Confluence INVESTMENT MANAGEMENT

Weekly Geopolitical Report

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Future of the Euro

January 1, 2017, marked the 18th anniversary of the induction of the euro, the European single currency. Once praised as the uniting force among European countries, the euro has become a source of populist backlash. From Greece to France, populist politicians have increased their political clout to the chagrin of the establishment.

The primary motivation of the European Union was to create a unified European identity so that countries would not be tempted to fight wars with one another. Special attention was paid to Germany, which had tried to dominate Europe in the past. Ensuring peace throughout Europe meant Germany had to be subdued. In order for this to happen, Germany had to become dependent on its neighbors such that waging war would be against its own interests. Although this worked in the beginning, the 2008 financial crisis exposed the flaws in this plan. Germany's excess savings and fiscal discipline led to it assuming the dual role as creditor and lender of last resort within the European Union. This gave Germany unparalleled leverage to dictate fiscal and foreign policies over other European countries.

In this report, we will take a deeper look into the factors that contributed to the formation of the European Union, as well as the negative effects the single currency has had on certain countries, particularly those located in southern Europe. As always, we will conclude with ramifications on the financial markets.

A Treaty Too Far

The conclusion of World War II left European countries decimated, vulnerable and suspicious of one another. France, in particular, felt threatened by West Germany, a country with which it had previously fought three wars. In order to protect itself from future conflict with West Germany, France sought to intertwine its economy with Germany's so that conflict between them would be problematic. France got its opportunity following a dispute with West Germany over control of the Saarland. After the war, the French were allowed to occupy the Saarland from 1944 to 1947. This area was strategically important due to its rich iron ore and coal reserves. France wanted to annex it but was incapable of assimilating Saarlanders into French society, who saw themselves as German. The resolution of this dispute led to the Treaty of Paris in 1951, which established a single high authority that would oversee the iron and steel industries of the two countries. Other countries within Europe liked the idea and also signed the Treaty of Paris. This bloc of countries would later be referred to as the Economic Coal and Steel Community (ECSC); it included France, Germany, Italy, Belgium, The Netherlands and Luxembourg. The United Kingdom (U.K.) was invited to join but refused, a harbinger for future relations.

In 1958, each member of the ECSC, now known as the European Economic Community (EEC), ratified the Treaty of Rome which established a common market and agricultural policy. The common market was such a success that the deadline to remove internal tariffs and quota restrictions was expedited by 18 months. There was talk

of a political union, but it never came to pass due to France's insistence that it should be the one directing the foreign policy of the other five countries. It is worth noting that West Germany at the time had a larger economy than France but shied away from taking on this leadership role.

In an attempt to emulate the success of the EEC, the U.K. would later form its own trading bloc called the European Free Trade Agreement (EFTA), which included Austria, Denmark, Norway, Portugal, Sweden and Switzerland. The EFTA had more member countries than the EEC, but the EEC had a larger market, with a population almost twice the size of EFTA. As a result, the U.K. and others within EFTA sought to join the EEC. In 1973, the U.K., Denmark and Ireland (who was not a member of EFTA) joined the EEC. Greece joined the community in 1980, followed by Spain and Portugal in 1986 and Austria, Finland and Sweden in 1995.

After the fall of the Bretton Woods system in 1971, leaders within the EEC sought an alternative mechanism that could stabilize prices throughout Europe and create greater economic and monetary unity. This led to the development of the European Monetary System (EMS) in 1979. The EMS established an exchange rate mechanism in which each country was assigned an exchange rate that was pegged to an artificial currency called the European Currency Unit (ECU). In order to create flexibility around the pegs, floor and ceiling bands were established. If a country violated its bands, its central bank was required to intervene and adjust it to the agreed upon limits. If this proved difficult, countries were able to realign their exchange rates with another country through mutual agreement without consequence. True to form, the U.K. refused to join the EMS until 1990 and then dropped out two years later after speculative attacks on the peg. Two years prior to the U.K. joining the EMS, Margaret Thatcher accused the EEC of trying to create an "identikit European personality."[1]

In 1992, the Maastricht Treaty, also known as the Treaty on European Union, was signed by all member countries except Denmark, Sweden and the U.K. It established that a full economic and monetary union be in place by January 1, 1999. It also stated the need for a political union in which there were common foreign and defense policies. Margaret Thatcher, never short for words, claimed that it was "one treaty too far."

Prior to the start of the euro, members of the single currency bloc, now formally known as the Eurozone, were required to give up central bank sovereignty. In its place arose the European Central Bank (ECB), whose primary objective was to maintain price stability for the Eurozone, defined as keeping inflation below 2%. Foregoing central bank sovereignty was essential to create trust among Eurozone members. Germany, in particular, was fearful that other members would start increasing the circulation of euros in times of crisis as many had done in the past.

