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"If something cannot go on forever, it will stop."

Herbert Stein (economist)

"If goods don't cross borders, armies will."

Frederic Bastiat (classical liberal economist)

"At the close of the 'American century', the euro has appeared as a potential rival, the countervailing power, to the dollar. The advent of the euro may turn out to be the most important development in international monetary arrangements since the emergence of the dollar as the dominant currency shortly after the creation of the US central bank, the Federal Reserve System, in 1913."

Robert Mundell, ('Father of the euro')

"If you believe some of the things said and written about my views on Europe, it must seem rather like inviting Genghis Khan to speak on the virtues of peaceful coexistence!"

Margaret Thatcher (Prime Minister, Great Britain)

In our October piece 'The World Monetary Earthquake' we used Herbert Stein's words in reference to the parlous state of Japan. How alarmingly prescient this aphorism has become for so many sovereign nations, and none more so than the eurozone.

This past decade the world has experienced a credit induced boom which led to a global over-indebtedness, unrivalled in history. The European boom, whilst a product of this global phenomenon, had its own special ingredients to assist it.

The introduction of the euro, aided the fall in interest rates in the high inflationary countries (Southern Periphery) even though savings did not increase. The result was a boom for Southern countries and Ireland. Implicit support on the part of core country members, namely France and Germany, toward members of the monetary union reduced interest rates (their risk component) for both private and public debtors artificially. The traditionally high inflation countries saw their debt burden reduced and, in turn, a spur in private and public consumption spending.

The relatively high exchange rates fixed forever in the euro benefited high inflation countries as well. Cheap credit spawned housing booms, the most spectacular of which was in Spain. Southern countries lost competitiveness as wage rates kept increasing. Overconsumption and the loss in competitiveness were sustained for several years by ever higher private and public debts and the inflow of new money created by the banking system. The European boom affected countries in unique ways. This misallocation of capital led to greater malinvestments and over-consumption in the high inflation countries and less in northern countries, such as Germany, where savings rates had remained higher.

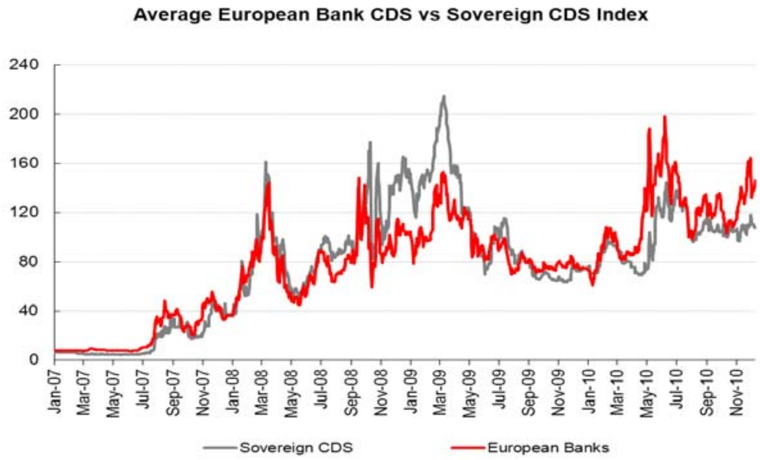
The Financial Crisis sparked by sub-prime mortgage issues precipitated a global liquidation of these malinvestments. A debt spiral of falling housing prices, failing credit products and bad loans wreaked havoc on the banking system. Defaults and investment losses have threatened the solvency of banks, including European banks. These solvency problems have triggered a liquidity crisis in which a mis-match in maturities at banks has caused difficulties in the rolling over of their short-term debt.

European policymakers are at present in a state of denial about the real likelihood of a cascade of periphery sovereign debt defaults, which is breeding a sense of complacency. There will be in our opinion an explicit default vis-a-vis an exit from the euro (and European Union) by one or all of the periphery countries, namely Greece, Ireland, Portugal, Spain (and possibly Italy).

The exit of any member state, particularly any of the periphery will most likely end the euro single currency. This is contrary to the prevailing and popular belief that a schism would see an alliance of a stronger European Union (and stronger euro) composed of core countries, namely Germany and France.

The exit of any nation from the euro, but most of all the periphery, will likely be a result of a default process. That would endanger the existence of the core's banking system as their contingent liabilities to periphery debt is sizeable not only on their balance sheets but as a percentage of their respective sovereign balance sheets. Although Europe's peripheral economies are small in size, their debts, both public and private, are large. A European banking crisis would clearly have substantial reverberations throughout the global financial system. It would make the sub-prime crisis and Lehman collapse in 2008 look trivial in comparison.

European policymakers are not impervious to the implications of a periphery default on West Europe's banks, ie a full blown European banking crisis with all the global ramifications it entails. Germany and France will ensure that financing spigots keep the illusion of this particular fiat ponzi scheme. However this is not a liquidity issue, it is a solvency issue with the periphery. Policy makers will only succeed in delaying the inevitable day of reckoning by indulging in repeated bailout operations directed at the periphery, and not the concept of the euro.



The Bank CDS is the average of the major European banks - Santander, DB, BNP and SocGen

The crisis is not just a making of the eurozone's flawed foundations. It is a crisis of the global fiat currency system.

European Union - How did we get here?

The European Union (EU), is a monetary union, without fiscal unity, of 27 member states. It is populated by over 500 million inhabitants that generated 28% or (+ US$16 trillion) of global nominal gross world product in 2009.

After World War II, moves towards European integration were seen by most as an escape from the extreme forms of nationalism. The founding fathers of the EU were Jean Monnet (France), Robert Schuman (Prime Minister, France), Konrad Adenauer (Chancellor, West Germany), Paul Henri Spaak (Prime Minister, Belgium) and Alcide de Gasperi (Prime Minister, Italy). These men were Christian Democrats, a party name throughout each country.

Predominately Catholics, they followed classical liberalism, based on the ideals of Smith, Say, Malthus and Ricardo. Classical liberalism espoused (and still does) limited government, liberty of individuals including freedom of speech, press and religion and importantly free markets. This work has been pursued by Austrian economists ever since, as resurrected by Friedrich Hayek, and was considered the most important cultural value of Europeans and Christianity.

The economist Philipp Baggus has explored the eurozone in a truly insightful work titled "The Tragedy of the euro". He depicts how this classical vision was threatened by a socialist vision of Europe. The Treaty of Rome in 1957 was the main achievement toward the classical liberal vision for Europe. The Treaty delivered four basic liberties: free circulation of goods, free offering of services, free movement of financial capital, and free migration.

"no one could prohibit a German hairdresser from cutting hair in Spain, and no one could tax an English man for transferring money from a German to a French bank, or for investing in the Italian stock market. No one could prevent, through regulations, a French brewer from selling beer in Germany. No government could give subsidies distorting competition. No one could prevent a Dane from running away from his welfare state and extreme high tax rates, and migrating to a state with a lower tax burden, such as Ireland." (Baggus, 2010)

We contend that the Socialist vision was in direct opposition to these four tenets. Under the guidance of Jacques Delors and Francois Mitterand the EU was merely to be the vision of a statist fortress: "protectionist to the outside and interventionist on the inside". Their dream was a centralised state with ruling technocrats (read

Brussels), where the core countries would reign over the periphery. A supranational state, where taxation is harmonised and social regulations are pursued in the interest of the ruling elite and not the people.

The Maastricht Treaty of 1993 usurped the ideals of the founding fathers as Delors succeeded in establishing a centralised state which had less and less democratic powers. Notably the European Commission (EC), which is the executive body of the EU, is very undemocratic. The Commissioners are appointed by member state governments, not by election.

There is a case to be made that such Socialist idealists welcome the crisis, as by delaying on sensible reform they are paving the way for more undemocratic centralisation. The creation of a 'European Ministry of Finance' or extension of the executive board, the European Commission, may have more sinister provocations of eradicating member liberties in the name of the twin pillars of growth and stability.

Delightful Delors

Delors was raised in the spirit of interventionism and after ten years as president of the EC and he used the Single Market Act of 1986 as a foundation to pursuing political union and the introduction of a single currency. This was the first undoing of the liberals' Treaty of Rome.

In 1988 Delors addressed the Congress of the British Trade Union promising that the EC would be forced to require nation states to pursue pro-labour legislation. Margaret Thatcher, the British Prime Minister, reposted with a brilliant polemic, 'The Bruges Speech', as it came to be known, at the College of Europe in Bruges, Belgium. In it she said:

"To try to suppress nationhood and concentrate power at the centre of a European conglomerate would be highly damaging and would jeopardise the objectives we seek to achieve."

