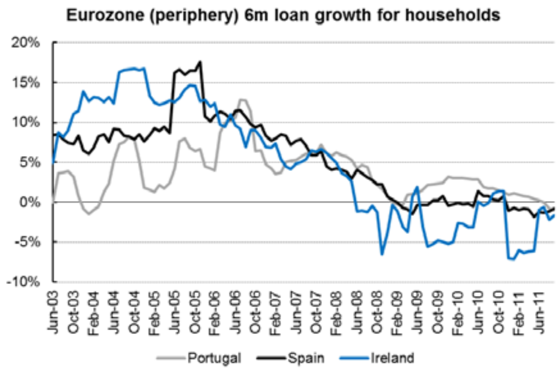
The most punitive scenario assumes not only a significant write-down on all sovereign debt holdings of the periphery but also that such holdings be treated as risky assets against which capital itself has to raised. In such a situation, then capital requirements needed would be substantial. However, much more relevant seems to be the decision on whether the tier 1 capital ratio is set at 5%, 7% or 9%.

Currently, the rules envision at 7% rule for the minimum amount of capital relative to risk assets. Most simulations we have seen appear too lenient in terms of the assumed provision for losses on sovereign debt as well as impaired private sector assets, but the reflexivity of the situation makes this exercise very difficult. This is to say that the likelihood of losses increasing is not only a function of the regulation process, but also a result of the debt restructuring process itself.

No matter how banks manage to abide to new capital rules (with significant risk of nationalisation as a result) the credit crunch is ongoing and will only intensify from here.

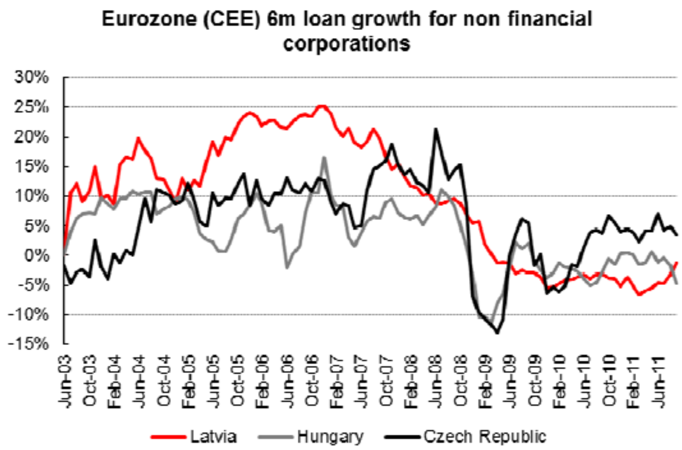
The credit crunch has so far been strongest in the periphery.





Source: Bloomberg

But Eastern Europe is an even more classic example of how foreign creditors' lending cutbacks holds back domestic spending and consumption. Credit growth to non-financial corporation's has been persistently negative in countries such as Hungary and Latvia for the past few years.



Source: Bloomberg

There are several examples of how financial integration is now working in reverse and also how domestic banks are now being forced to finance their respective sovereigns (financial oppression). Russell Napier from CLSA provides a good overview in his latest 'Solid Ground' publication.

In Ireland, national pension reserves have been used to finance bank bail outs as well as to fund government funding programmes. In France, the government will change rules for pension reserves to force a higher weighting of government bonds. In Hungary, private pension plans are being forced under state control. In Portugal, €5.6 billion has been transferred to from banks' pension fund accounts to the government.

Finally, Austria recently instructed its biggest banks, Erste Bank, Raiffeisen Bank International and Bank Austria, to boost capital reserves and limit cross-border loans (mainly to Eastern Europe). This is widely seen as an attempt to shield the country's AAA rating which underscores the link between sovereign debt woes and the banking system.