Induction of the Euro

The euro began circulation on January 1, 1999, with the remaining legacy currencies ending their circulation in 2002.[2] The establishment of an economic and monetary union not only gave way to a new intercontinental currency, but also a

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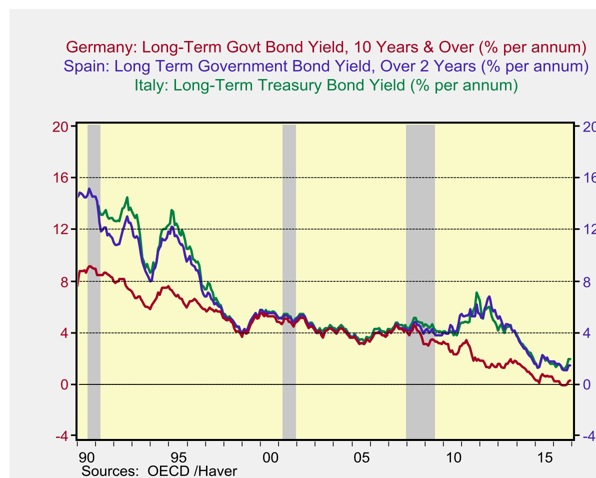
[1] Leonard, D. (2005). *Guide to the European Union* (9th ed., The Economist, pp. 3-60). London, England: Bloomberg Press.

[2] Greece, Italy and Spain were the last holdouts as they struggled to meet the budgetary and inflation targets set by the Maastricht Treaty.

perceived European identity, at least in the short term. As a result of this unity, European financial institutions became more integrated as the euro made it easier to lend across borders. Essentially, the enlarged market gave financial institutions a broader network to match creditors with borrowers.

The establishment of the ECB and the euro not only eliminated currency risk and reduced inflation risk, but it also limited perceived credit risk. It was assumed that if any member was to default, then Germany would bail it out. This led financial firms to loosen their lending standards for all members of the Eurozone. As the chart below shows, the implied German guarantee as well as increased competition among banks led bond yields for all European countries to converge to German levels by 1998. This allowed southern European countries to consume more than they otherwise could have prior to joining the Eurozone. In fact, Spain's increased borrowing caused an economic boom due to increased consumption and a housing bubble. In a sense, it was as though Germany had handed each southern European country a credit card and told them to go wild.



The increased access to financial markets spurred optimism as southern European countries began to borrow at high levels. At the same time, German competitiveness encouraged greater exports to the rest of the Eurozone. The global credit crunch caused by the financial crisis in the United States would end this honeymoon. Tighter underwriting standards by financial institutions caused interest rates to diverge, which hurt southern Europe's ability to borrow. Due to declining economic growth and loss of currency control, governments had become insolvent. This would pave the way for the sovereign debt crisis across the European Union.

Things Fall Apart

When the architects designed the European Union, they imagined that one day Europeans would see themselves as one society that shared in each other's values and culture. The problem is that no one told Germany that it also meant it would need to run trade deficits from time to time. This dilemma came to a head during the sovereign debt crisis.

The unexpected global effects of the financial crisis in the U.S. wreaked havoc on European sovereign bond and commercial lending markets. Countries became more dependent on debt for growth as financial institutions expanded their balance sheets with more cross-border finance transactions. During this time, firms in southern Europe failed to invest domestically due to burdensome regulations that prevented them from being competitive with their northern European counterparts. Southern Europe was able to make up for this lack of investment from firms by running budgetary deficits, expanding social programs and buying real estate. Generally, the increased consumption fueled GDP growth and tax revenue throughout southern Europe. Spain was the largest beneficiary during this time

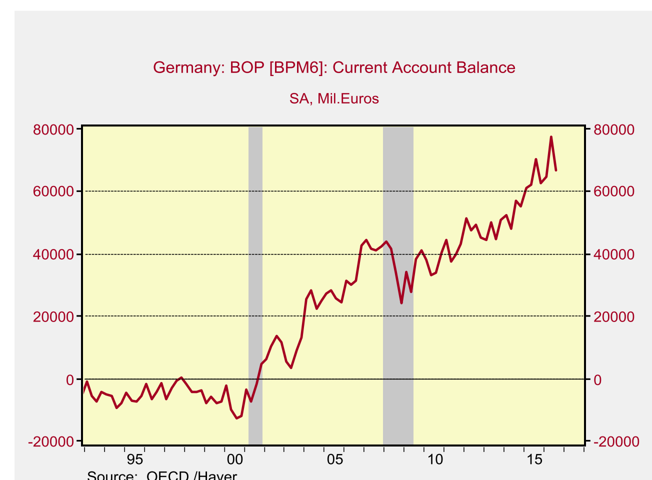
as its economy grew three times faster than the European average.[3]

When the crisis began to spread throughout Europe, it became clear that countries such as Spain, Portugal and Greece were going to need bailouts. Despite its initial reluctance, Germany stepped in to rescue these countries on the condition that they institute austerity measures. According to German officials, austerity measures were designed to help the long-term prospects of the countries seeking help. The rationale was that if these countries ran current account surpluses they would be solvent in the long term. The logic failed to take into account that Germany's insistence on running trade surpluses in conjunction with economies trying to pull themselves out of debt would cause undue pain to the constituents of these countries in the short term. To put it simply, one country's trade surplus is another country's trade deficit, therefore it would be easier for these countries to run trade surpluses if Germany were to run trade deficits. In order for this to happen, Germans would essentially need to reduce savings and start spending, while the bailout countries would need to do the opposite. Unfortunately, that is easier said than done as Germans view debts and deficits as inherently evil. This is exemplified in the German word for debt, *schuld*, which also means guilt.[4]