"We have not successfully rolled back the frontiers of the state in Britain, only to see them re-imposed at a European level with a European super-state exercising a new dominance from Brussels."

http://www.margaretthatcher.org/document/107332

We will return to Thatcher later.

Snakes & Ladders

Post the collapse of Bretton Woods, the world has experienced an unfettered system of fiat currencies, which has allowed almost unrestricted inflation of the money supply with huge redistribution effects. European banks inflated under a fractional reserve basis to primarily finance expanding welfare states and subsidize companies. However because not all countries could inflate simultaneously there were wild fluctuations in exchange rates, which negatively affected trade between European nations. The concomitant negative impact on division of labour resulted in sharp welfare losses. Such losses meant lower tax revenues, which are not a good ingredient for statists.

The European political elite needed to stabilise such fluctuations as they threatened European integration. The European Monetary System (EMS), originated in 1979 was considered the solution. It institutionalised a former currency "snake". Between 1972 and 1973 there was, for a short time, a system called "snake in the tunnel", whereby EEC countries agreed to maintain stable exchange rates by keeping fluctuations to no more than ±2.25 percent against each other. The new system led to the creation of the European Currency Unit (ECU):

[In this informal system currencies were allowed to fluctuate ±2.25 percent against each other. The tunnel was provided by the dollar. The Smithsonian agreements (1971) had set ±2.25 percent bands for currencies to move relative to the US dollar. When the dollar started to fluctuate freely in 1973, the tunnel disappeared. The snake left the tunnel and a Deutschmark-dominated block remained, with currencies fluctuating ±2.25 percent. As the Bundesbank was no longer obliged to buy the excess supply of dollars (gold standard), it could raise interest rates and restrict liquidity. While the French government wanted to influence the economy by credit expansion, the German institutions wanted to fight against inflation. France left the snake in 1974. It returned in 1975 in an attempt to reduce German hegemony, but was gone again one year later. In 1977, only Germany, Benelux and Denmark remained in a de facto Mark zone.]

The basic elements of the arrangement were:

1. The ECU: A basket of currencies, preventing movements above 2.25% (6% for Italy) around parity in bilateral exchange rates with other member countries.

2. An Exchange Rate Mechanism (ERM) or semi-fixed currency peg where the ECU was determined as a weighted average of the participating currencies.

3. An extension of European credit facilities.

4. The European Monetary Cooperation Fund created in October 1972 and allocated ECUs to members' central banks in exchange for gold and US dollar deposits.

Tyranny of the Mark

The EMS was not only an attempt to control diverging inflation rates by maintaining currency fluctuations within small limits, it was also a means of restraining the Bundesbank supremacy in monetary matters. The French had much despised the 'tyranny of the Deutschmark'. Even Germany's own chancellor Schmidt had threatened to draft a law ending the Bundesbank's formal independence if it did not agree to the EMS. (Control of the printing presses was always a political motivation.) Central banks primarily have been used to finance government deficits. In the early days of the European Union the "Bundesbank was the brakeman of European inflation: a hated corrective." (Baggus 2010)

The single currency inception lay perversely in the collapse of its forerunner the ECU (European Currency Unit), as a flawed exchange rate stabiliser that was still highly inflationary. The German Bundesbank had stood as a bastion of relative sobriety when it came to creation of currency reserves. Any nation who inflated their currency more than the mark, was consigning their citizens to a loss of purchasing power through the Exchange Rate Mechanism (ERM) that accompanied the ECU. The hard money stability of the Bundesbank merely led to the recognition by European Institutions that a Bundesbank-styled European Central Bank could actually offer stability with regard to a currency union - a single currency. And so the seeds were set for a monetary and political union with the euro at its centre.

The Bundesbank did not inflate as much on account of German monetary history. A single generation had lost almost all monetary savings two times, namely, after two world wars: in the hyperinflation of 1923 and the currency reform in 1948. Most Germans wanted hard money, and expressed that through the institutional set up of the Bundesbank, which was relatively independent of the government. What all of this means is that, in practice, the EMS would only function if central banks were only able to inflate as much as the slowest links in the chain: the Bundesbank and its traditional ally, De Nederlandsche Bank.

The euro was introduced on 1st January 1999 for accounting purposes, achieving full circulation on 1st January 2002, and to date has the highest combined value of banknotes and coins in circulation in the world, surpassing the US dollar. Inspiration for the € symbol itself came from the Greek letter epsilon (Є) – a reference to the cradle of European civilisation – and the first letter of the word Europe, crossed by two parallel lines to certify the stability of the euro. The euro concept was derived from the economist Robert Mundell. His 'Optimum Currency Area' theory, postulated that a geographical region's economic efficiency would be maximised by that region sharing a single currency, (a group of countries comprised a region). His theory better suited the Federal model of the USA than the newly federated European bloc.

After the adoption of the euro, policy changed to linking currencies of countries outside the eurozone to the euro (having the common currency as a central point). The goal was to improve stability of those currencies, as well as to gain an evaluation mechanism for potential eurozone members. (This mechanism is known as ERM2.)

MAaSTrICht Misery

At the heart of the European Union lies a series of Treaties. We have touched on the Treaty of Rome, but it was not until the Treaty of Maastricht (or Treaty on European Union,) signed in Netherlands on 7th February 1992 (implemented 1st November 1993), that Delor's socialist vision was set in motion. It was the treaty that set the convergence criteria that supposedly would bind the European Union firmly together and set in motion the political will favouring a single or uniform currency.

Unfortunately the Maastricht binding was to prove less reliable than 'Mastic', or the resin obtained from the eponymous Mediterranean tree. The tree predominately resides, ironically, in Greece. The resin, named the "tears of Chios", as it is produced on Greek island of the same name, is perhaps more binding than the Treaty has been for Greece and certainly has produced less misery.

Five criteria for selection were negotiated and established:

1. Price inflation rates had to be under a limit set by the average of the three best performing, with the lowest inflation rates + 1.5 percent.

2. Public deficits had to be not higher than 3 percent of GDP. Only exceptional and temporary excesses would be granted for exceptional cases.

3. Total public debts had to be not over 60 percent of GDP.

4. Long term interest rates had to be under a limit established by the average of the three governments paying the lowest interest rates +2 percent.

5. Exchange rates had to stay within the limits set by the European Monetary System for two consecutive years (ERM- 2) and should not have devalued currency during period.

The purpose of setting these criteria was (is) to maintain the price stability within the eurozone even with the inclusion of new member states. As by attaining such conditions, countries would in theory be of sufficient financial health to withstand a one-size-fits-all monetary policy.

'Broken' Bundesbank

Karl Otto Pohl, President of the Bundesbank, was opposed to the euro. He maintained monetary union would only be possible given political union which was far off. He felt if he defined the conditions for a currency union that was supported by a European central bank modelled on the Bundesbank the French would never accept. He badly misjudged the situation and they accepted, forcing Pohl to give up his desire have political and monetary union introduced in a parallel way.

The German government under Chancellor Schmidt used propaganda worthy of the Third Reich, when pursuing the single currency. They convinced the populace that if Germany did not join she would be a threat to global peace as she had once been, instigating the First and Second World Wars. Schmidt played the fear card, claiming Germany could become isolated politically as Mitterand had proposed a triple alliance with Great Britain, France and the Soviet Union, around the time of German reunification, which only joining the euro would prevent such an eventuality.

Legal experts raised constitutional concerns about the Maastricht Treaty. German Law professor Karl Albrecht Schachtschneider argued that a monetary union could only be stable and work in a political union. A political union, however, implied the end of the German state, which itself was unconstitutional. Schachtschneider also pointed out that the German constitution demanded a stable currency, an end not achievable in a monetary union with independent states. The right to property would also be violated in an inflationary monetary union. The German constitutional court, however, found that the Maastricht Treaty was in fact constitutional. The court stipulated that Germany could only participate in a stable currency, and would have to leave the monetary union if it proved to be unstable. (Baggus 2010).

The reason German politicians did not have the fortitude of their Bundesbank brethren is most likely because first and foremost they are politicians, (so by definition ego-centric and self-serving – a generalisation? Perhaps), but secondly because Germany required authorisation from the US, France, Great Britain and the Soviet Union to pursue reunification of East and West Germany. Incredibly this was a legacy of the WW1, where no peace treaty had been signed conferring full sovereignty to Germany. These four powers still feared a reunified Germany, but they feared the Bundesbank arguably more, as we have mentioned this central bank had more influence on other nation's banks by exposing their money printing ways, as relatively speaking the Bundesbank pursued non-inflationary monetary policies. Many have suggested that Germany had to sacrifice their monetary and political independence for reunification. As German President, Richard von Weizacker said himself the "euro would be nothing else than the price of reunification."

