Preparing for a Breakup in the European Monetary Union

A look at the rising risk of a Euro implosion

Executive Summary

> *"Politically, though, this unity also has the potential of brining about explosive disunity. During deep recessions, the single, one-size-fits-all monetary policy could pit national politicians against the European Central Bank as a feeling grows of national impotence in the face of rising unemployment. It is not improbable that one or more member countries might withdraw from the euro and reintroduce their national currencies at some stage during the currency's first decade."*
>
> Bill Emmott, *20:21 Vision*, Published 2003

> *"Anybody who still believes that a breakup of the Euro is impossible should at least re-examine this assumption with a skeptical eye. Experience shows that, in confrontations between politics and financial markets, events sometimes move from impossible to inevitable without ever passing through improbable."*
>
> *GaveKal Research*

The Eurozone's highly vaunted European Monetary Union (EMU)—the Euro—faces many key threats to its existence. Any one of many potential threats might alone do the trick, but currently there are **multiple threats to the existence of the EMU**; they are listed below:

- Fiscal
- Demographic
- Political
- Historical
- Financial

We can't say for sure that it's inevitable the EMU will disappear, but we can say with certainty the probability of a breakup is rising. This report examines each of the key threats in context so you can better understand the rising risks to the euro, and how to potentially profit from EMU demise.

Introduction

Despite significant concern being raised about the US dollar's world reserve currency status, and for good reason, we believe there are major structural changes taking place within the global economy. We call it global rebalancing. Some of these changes, we believe, will lead to many years of subpar growth in the major industrialized economies of the world. And this is threatening the status of the euro - to much greater degree than the US dollar and its reserve currency status. In fact, we believe the structural change in the global economy will lead to a relatively sustained period of risk aversion* which will ultimately lead to a surprising degree of support for the dollar. It is precisely this risk aversion that we believe is now exposing, and will continue to expose, the major underlying flaws within the European Monetary Union effectively representing the euro.

In other words, the current crisis in the global economy and the danger it represents for the future of the euro are finally being priced into the monetary system. For many years this has not been the case, which is typical of structural flaws building beneath the surface during good times. It's only when things turn bad, when the credit spigot is turned off and people stop making money do we see the inherent flaws that have been papered over. And in this upswing of the business cycle, which effectively began in mid-late 2000, the euro has benefitted mightily thanks to its fortunately timed introduction as a currency in January 1999.

Thus, we are now in the midst of the euro's first real test. So far the currency has weathered the storm, but there's blood in the water and sharks are circling.

One of our favorite economists, Milton Friedman, was never a fan of the euro or the idea of Europe ever being a good place for a common currency. In 1999, Mr. Friedman said the following:

> *"It seems to me that Europe, especially with the addition of more countries, is becoming ever-more susceptible to any asymmetric shock. Sooner or later, when the global economy hits a real bump, Europe's internal contradictions will tear it apart."*
>
> Milton Friedman

Well, the global economy has hit a real bump; it's been dubbed the credit crunch. We think the credit crunch has already begin to usher in multi-year structural changes to the global economy ... changes that will continue to threaten the euro in particular because they go right to the heart and soul of multi-nation economy– Germany.

The globe is in the process of rebalancing the excess production of the big trade surplus countries against the overconsumption of the big deficit countries. In short, those countries and regions where growth is primarily dependent on rising global demand for their exports will be hit the hardest. The world's consumers are permanently hiking up their savings rates instead of spending beyond their means. Germany is the engine of growth for Europe and the world's largest exporter. They are in the cross-hairs of global rebalancing. Europe's engine is sputtering and it's reverberating across the entire region ...

> June 12, 2009 (Bloomberg) -- **European industrial production dropped by the most on record in April as the worldwide recession ravaged demand for goods.**
>
> **Production in the euro region plunged 21.6 percent from a year earlier**, the most since the data series started in 1986, the European Union's statistics office in Luxembourg said today.