The New German Problem

Typically during a financial crisis there is a rebalancing between debtor countries and creditor countries, in which one of the countries adjusts so that in the long run the balance of payments between the two countries is zero. As the creditor's surplus widens its currency appreciates, which should subsequently cause the price of its goods to rise to a level that is unattractive to the debtor. If this does not happen, the debtor country can depreciate its currency to cause the prices of its goods to fall to levels that are attractive to the creditor; this is done by printing more of its currency. Another alternative would be for the debtor to place tariffs on the creditor's goods.

Because members of the Eurozone gave up their central banks, the ability to depreciate their currencies was no longer an option. In order to make their products more competitive, countries needed to either become more efficient by doing more with less or wait for Germany to stimulate the economy by propping up the prices of its goods. Germany, to the dismay of many including the U.S., never even considered the latter and instead forced bailout countries to institute contractionary policies. As a result, German exports didn't suffer because its goods were not forced to appreciate relative to the rest of Europe.



Germany's refusal to stimulate its economy forced bailout countries to bear most of the burden of the sovereign debt crisis. In order

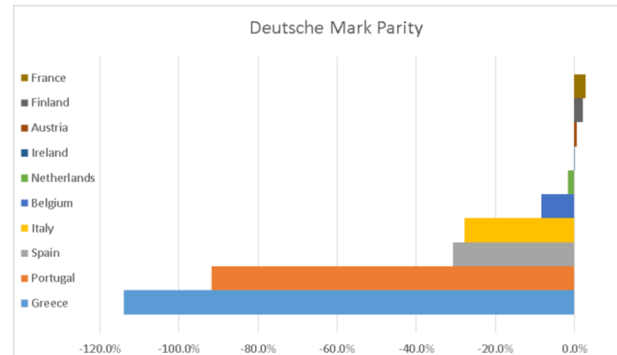
[3] Diagnosis and Challenges of the Spanish Economy. (2008). *The Spanish National Reform Program* (pp. 13-41). Madrid, Spain.

[4] Jack, S., & Clark, K. (2015, February 13). Inside the Germans' debt psyche - what makes them tick? *BBC News*. http://www.bbc.com/news/business-31369185

to run trade surpluses, bailout countries needed to look outside of the European Union in the long term to sell their goods and adopt draconian measures in the short term that would allow their country to run as efficiently as Germany. In essence, the pressure to become more efficient is what ignited the populist backlash that we are seeing today across Europe.

In order to satisfy the Germans, these countries had to cut welfare programs and pensions, privatize public institutions, raise taxes and create a more business-friendly environment for foreign direct investment. Additionally, businesses were forced to slash budgets to make up for the lack of demand. The consequences of these measures were felt most by workers who suffered pay cuts, were forced to work longer hours and, in some cases, were laid off. To make matters worse, those that were laid off no longer had as much of a welfare safety net to fall back on, which made their daily lives even harder.

Despite all these measures taking place, bailout countries still struggled to meet the level of German efficiency. This can be explained with the law of one price, also known as purchasing power parity, which states that in a free trade society goods are the same price across nations because they adjust to the exchange rate due to the arbitrage that takes place when prices differ. The bailout countries' inabilities to manipulate their currencies and Germany's unwillingness to inflate the prices of its goods meant that companies within the bailout countries could only achieve parity by reducing costs or adding value to their goods. Since the latter cannot be achieved in the short term, the former was the go-to approach. The chart below shows the percentage price change needed today by Eurozone countries in order to create German parity.



(Source: Haver, CIM)

To put this chart into perspective, let's reimagine the Big Mac Index created by *The Economist*. If the euro were to end today and each country was forced to go back to its respective currency, a Big Mac denominated in Deutsche marks would cost DM 3.67 in Germany and DM .03 in Greece due to the depreciation of the drachma. In other words, one Big Mac in Germany would cost more than 122 Big Macs in Greece.

In short, the euro protects German goods from price increases by eliminating the currency appreciation that would otherwise take place as Germany's trade surplus widens. Basically, the euro is drastically undervaluing German goods to the detriment of southern Europe. As a result, Germany is able to export more goods to southern Europe than it imports. Unless Germany decides to import more from its neighbors or inflate the prices of its goods through stimulus, it is unlikely that the European Union will be able to stay together.

Ramifications

In our opinion, the Eurozone as it is currently constructed is not feasible for the southern European countries. As a breakup of the single currency system becomes more likely, we believe that investors will look at German euro bonds as a hedge against the

currency risk that occurs with the reintroduction of legacy currencies. If German yields fall, it may also lower U.S. rates as well.

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