As we will discuss later it is the making of the euro under such conditions that makes it febrile, especially in light of the German's rightly perceived loss of monetary and political sovereignty. This in part explains Merkel's resistance to the "E-bond" concept, and the extension of the EFSF.

Essentially her predecessors had altered the German constitution in order to make transfer of the sovereign power over the currency to a supranational institution. The citizens were not consulted.

The path was now set for convergence to the euro, but the Stability and Growth Pact that was established to oversee the process was laughable. Many nations flaunted the rules prior to entry, fulfilling the criteria due to accounting tricks which postponed expenditures into the future or generated one time incomes.

Accounting tricks included manoeuvres with France Telecom, the Eurotax in Italy, Treuhand in Germany, Germany's hospital debt, and an attempt to revalue gold reserves in several countries.

'Stupid' SGP

The Stability and Growth Pact (SGP) was established to monitor the fiscal situation of the member countries. If the fiscal discipline of Maastricht was not adhered to warnings and sanctions were to be invoked. This was a sham. Member countries flaunted the rules, and sanctions were applied inconsistently. France and Germany having failed to meet the criteria were not punished, whilst sanctions initially were invoked on Portugal (2002) and Greece (2005), though fines were never applied. Romani Prodi, the Italian PM referred to the concept as "stupid" in an interview with *Le Monde*. Although he was right it was probably for the wrong reason. He detested the inflexibility. We disliked it, because it was a sham. Accounting trickery, not least of all by Greece[*], who serially under-reported its budget status has undermined the eurozone's reputation, as clearly policing of member public finances was ineffectual.

Prime Minister George Papandreou effectively triggered the Eurozone sovereign debt crisis, by owning up to the fact that Greece's budget deficit for the year would not be the six percent of GDP that Greece had earlier reported but would rather be of the order of a staggering 12.5 percent of GDP. EUROSTAT, the Eurozone's official budget score keeper, through sleight of hand, helped Greece mask its true budgetary position. They were aided in this by Goldman Sachs, who enabled Greece to make extensive use of complicated derivative instruments that also helped disguise their true budget position.

Many have referred to the SGP as a 'paper tiger', but if commentators felt this, then the undoing of the 'no bailout clause' enshrined in Article 125[*] of the Lisbon Treaty makes a mockery of the whole union. On the 9th May, 2010, the EC acquiesced as the European sovereign debt crisis exposed the weak structure of the EU and single currency. The EU members and IMF put in place, as we all know, a EUR750 billion bailout fund - the European Financial Stabilization Facility (EFSF). The member states had to legally appeal to Article 122, which stated that financial assistance can be provided to a member country "which finds itself in difficulties or which is seriously threatened with severe difficulties"..wait for it....by of all things....."*natural* disasters or exceptional occurrences beyond its control." *Naturally* Greece walked off with all the money. A total farce. The whole idea of the no-bailout clause was to deny errant countries access to market financing at reasonable terms should their budget deficits move down a potentially unsustainable path[1].

[1] *http://www.efsf.europa.eu/attachments/faq_en.pdf*

The EFSF - or the European Futile and Stupid Fund - is a totally flawed concept, as it overburdens already comprised sovereign balance sheets. As each member country becomes more fragile, its ability to contribute becomes reduced in a downward spiral.

The European Financial Stability Facility (EFSF) is a company which was agreed by the 16 countries that share the euro on May 9th 2010 and incorporated in Luxembourg under Luxembourgish law on June 7th 2010. The EFSF's objective is to preserve the financial stability of Europe's monetary union by providing temporary financial assistance to euro area Member States in difficulty. In order to reach its objective the EFSF can, with the support of the German Debt Management Office (DMO), issue bonds or other debt instruments on the market to raise the funds needed to provide loans to countries in financial difficulties. Issues would be backed by guarantees given by euro area member states of up to EUR440 billion, on a pro rata basis, in accordance with their share in the paid-up capital of the European Central Bank (ECB) (see table below).

Country	Percentage of bailout
Germany	27.92
France	20.97
Italy	18.42
Spain	12.24
Netherlands	5.88
Belgium	3.58
Austria	2.86
Portugal	2.58
Finland	1.85
Ireland	1.64
Slovakia	1.02
Slovenia	0.48
Luxembourg	0.26
Cyprus	0.20
Malta	0.09

Source: ECB (2010)

The Facility may be combined with loans up to EUR60 billion from the European Financial Stabilisation Mechanism (EFSM), reliant on funds raised by the EC using the EU budget as collateral and up to EUR250 billion from the IMF to obtain a financial safety net up to EUR750 billion.

* Article 125 of the Lisbon Treaty provides that "the Union shall not be liable for or assume the commitments of central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of any Member State, without prejudice to mutual financial guarantees for the joint execution of a specific project. A Member State shall not be liable for or assume the commitments of central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of another Member State, without prejudice to mutual financial guarantees for the joint execution of a specific project".

ECB - The Money Redistributor

A single monetary entity the ECB was to oversee the whole of the single currency union, but it was tarnished from the start. The Bundesbank was hoodwinked into believing that the ECB would be essentially be the Bundesbank in all but name only. The German central banks stability has not been exported to the single currency, again undermining the veracity of the euro to our mind. Wim Duisenburg was 'voluntarily removed' mysteriously halfway through his term to make way for the French candidate Jean -Claude Trichet. Before the introduction of the euro, he had strongly opposed the 'independence' of the ECB. The intention of the political

http://www.bundesfinanzministerium.de/nn_1270/DE/Wirtschaft__und__Verwaltung/Europa/20100609-Schutzschirm-euro-Anlage-1-eng,templateId=raw,property=publicationFile.pdf elite was very clear - to have the ECB do as it bade. The ECB, unlike the Bundesbank, focuses not on the monetary growth pillar, but merely uses it as indicator of the Bank's policy. The Maastricht Treaty states that the ECB "shall without prejudice of the objective of price stability, the [Eurosystem] shall support the general economic policies in the Community."

This was an addition put in by the socialist French which means they have direct political control over the ECB, and hence printing press, which is why we believe monetisation of periphery bonds will ramp up.

"Before the introduction of the euro, the Deutschmark was a standard that laid bare the monetary mismanagement of irresponsible governments." (ibid)

The Bundesbank, of course, inflated the money supply, but just at a rate slower than the southern periphery, who used their central banks ultimately to deficit finance. Hence the higher levels of inflation in the Club Med. Clearly a single currency would end such an embarrassing comparison between the low inflation Germany and the high inflation periphery. Even better if ECB members reside from these countries they can have substantial influence. And clearly this has been the case. (German and northern European hard currency countries such as the Netherlands, Luxembourg and Belgium hold the minority of votes against countries like Italy, Portugal, Greece, Spain, and France.)

The irony is that at the same time the stabilising effect of the Bundesbank was surreptitiously removed from Europe, markets developed an expectation that the euro was a more stable currency for southern European countries. Inflation expectations fell dramatically and with it bond yields fell. This precipitated these countries achieving some of the criteria of Maastricht, namely lower inflation rates and lower debt levels.

We have often wondered why seemingly impoverished countries in the South seemed to grow 'rich' overnight. Baggus brilliantly points out that it was via seignorage. The EMU socialised seignorage (the net profits resulting from the use of the printing press - when a central bank produces more base money, it buys assets, many of which yield income; for instance, a central bank may buy a government bond with newly produced money).

"The net interest income resulting from the assets is seignorage and transmitted at the end of the year to the government. As a result of the introduction of the euro, seignorage was socialized in the EMU. Central banks had to send interest revenues to the ECB. The ECB would remit its own profits at the end of the year. One could imagine that this would be a zero sum game. But it is not. The ECB remits profits to national central banks based not on the assets held by individual central banks, but rather based on the capital that each central bank holds in the ECB. This capital, in turn, reflects population and GDP and not the national central banks' assets.