This is the asymmetric shock Milton Friedman warned us about many years ago—global rebalancing. It's enough to either completely tear apart the EMU or lead to substantial declines in the value of the euro against other world currencies, especially the US dollar.

From here we will examine:

- **The structure of the euro**
- **The real reasons why the euro was established**
- **The inherent contradictions of the system**
- **Rising market risks to the system**
- **Declining incentives for key countries to maintain euro membership**
- **A case study for potential exit by a key member of the Union**

To reiterate, an exit from the Union is a rising probability. And if one country leaves, we would expect one or two more others to jump ship. And that would likely represent a death blow to the European Monetary Union and the euro.

What are the probabilities of breakup? We don't know. We know only that the odds are growing. Perhaps you'll agree. So let's get started…

The Euro

The euro, as it stands now, is best summarized by the definition you can find at Wikipedia:

The euro (€) is the official currency of 16 of the 27 member states of the European Union (EU). The states, known collectively as the Eurozone, are Austria, Belgium, Cyprus, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Malta, the Netherlands, Portugal, Slovakia, Slovenia, and Spain. The currency is also used in a further five European countries, with and without formal agreements and is consequently used daily by some 327 million Europeans.[2] Over 175 million people worldwide use currencies which are pegged to the euro, including more than 150 million people in Africa.

The euro is the second largest reserve currency and the second most traded currency in the world after the U.S. dollar. As of November 2008 [update], with more than €751 billion in circulation, the euro is the currency with the highest combined value of cash in circulation in the world, having surpassed the U.S. dollar. Based on IMF estimates of 2008 GDP and purchasing power parity among the various currencies, the Eurozone is the second largest economy in the world.

The name euro was officially adopted on 16 December 1995. The euro was introduced to world financial markets as an accounting currency on 1 January 1999, replacing the former European Currency Unit (ECU) at a ratio of 1:1. Euro coins and banknotes entered circulation on 1 January 2002.

Source: The Economist

The members of the euro are governed by two major agreements: the 1992 Maastricht Treaty and Growth and Stability Pact, which defines the monetary and fiscal responsibilities criteria for membership as a way to ensure common fiscal discipline and overall price stability. These criteria include [source: Wikipedia]:

1. **Inflation rate**: No more than 1.5 percentage points higher than the average of the three best performing (lowest inflation) member states of the EU.

2. **Government finance**:

Annual government deficit:
The ratio of the annual **government deficit to gross domestic product (GDP) must not exceed 3%** at the end of the preceding fiscal year. If not, it is at least required to reach a level close to 3%. Only exceptional and temporary excesses would be granted for exceptional cases.

Government debt:
The ratio of gross **government debt to GDP must not exceed 60%** at the end of the preceding fiscal year. Even if the target cannot be achieved due to the specific conditions, the ratio must have sufficiently diminished and must be approaching the reference value at a satisfactory pace.

3. Exchange rate: Applicant countries should have joined the exchange-rate mechanism (ERM II) under the European Monetary System (EMS) for 2 consecutive years and should not have devaluated its currency during the period.