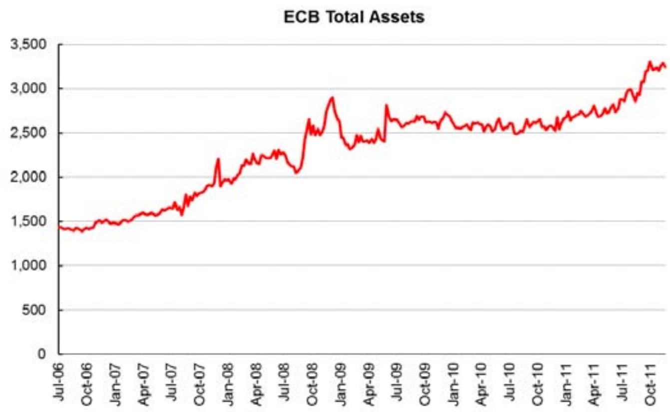
This two sided process of bank deleveraging/financial integration in reverse and financial oppression is meant to serve one main purpose: to force bond yields below the level of inflation and thus impose a negative real return on financing the sovereign. **This is the only way over-indebted economies can avoid the debt snowball, without undertaking a full and hard default.**

The ECB's Printing Press - 'All Hail, Draghi'

Another event eagerly awaited was the ECB meeting on the 8th December, the day before the Summit. It was widely felt and indeed it was rumoured the day before that the ECB would make provisions to shore up the banks, but there was also hope of bond yield targeting, ie quantitative easing. We were less sure of a bond purchase announcement pre the Summit conclusion but we felt sure of a version of it. And we got it - 3 year loans in return for any collateral the banks wish to give.

While the ECB refused to step up its sovereign bond purchases through its securities market programme (SMP), the decision to provide 3 year full allotment liquidity to European banks is very significant and can be interpreted in no other way as outright QE. More precisely this is covert *qualitative* easing, as they have eased the credit criteria of assets that the banks can place with the ECB in return for cash.

ECB President Draghi pulled a fast one and we don't believe market participants gave due credit, excuse the pun. Risk assets after initially rallying on the 8th December went into free fall. Most notably the precious metals complex and commodities. **Rumours of central bank selling gold at $1740 to $1760 were widespread.**



Source: ECB

Take up on the ECB's first full allotment LTRO operation (21st December) was extensive and came in at €489 billion (of which €43 billion was pushed over from the previous 1y LTRO). This only goes to show the significance of the liquidity issues among European banks.

Two components are important here.

Firstly, the ECB is (once again) providing this liquidity on a full allotment basis which basically means that the banks are free to demand whatever amount of liquidity they need. Given the maturity of these operations the European banking system essentially decides how big the ECB balance sheet becomes or more specifically, they are free to choose whatever levels of reserves they need.

Secondly, the ECB has significantly widened its collateral base accepted to supply loans. Under the new rules, almost any form of loan can be used as collateral against liquidity which means that the ECB now acts as a de-facto (and potentially limitless) backstop for euro zone banks' deleveraging needs.

One critical question here is the extent to which the banks will use this liquidity to buy government bonds and thus essentially to shift loans on their balance sheet for domestic government bonds.

Surely, the incentives are now in place for the banks to play this game. New regulation will incite banks to hold sovereign bonds (assuming they continue to be counted as risk free assets) and if financial oppression is the ultimate end game, pushing yields below the level of inflation implies significant positive carry for banks in countries with high *current* government bond yields. A related issue here is the maturity of government debt the banks are likely to buy. Most analysts expect any buying for carry trade purposes will be done on the front end of the curve which will further exacerbate the rollover risk.

It is very important to understand that this carry trade is politically sanctioned. French president Nicolas Sarkozy has openly suggested with the ECB's new liquidity measures Italy and Spain could look to their domestic banks to get funding.

However, the market may not yet have reached a tipping point which sanctions this carry trade as a way to fund sovereigns. One issue here is the fact that banks have spent a lot of time *reducing* sovereign risk on their balance sheet as this was assumed to be impaired assets and also because the stress tests performed so far have penalised banks for holding substantial forms of sovereign assets.

In the end, it will be a wait-and-see exercise to gauge how much the banks take on and what the liquidity is used for. Much here will also depend on the banks' own funding requirements in the short-term funding market which needs to be rolled in 2012.

The key is that the combined set of ECB initiatives of 3 year LTRO, wider collateral and $ swap lines together make a significant reduction to risk of European banks. It does not however solve the solvency issue of the member states and it has now heightened the risks at the ECB of insolvency (even allowing for seigniorage).

Now we really do think that the ECB is in all sorts of trouble here and that given the maturity of these operations this is effectively QE. It is all so déjà-vu of the first 1y LTRO about the same time as the Fed's first QE announcement.