The Bundesbank, for instance, produced more base money in relation to its population and GDP than France, basically because the Deutschmark was an international reserve currency and was used in international transactions. The Bundesbank held more interest generating assets in relation to its population and GDP than France did. Consequently, the Bundesbank remitted relatively more interest revenues to the ECB than France, which were then redistributed to central banks based on population and GDP figures. While this scheme was disadvantageous for Germany, Austria, Spain and the Netherlands it was beneficial to France. Indeed, the Bundesbank profits remitted back to the German government fell after the introduction of the euro. In the ten years before the single currency, the Bundesbank obtained EUR 68.5 billion in profits. In the first ten years of the euro the profit fell to EUR 47.5 billion."

These newly assigned European states received all the benefits ironically of an inflationary fiat currency system because of the inflation-reducing credibility of the Bundesbank. There was no real savings created by productive capital from entrepreneurship. It was the usual fiat monetary illusion of 'wealth'. The consequences of this transfer of 'unreal' wealth from the core to the periphery would be increased further by the boom in real estate construction. After all credit was now extremely cheap and so the housing boom began in Spain, and in Ireland in particular. The periphery saw an asset boom without a measurable increase in savings and investment, and because money was cheap there was no increase in productivity.

This is unlike in Germany, whose manufacturers in order to compete on the world export stage, had to be become even more productive, as the euro firmed due to German monetary and fiscal strength. Under a single currency zone, money gets redistributed. The credit-induced consumption boom fostered price rises in the core as periphery countries bought German exports. The Club Med current account deficits swelled, which becomes an issue when in reality fiscal deficits are much higher than one is lead to believe. It leaves those countries vulnerable to external funding. This is the prime issue for the euro now. Bond expenditures have to be financed at some point either via inflation or taxes. Right now the rigidity of the eurozone does not allow easily for inflation, and as taxes cannot be raised without growth, the adjustment or payment will come via lower wages and prices in order to foster private sector profitability.

The introduction of the single currency merely lowered rates in the periphery compared to those of the core, but this should not have been the case in our opinion as in effect the core was implicitly guaranteeing the debt of the Club Med. The Western European banks loaded up on periphery debt to take advantage of this yield compression. We believe the market is severely underestimating the fiscal fortitude of the core should the periphery start to default.

European Union - Where are we now?

The Treaty of Rome (1957) was a charter for economic liberty. **The set up of the European Monetary Union has been to create a self-serving institutional edifice,** which usurped the ideals of those far-sighted men of 1957.

So the euro arrival masked the inflationary ramifications of each nation's fiat currency system. It delayed what we believe will be an inevitable default, which prior to the single currency could have occurred due to an explicit default or an implicit default. Many periphery nations had debt to GDP ratios consistent with historic hyperinflationary episodes in other countries. (Please refer to our presentation 'Debt: There is No Jubilee' to observe the methods of deleveraging.)

A decade on from the arrival of the euro and one can see how the 'mastic' for EU was lacking real adhesive structure. The flaws that we have outlined explain why it is highly likely that if one of the periphery countries defaults then it will be likely as a result of an exit from the single currency and the European Union. This, in our opinion, would lead to the demise of the single currency, as most likely the rest of periphery would exit as capital flows stop.

The implications for an encumbered Western Europe banking system would be disastrously deleterious, put mildly. We just do not think the euro can ultimately survive that. Hopefully it will result in a reassessment and reaffirmation of the original core values of the Treaty of Rome laid out by the Union's fore-fathers.

We have long stated that this is a solvency issue not a liquidity issue, although large infusions of EU and IMF 'money' will stave off the inevitable for a time. Desmond Lachman, a fellow at American Enterprise Institute (AEI) rightly suggests in his piece *'Can the euro survive?'* that a major part of the European periphery's fiscal deficits constitutes primary balances (ie excluding interest payments). This means that even draconian debt restructuring will only be a partial remedy budgetary issues, as further retrenchment in budgets would later be needed. In essence you can reduce the *stock* of debt, but the budget deficit excluding interest payments still remains, ie the *flow* of debt continues to accumulate.

We mentioned earlier Mundell's body of work on Optimal Currency Regions being the footprint for the eurozone. Far from being optimal we believe the eurozone has always been a sub-optimal currency regime. Let's use Lachman's analogy of the eurozone to another currency union - the USA - to illustrate our point:

- Europe does not enjoy nearly the degree of wage flexibility that characterises the US economy. Its rigid labour markets and legislative protections mean that wages in Europe are very slow to adjust to rising unemployment and to declining production. This lack of wage flexibility, in the context of a currency union, makes it difficult for individual European economies to regain lost international competitiveness as needed through downward movements in wages. This lack of wage flexibility also makes the European countries vulnerable to sharper declines in output and employment than is the case for the individual states in the United States.

- Considerable language and cultural barriers, combined with poor housing infrastructure, makes labour very much less mobile in Europe than in the United States. Unlike the United States, where labour readily moves from states in recession to states enjoying a boom, European labour does not readily move towards job opportunities in other parts of the Eurozone.

- Unlike the United States, Europe is yet to develop an effective system of fiscal federal transfers. Lacking the same sense of shared national purpose as in the United States, there is a strong reluctance of the more prosperous European countries to have their tax revenues be transferred to countries experiencing fiscal shortfalls.

- The European economies are characterised by a great degree of diversity which makes them particularly susceptible to adverse asymmetric shocks. This vulnerability can prove to be important in a currency union where the central bank can only set one interest rate to satisfy the needs of all of the union's member states. The greater susceptibility to asymmetric shocks in Europe also highlights its greater need for labour market flexibility and labour mobility in a currency union.

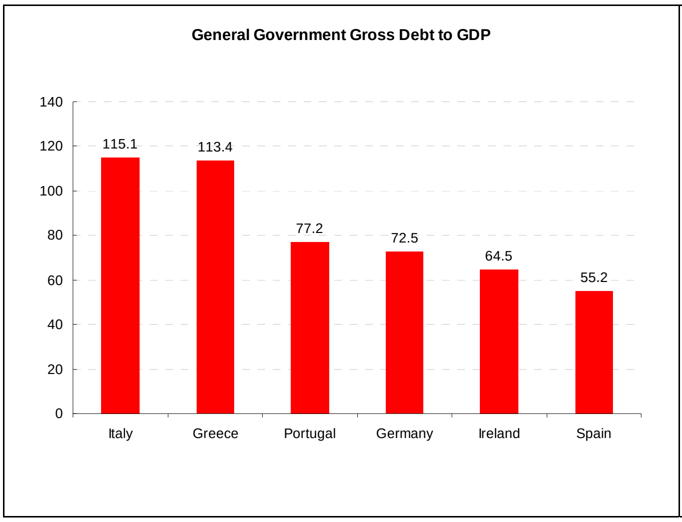
Problematic Periphery

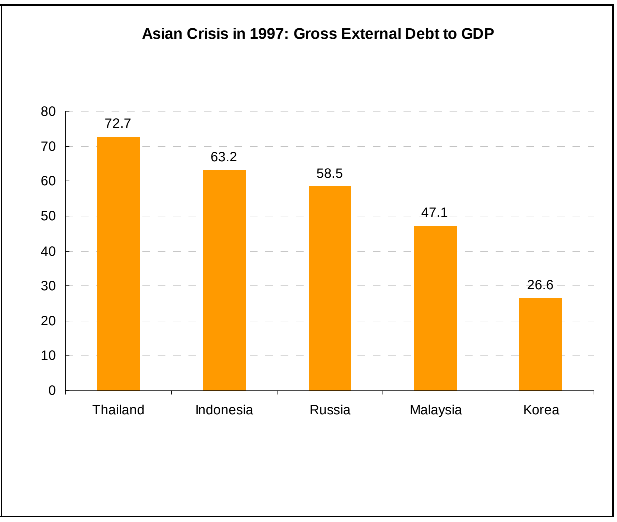
We have discussed how we believe the convergence of inflation and bond rates helped fuel a massive consumption boom, especially in the periphery.

The PIIGS were able to build up large debts as revenue from this boom masked the burgeoning deficits that would eventually materialise as the periphery governments maintained their status quo - prior to joining the monetary union, they indulged in deficit financing and currency devaluation or post entry via cheap funding from the ECB.

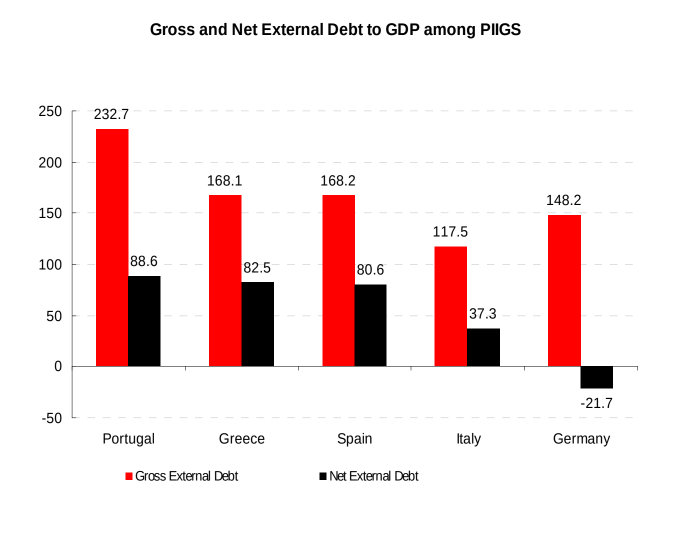
These large fiscal and private sector imbalances far outstripped anything seen in the USA. Employment in the construction sector peaked at around six percent of the labour force in the United States, a level which in Spain reached as high as 18 percent. The bursting of the housing bubbles in Ireland and Spain has been a primary driver in the dramatic deterioration in their public finances.

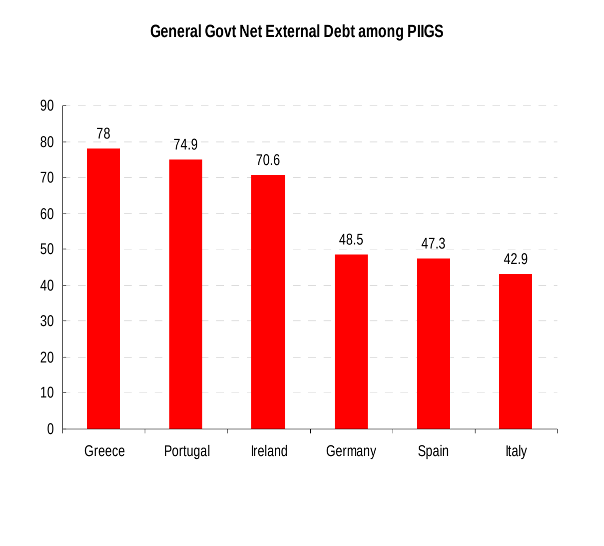
Today, Greece and Italy have too much government debt. Ireland and Spain have too much private debt. Portugal has too much public and private debt. Portugal is extremely reliant on foreign funding for its current account and government deficit and is likely to be the next domino to fall in Europe. Italy is more insulated, but we outline the country's longer term challenges. Without fiscal centralization or debt monetization, the economic crisis in Europe's periphery will lead to debt restructuring very quickly.





Source: VoxEU.com





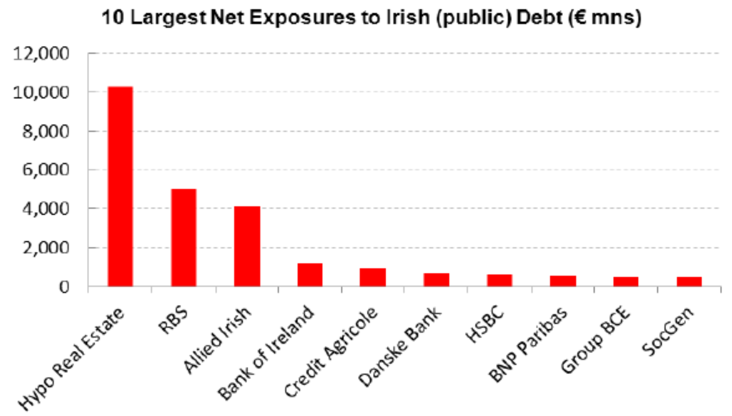
Source: VoxEU.com

Given the limited ability of the periphery to maintain economic competitiveness via labour productivity, primarily due to structural issues (wage contracts and unions), and in the absence of their own domestic currency devaluation, an 'internal devaluation' is the only path for these countries, if they want to remain in the euro and EU. Wages and prices will have to fall and be kept low for a prolonged period in order to restore their competitiveness. But this is like taking the toys out of the baby's pram; the baby will spit the proverbial dummy out. Austerity measures and the ensuing internal devaluation has already led to civil unrest.

So after years of failed guidance by the SGP, a loose monetary and fiscal policy fostered higher wage and price inflation in the periphery. These illusionary benefits have now come home to roost. We suspect that adjustment to a new reality of low income will ultimately prove the greatest challenge to periphery governments.

Celtic Tiger Tamed

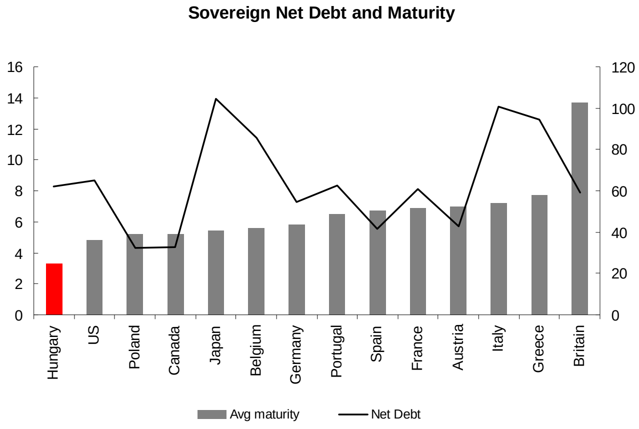
The largest event to impact the financial world, for now at least, has been Ireland's acceptance of its need for an EU/IMF bailout of its banking sector on 21st November 2010. The Fianna Fail government agreed to a EUR85 billion package, of which EUR35 billion has been set aside already to recapitalise the banks. It was the Irish banks commitment to the housing boom that led to over zealous lending with little or no sound criteria. The socialisation of bank losses by the Irish government in 2008 although considered a positive by markets has ultimately impaired the public sector, as revenues to state coffers collapsed from the construction profits.



Source: Peterson Institute

Italy and Portgual: Two More Dominoes

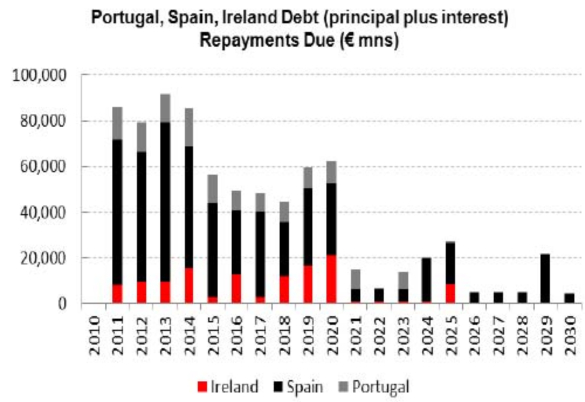
High interest rates on sovereign debt only has an impact when new funding is required and this introduces an additional sense of urgency in terms of providing a roadmap for refinancing sovereigns in the eurozone periphery.

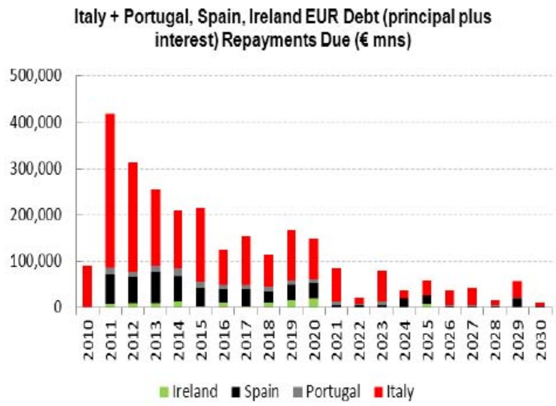


Source: Variant Perception

The chart below on the left shows the repayment profile for Portuguese, Spanish and Irish government bonds. Portugal, Greece and Ireland will need to borrow over €80bn between now and the end of 2011 (if they replace retired debt with new debt, which they will almost certainly have to do).