Back then there was a considerable and, in our opinion, legitimate debate about just how the Fed could exit QE. Basically, if the central banks buys private and government sector assets what does it do with these assets? Hold them to maturity or perhaps, in the case of equity, in perpetuity? The issue for the Fed was always going to be a sticky balance sheet. This is to say that you can increase your balance sheet and you can signal your intention NOT to increase it anymore, but actually dumping assets - effectively unwinding QE - is very difficult even after a considerable amount of time. And of course, the more you buy the more difficult it gets. A related issue here is what the central bank does when its government debt matures ... rolls it over to keep its holding changed or ... ?

In all this of course, the former ECB President, Trichet was adamant. The ECB's measures were always going to be "temporary" and much more flexible and they could thus be unwound. We know now that this is nonsense. This is not temporary. Variant Perception analysts Claus Vistesen and Edward Hugh's wrote a paper on the ECB, an excerpt from which we add here:

The measures collectively known as Enhanced Credit Support are by their very nature flexible. However, if there is anything we have learnt from the operation of monetary policy in Japan over the last twenty years it is that premature exit from the sort of substantial support the ECB is offering only makes matters worse, and in addition this kind of massive liquidity easing is a lot easier to get into than it is to get out of.

Well, we rest our case. This is demand pull QE. You want a trillion, we give you a trillion. The only thing that would prevent a bank from taking up liquidity is lack of collateral. Whether this liquidity then goes in to the carry game and props up the sovereigns, well, this is debatable and we will have to see. We definitely agree with the cautious voices that the solvency issue of the sovereigns is largely unresolved. And ultimately if they are not resolved the bank reprieve may just be that, a reprieve.

What are the Choices?

As we have shown above, the *sources* of debt are as important to appreciate as the total debt level. This may ultimately inform the choices of the individual countries concerned. As we discussed above, Greece, Italy and Portugal have very high sovereign debt-to-GDP levels, which makes the prospect of a sovereign default or restructuring higher than in, for example, Spain. Spain's debt issue is primarily with its financial sector, which faces a huge capital shortfall, while its public debt ratio remains relatively low. Spain, to some extent, has a choice not open to Greece, Italy or Portugal. Ireland decided to backstop its banks explicitly, and saw its debt-to-GDP swell massively. Spain may try to resist going the same way.

The UK also has a choice. This was made quite clear at the latest European summit on the 9th of December. David Cameron, the UK Prime Minister, used the UK's veto to signal the country was out of the proposed fiscal compact, designed to increase fiscal harmonization across the EU. This was ostensibly as he could not get the safeguards protecting the City of London he had asked for. Nevertheless, the remaining the 26 countries of the EU have decided to push on regardless, without the UK (which raises the question what, exactly, did David Cameron veto?)

The UK has never been an overly enthusiastic member of Europe, instead more interested in the free market, rather than the single currency, fiscal harmonization, or ceding any more of its sovereignty than it must. However, the UK's decision to use its veto may freeze the country out of further negotiations, and reduce Britain's influence on the global stage.

Nevertheless, there are many unknowns, and the UK may yet end up becoming the 'Singapore of Europe' David Cameron envisages.

One thing is for sure the UK will be removed from anti-competitive regulation and tax harmonisation. We would note another Optimal Currency area that of the USA works precisely because the member states have independent tax systems (apart from the Federal income tax). It keeps them competitive in our opinion and fosters entrepreneurship more than stifling it. We favour deregulation and a lower tax regime to foster growth. Europe brought benefits to the UK but it is an inflexible currency zone run by technocrats all too keen to serve themselves.

Thus the European crisis is bringing to a head many underlying tensions. David Cameron was not the first – and will not be the last – country leader to be forced into making a 'momentous' decision. Italy and Greece, for instance, face years of grinding austerity, necessary to move their budgets into surplus, and their debt levels sustainable. And even then there is no guarantee this will be enough. They may ultimately decide leaving the eurozone is less painful.

Sovereigns will ultimately act in their own best interests, and leaving the eurozone, or re-evaluating the nature of their relationship with Europe, may become a reality for several European nations. The question "Should I stay or should I go?" will become a crescendo; its growing loudness eventually drowning out the sound of a kicked can bouncing down the road. However, we fear that it is highly likely a disorderly default will ultimately disburden countries of the choice of whether to stay or go.

Is there a sound solution? Well the Eurosystem has over 10,798 tonnes of gold, or 34% of total global gold holdings to stabilise it. We would encourage you to read 'Currency Wars - The Making of the Next Financial Crisis', by the irrepressible and fascinating James Rickards to garner more insight to this solution.

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