The chart below-right adds Italy in. The refunding figure for the same period then grows to over €500bn. As we highlighted in a recent report by our macro research partners Variant Perception, 'Italy and Portugal: Two More Dominoes', Italy has the second highest public debt ratio in the eurozone. Although it is less dependent on foreign buyers for its debt than other periphery countries, sluggish growth and demographic headwinds will hinder any meaningful reduction of public debt in the coming years. What may be the near-term tipping point for Italy, however, is if Spain needs a bailout. **Italy's contribution to such a bailout would put an unacceptable burden on its finances. It is our belief that Italy's fortunes will become much entwined with that of Spain's over the next few months.**





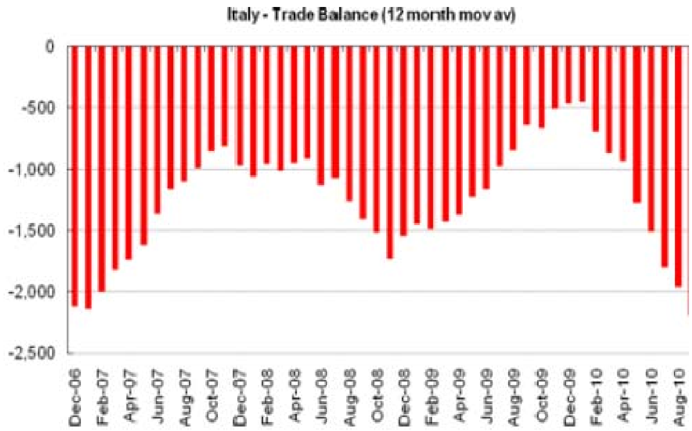
Source: Bloomberg

We also believe that Portugal will have to apply for an EU/IMF bailout in weeks rather than months. 80% of Portugal's public debt is held by foreigners (Portugal is very similar to Ireland in this respect), and its total external debt position amounts to 90% of GDP. The deflationary dynamics of the euro and the austerity measures implemented will cause real debt burdens to surge which will encourage these overseas investors to depart the Iberian peninsular.

This will continue to be a source of vulnerability because it leaves the country exposed to the continuing risk of having financial markets shutter to its debt. Portugal's government debt, at 82% of GDP, currently sits at less than that of Greece (126%) and Ireland (almost 100%). Yet adding in corporate and private debt, Portugal's debt-to-GDP ratio rises to over 250%.

Italy has so far remained largely out of investors' sights. There are often reassuring statements made that Italy is not in the same camp as the other members of the PIIGS group. Yet, these reasons are not entirely convincing.

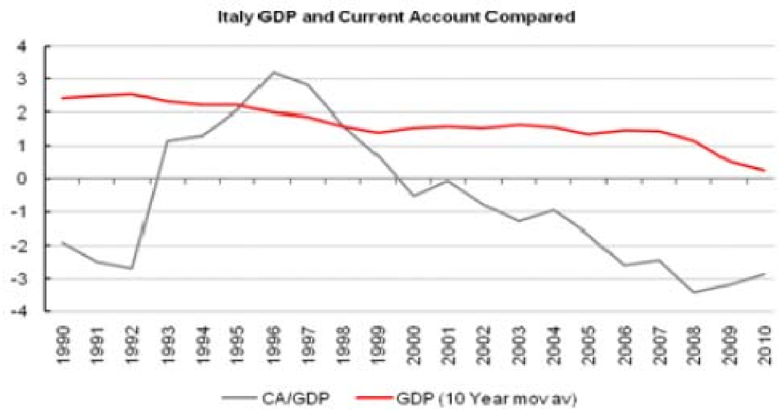
Italy's low level of private sector debt, and a public debt level that, although high, is funded mainly by the domestic market, are taken as the saving graces for why Italy does not – and will not – find itself in the same situation as, eg, Spain or Greece. Japan, it is often argued, has similar features to Italy, and has survived happily for many years with high levels of public debt. Yet, unlike Japan, Italy does not have its own central bank to buy public debt (although ECB is doing a good job), does not have its own currency to devalue in the last resort, and does have a serious competitiveness problem that has only worsened during the years of monetary union.



Source: Variant Perception

Where you export to also matters. German export volumes are now back at their pre-crisis levels while Italy's remain mired around 20% below their 2008 peak. Lack of flexibility, and inability to diversify quickly enough from traditional markets in the eurozone, come with a price. Italy's current account position has deteriorated over the years of eurozone membership. With the present deterioration in the trade balance, this year's current account deficit will be between 3% and 4% of GDP.

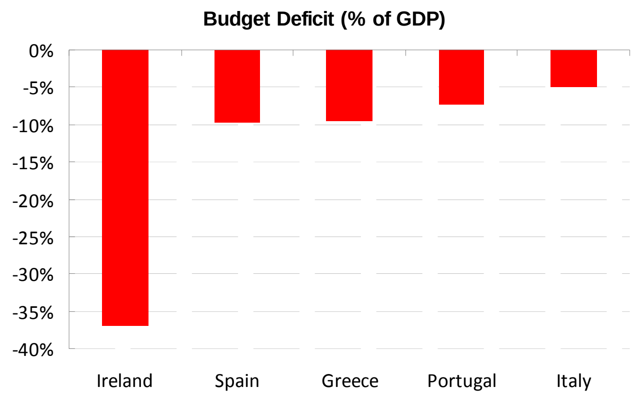
GDP growth has deteriorated along with the current account deficit. An economy which is export dependent and runs an external deficit can hardly expect things to turn out differently.



Source: Variant Perception

Comparing Italy's public debt to its exports, instead of to its GDP, gives a debt-to-"income" ratio of roughly 4. Not only is this a large number, it is more or less the multiple which Ken Rogoff and Carmen Reinhart identified as being one of the key 'tipping points' for identifying when crises are likely to occur. (See *This Time is Different*, Princeton University Press, 2009.)

The Italian government remains optimistic. They focus on the budget deficit, which is low (in 2009 it was 5.3% of GDP). However, Italy has a stock, not a flow problem. Debt-to-GDP sits at over 115%, one of the highest in the world. **Even with a falling deficit, Italy's structurally low growth and the expectation of further support for the EFSF (if Spain needed a bailout, this would be an enormous burden for Italy) will make the reduction in country's stock of debt an ambitious and challenging objective.**



The Italian economy depends on exports. However, unlike the industrially stronger economies of Germany and Japan, Italy's long standing competitiveness problem means there is not enough export momentum to drive the whole economy. Indeed, the goods trade deficit has been worsening

One positive: Italy has a healthy private sector, but its public sector is the real problem – Private debt levels in Italy are low. However, Italy's public debt, at 116% of GDP in 2009, is the second highest in Europe and one of the highest on the world. Years of sub-par growth mean Italy's GDP is still stuck at 2003 levels.

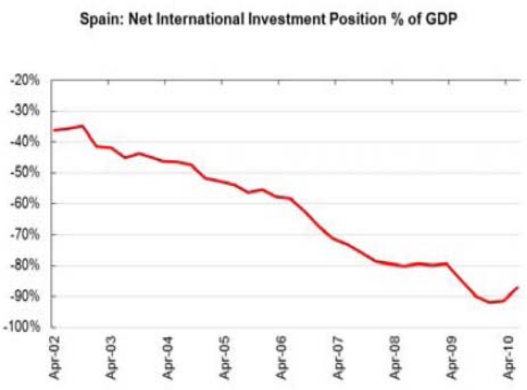
Spanish Solvency

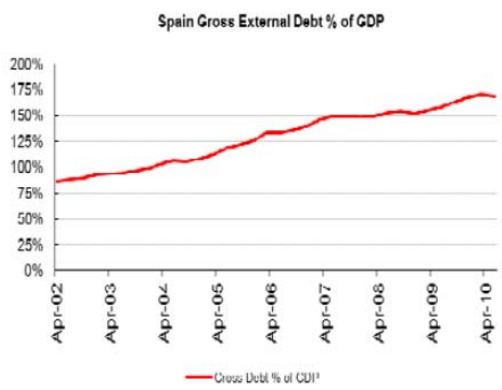
Spain looks very much like Ireland: a massive housing bubble, low public debt, but extremely high private indebtedness, terrible investment positions with large external liabilities. The similarities do not end there. Before the Irish bailout, Irish banks all passed the stress tests. Spanish banks all passed the stress tests as well.

Variant Perception were arguably the first to declare that Spain had a problem in Jonathan Tepper's piece Spain: The Hole in Europe's Balance Sheet (2008). Spanish banks, he has long argued, are hiding their losses. Last week, for example, after examining the books of CajaSur, auditors declared that its delinquency rate was not its reported 5%, but 10%, and its losses quadrupled. This pattern happens with any Spanish company or bank that is audited properly.

The real problem in Spain, beyond zombie banks and insolvent companies, is that growth is now zero and Spain will likely contract over the next year based on leading indicators. Paying 5% on 10 year paper with flat to negative economic growth means debt levels can't stabilize.

Assuming Spain does not assume private sector liabilities, the Spanish state is likely solvent, but could be illiquid if a crisis in the debt markets could leave Spain unable to rollover its debts. Spain has a cash flow issue where they are running a government deficit and current account deficit. Someone needs to fund Spain every quarter, particularly given that Spain needs to issue a gross amount of €190 billion next year of government debt. And in terms of stock vs. flow, the stock of net external debt is 90% of GDP and the Net International Investment Position is -90% of GDP. So to de-lever they would need to run large surpluses. That simply isn't going to happen.





Source: Variant Perception

Beware Greeks Bearing Gifts

The Greek GDP contribution to the EU was a fraudulent illusion, dodgy accounting (applies to most countries to be fair). Greece had an excessive budget deficit standing at 15% of GDP by 2009. The Socialist elite in Greece have chosen not to default yet, and perhaps the socialist master plan of ultimate centralisation may come to pass as periphery after periphery seems to be showing extraordinary levels of servitude. By agreeing to the 10th May 2010 bailout package of EUR110 billion and the subsequent draconian fiscal retrenchment requirements as a solution to their woes they are consigning themselves to the waste paper basket of Europe. On one level we have sympathy that the allure of a single currency union promised so much that they beg, lied and stole to join.

Trichet has consistently reiterated that the eurozone's sovereign debt crisis will not pose a significant threat to the overall EU. He has been at pains to point out that the periphery comprises only a relatively small part of the eurozone economy, less than 15% of overall GDP. **But they are highly indebted.** If Greece were to default it would be the largest default to date. As Lachman points out this would be 4 times the 2001 Argentinian default, which reverberated throughout the financial system. That default is the largest on record and although today's money is not worth the paper money of 10 years ago, it is a sobering thought.

ECB Evaporates

Without reliving the whole Greek demise again, we just want to emphasise how Trichet's handling of the Greek situation has exposed the truth about the ECB. There is no impartiality. **It is a political money machine.** The ECB is supposed to be an independent pillar of eurozone monetary stability.

If one recalls on January 15th 2010 Trichet stated in response to growing fears by markets over the Greeks to repay their debts. He said, "We will not change our collateral framework for the sake of any particular country. Our collateral framework applies to all countries concerned."

The ECB during the 2008 financial crisis had lowered its criteria from A- to BBB- on collateral. It was supposed to be a temporary measure due to expire in 2010. So when Trichet made his statement the markets took this to mean that the ECB would not extend the exceptional reduction of the required minimum rating of BBB- just to save the Greek government. By May 2nd after a second rescue package for Greece, the independence of the **ECB evaporated** when it stated it would drop all rating requirements for Greek bonds. The ECB is now a political tool. We suspect it always was, but not so overtly.

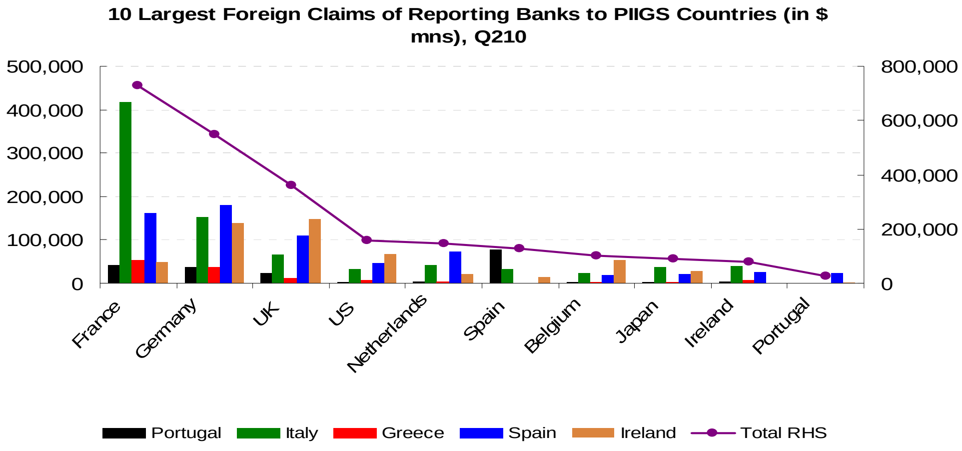
The monthly report of the ECB for June 2010 confirmed that their had been an imminent threat of a total collapse of the Eurosystem on May 6 and 7. The ECB stated that the danger had been greater than after the collapse of Lehman Brothers in September 2008. It admitted a dramatic rise in the bankruptcy probability of two or more major European banking groups. Apparently banks that had invested in Club Med sovereign debts had severe problems with refinancing.

This led Trichet by May 10th 2010 to announce the purchase of government bonds by the ECB in the open market, even as the EFSF was put in place. Trichet had broken his word. By doing this he was denigrating the balance sheet of the ECB and diminished the quality of the euro. He had crossed the Rubicon in the eyes of many by buying government bonds outright (even though, economically, there is not a substantial difference in accepting government bonds as collateral for lending operations).

PIIGS in the Trough

For us the question still remains that if the EFSF was in place why would they need to buy any bonds? Was it collusion with the Western European banks who perhaps urgently needed to offload bonds to the ECB ahead of the Bank Stress Tests? Greece may have been a small country but the Western European banks have over US$200 billion exposure to Greece. More worryingly, and the real reason for the EFSF, was that they also held over US$700 billion Spanish bonds.

French banks have the most direct exposure to the debts of the PIIGS; excluding Italy, it has over US$400 billion of exposure. If we include Italy's debt it is almost three quarters of a trillion dollars. German banks have a total exposure of almost US$400 billion excluding Italy, and US$550 billion including it. Total German exposure to Spain is US$180 billion. All creditor countries in the chart below have been reducing their exposure to PIIGS debt over the last year. (All figures as at end of Q2 2010.)



Source: Variant Perception; BIS

The potential default web of Europe is a classic example of how "systemic" collapse could occur. Defaults of Spanish banks or the Spanish government would have an adverse impact on German and French banks. A default of Portuguese banks could, in turn, cause the collapse of Spanish banks, who hold US$100 billion dollars in Portuguese debt. (Note we have not even begun to examine the amount of sovereign debt in European Pension and Insurance Fund portfolios.)

The banking system and sovereign interest is so entwined now, that systemic failure is a very real possibility. Failure of the banking system will trigger a sovereign default risk as bailouts are pursued, and conversely if there is a sovereign default the banking system will likely collapse triggering not only a European crisis but a global crisis.

The introduction of the bailout vis a vis EFSF has centralised control, undoing the principles of the EU and EMU. **The EFSF provokes further indebtedness and bailouts.** The exact opposite of why it was instituted. **It will no doubt not be long before it grows in size and power in terms of constitutional jurisdiction.** The EU has no stability as offered by the core anymore, it is now an open transfer system with Brussels' bureaucrats fully at the helm.

Domestic Bliss?

Recent moves to impose haircuts on bondholders completely changes the dynamics of peripheral debt markets. Proposing haircuts makes debt restructuring and haircuts themselves a self-fulfilling prophecy, as it is clear the periphery countries cannot survive without foreign financing.

The EFSF, or "Emergency Parachute", which has been enabled by the Greeks and now the Irish has enforced very harsh austerity measures on these countries, which threatens political and civil stability in those countries. This is not unique to the bail out countries, as Spain and Portugal are pursuing similar measures in order to avoid a bail out scenario. These range from spending cuts, tax increases, and retirement age increases.

These very measures are causing political friction internally in the periphery countries. Portugal experienced an initial veto from the opposition party to proposed budget cuts of Jose Socrates, the prime minister of the socialist government. In Ireland the Fine Gael/Labour government that will most likely emerge after the next election could well opt of the euro. The opposition parties have openly opposed the budget proposals and bailout process, because of what they see as Irish taxpayers taking the fall to protect the other countries from facing default issues.

In May 2010 Merkel's CDU party experienced a crushing defeat in the Westphalian state elections, a clear reaction to the Greek bail out. This makes further capitalisation of the EFSF or even the ECB (who has experienced degradation of it balance sheet quality) very contentious. Further calls for a review of whether the bail out was constitutional will know doubt resurface.

We would like to point out Greece, Ireland, Portugal, and Spain, have between them a combined US$1.5 trillion of sovereign debt. A default by Greece or Ireland (at this stage), could thus bring into serious question the serviceability of around US$2 trillion of European sovereign debt. We suspect this would not be a trifling matter for the EU.

Consolidated foreign claims of reporting banks, end of 04 09 (% of GDP)

Lending from banks in:	Lending to: Greece	Portugal	Spain	Ireland	Italy	Total PIIGS
Austria	1.3	0.8	2.5	2.4	7.2	14
Belgium	0.8	0.7	5.0	14.1	6.9	28
Denmark	0.1	0.1	0.8	7.3	0.2	8
France	3.1	1.8	8.9	2.5	20.8	37
Germany	1.5	1.5	6.2	6.0	6.2	21
Greece	0.0	0.0	0.1	0.3	0.2	1
Ireland	4.0	2.6	14.5	0.0	22.1	43
Italy	0.4	0.3	1.6	0.9	0.0	3
Netherlands	1.6	1.7	16.4	4.2	9.4	33
Portugal	4.7	0.0	13.4	10.3	2.5	31
Spain	0.1	6.4	0.0	1.2	3.5	11
Sweden	0.2	0.1	1.6	1.3	0.7	4
Switzerland	0.8	0.9	4.0	3.6	3.6	13
UK	0.8	1.2	5.7	9.4	3.8	21
European banks	1.3	1.7	6.0	4.5	7.3	21

Note that the numbers must be interpreted with caution as there are large changes in the figures from quarter to quarter in some countries (e.g. Switzerland from Q3 to Q4). Source: BIS Quarterly and Danske Markets

Source: Can the euro Survive? Desmond Lachman

Madame Non and the Iron Lady

As a UK citizens we thank everyday Margaret Thatcher, a disciple of Austrian economic values. (She reputedly carried within her handbag, at all times, a copy of Hayek's "Road to Serfdom".) She fought hard to keep us Brits from entering into the EMU, and the implicit loss of national sovereignty that would have entailed within a centrally controlled bloc.

Thatcher's objection to EMU, though, was not xenophobic, rather it was economic:

"I want to see us work more closely on the things we can do better together than alone....Europe is stronger when we do so, whether it be in trade, in defence or in our relations with the rest of the world. "

She understood the deflationary implications of such a "fixed" currency bloc. She understood Germany's phobia of inflation and the need of the periphery countries to devalue in the absence of any productive mechanism of growth; an impossibility within a single currency union such as this.

Twenty years ago, her deputy PM Geoffrey Howe, treacherously went on television to declare Britain did not 'in principle' oppose the euro. Earlier that very same week she had declared to Jacques Delors, at the European summit in Rome that moves beyond the ERM membership towards further economic and monetary integration would not be contemplated by Britain.

Thatcher returned to Britain and rebuked her deputy openly in the House of Commons, stating very firmly that "this government fully believes in *the* pound sterling". Howe resigned, and a month later having lost an internal leadership contest she resigned on 22nd November 1990. An election was called and John Major, her former Chancellor, rather against the tide, defeated Neil Kinnock, the Labour leader.

Though Thatcher had supported British membership in the EC, Thatcher believed that the role of the organisation should be limited to ensuring free trade and effective competition, and feared that the EC approach to governing was at odds with her views of smaller government and deregulatory trends. In 1988 she remarked, "We have not successfully rolled back the frontiers of the state in Britain, only to see them re-imposed at a European level, with a European super-state exercising a new dominance from Brussels."

Many have compared Merkel to Thatcher. For a while Merkel vehemently resisted bailing out the periphery countries, which earned her the nickname 'Madame Non', unfortunately unlike Thatcher she sacrificed her principles and ultimately the integrity of the EMU and EU.

2011/2 – No more euro?

2011 will be the moment of truth for the eurosystem, judging by the rapid pace of events. Either the core countries will find a way to pay for the mess the common currency experiment has created, or contagion will spread beyond individual countries and straight to the heart of the euro itself.

The most obvious solutions are the issuing of EU bonds to guarantee **full** periphery issuance (fiscal centralization), and increased purchases of periphery debt in the primary markets (debt monetization).

As this is much a banking crisis as it is a sovereign crisis, then a recapitalisation of the banks would be in order to help them survive the restructuring or default process that seems almost inevitable. But how can a recapitalisation be paid for by already encumbered nations? Germany can't fully fit the bill either and the private sector is not in a position to fund them.

A successful recapitalisation of banks would circumnavigate the loss of fiscal sovereignty that would occur under an EU bond guarantee. Perhaps even the inception of a pan-European regulator to oversee banks would assuage market fears over the veracity of bank balance sheets as new stress tests are implemented. Sounds great, but in truth it doesn't permanently solve the inherent imbalances in the eurozone, which can't be solved easily without fiscal union.

We believe the coming EU Summit in December will see little real solution, other than a commitment to putting in place some **collective** bond - an EU bond or some form of Permanent Crisis Mechanism (PCM), perhaps a bastardisation of the Latam Brady bonds – please see our King World News blog on this topic:

http://kingworldnews.com/kingworldnews/KWN_DailyWeb/Entries/2010/12/7_Ben_Davies_-_Gold%2C_Defaults_%26_A_New_Brady_Bunch.html

Further bending of Treaties will be need to be undertaken for this PCM. This may well lead to further claims of unconstitutional behaviour by member country civilians. **If proper fiscal centralization or debt monetization cannot be achieved, the continuing viability of the common currency will be a growing focus for market concern and we will see a series of debt restructurings.**

The EFSF mechanism has made it easier for the periphery to contemplate exiting the euro which we suspect (although we are not sure) would entail expulsion from the EU as punishment for reneging on debts. The interpretation of the Treaty of Lisbon is that any country choosing to leave the euro, will also be obliged to leave the EU. Such countries would no doubt be frozen out of the debt markets. It would lead to a run on those nation's banks, perhaps leading to bank defaults, unless capital controls were invoked by those countries. And even if they agreed to make some payments on their debt from outside the euro, with debts residing in euros they would be hard pushed to make payments. It is most likely that a new fiat currency introduced for that country would be structurally weak, due to deficit financing and a lack of foreign sponsorship.

This seems an awful scenario to have to contemplate but then countries such as Ireland are likely to see a new government rise to power on a wave of populist support based on premise that a newly elected government does not accept the bailout conditions. The Irish people feel particularly aggrieved at what they perceive as their taxpayers bailing out or saving the rest of the EU states. As seemingly onerous and horrific as it might seem to exit this may well come to pass due to a rising anti-euro sentiment. Think about this 4.5 million Irish are to be sacrificed for the common good of 500 million Europeans.

As Martin Wolf put it “once a country has been forced to restructure its public debt and seen a substantial part of its financial system disappear as well, the additional costs of re-establishing its currency must seem rather smaller.” Clearly the fear of this heightens the risk of runs from the liabilities of these countries.

Should one country exit, ie default we believe all the PIIGS will follow. The banks, insurance and pension companies will not be able to withstand such losses, which means there would be no hope for a Northern based euro comprising of France, Germany and the Benelux countries. The core EU may well remain, in a less centralised form, and this would be a good event. We do not need monetary union to achieve the four tenets of the original grounds of the EU.

It is worth noting that a restructuring of the debt via a PCM could provide breathing room for the banks to recapitalise – but most likely that will be assisted by generous amounts of ECB seignorage.

The principle danger for the system is that domestic considerations will continue to dominate decision-making. This is most notably the case in Germany where anything resembling a bailout is highly unpopular with voters. We have heard that Irish and Greek citizens are taking euros out of their domestic banks and depositing in German banks. “Out of the frying pan into the fire” springs too mind.

European citizens are worried about the integrity of the banks. They also fear the legalities of a euro. If a country defaults and sets off a dominoe effect, although euros will remain legal tender they are only worth what someone is prepared to exchange for them. Consequently the asset side is looking more tenuous each day because as liabilities become worthless, these will be written down more and more. This is the nature of a deflating system such as the eurozone. This environment is ripe for surplus countries to be a creditor. The discounts on some periphery debt may well entice China, for example, to help fund the periphery. This will allow them to exert a lot of political capital in the future.

Ultimately for the euro to survive, policymakers need to be able to face up to and answer a number of simple questions:

- Are they prepared to provide the necessary level of support to periphery governments which are taking the agreed measures to get the public finances on an even keel, including to help them to finance their debt at reasonable levels of interest?

- Are they willing to accept that some of the costs of restructuring existing debt need to be shared by all euro participant states?

- Are they ready, willing and able to put forward a viable plan to enable the least competitive countries to find a path back to sustainable growth?

- Are they willing to tackle head on the major internal imbalances which have developed inside the eurosystem?

If European policymakers are able to offer positive answers to these questions, then they must act decisively and rapidly to put in place the kind of institutional structures that will be needed. If not the situation will continue to deteriorate, and possibly more rapidly than most imagine.

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