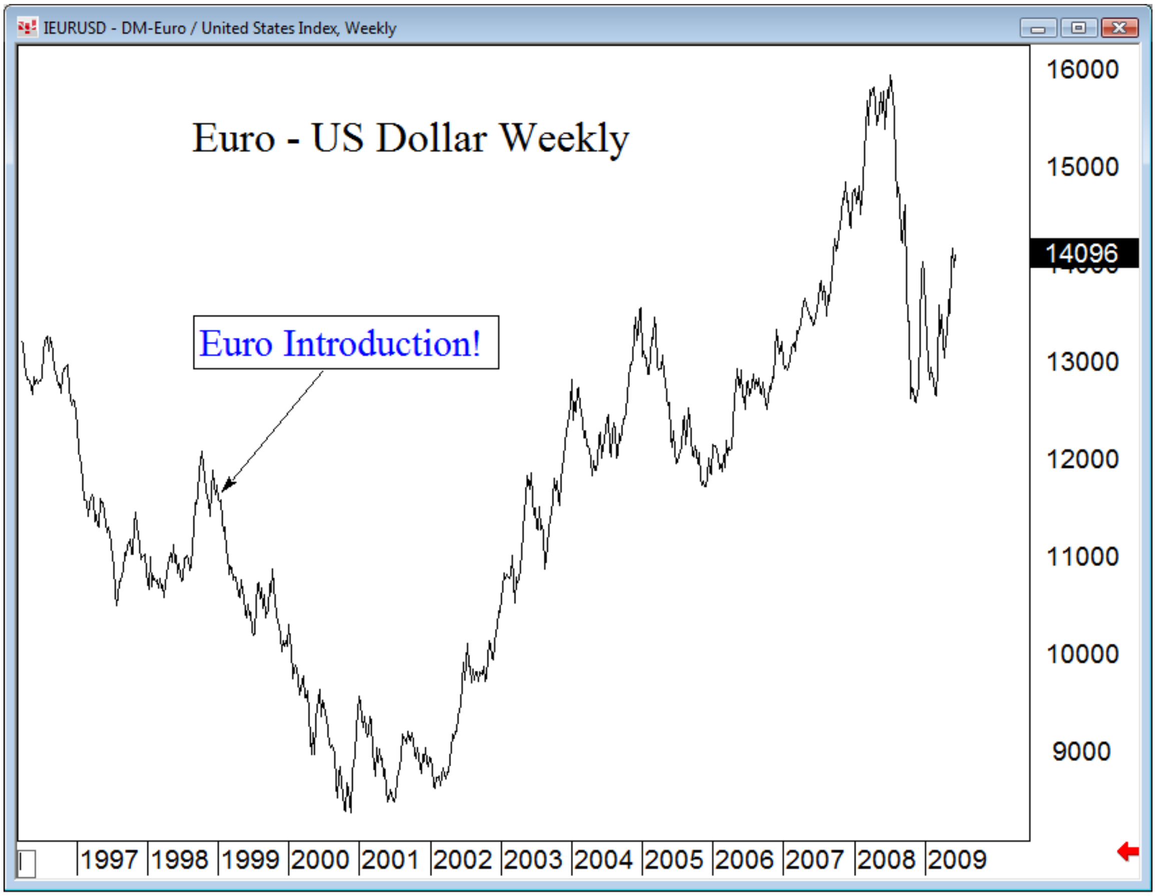
4. Long-term interest rates: The nominal long-term interest rate must not be more than two percentage points higher than in the three lowest inflation member states.

However, the European Union members do have wiggle room. This little exception has been added to the original criteria:

"The decision to declare a country in excessive deficit can now rely on certain parameters: the behaviour of the cyclically adjusted budget, the level of debt, the duration of the slow growth period and the possibility that the deficit is related to productivity-enhancing procedures."

And you can bet in the midst of this crisis, the Union is making many exceptions to keep everyone in the boat.

Below is a weekly chart of the Euro with its introduction back in December 1999 marked on the chart. The data prior to that time represents the price data for the German mark against the US dollar, as the German Mark was the anchor currency used for the establishment of the euro:



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Since introduction back in January 1999 the euro has traded in a wide range against the US dollar. It started out around $1.10 then fell to a low of approximately $0.84 in late 2000 (a 27% decline). It then rallied to a high of around $1.60 over the next seven and a half years, peaking in July 2008 (a 90% appreciation).

When you look at the massive rally in the euro from its low in 2000 relative to the dollar, it's easy to understand why many believe the euro is a real challenger for world reserve currency status. But most have never looked underneath the hood of the euro to examine its basic structure and reason for being. Let's do that now.

A Currency Union not Ready for Primetime

The euro was supposed to be a currency modeled around Germany's Deutsche mark and the European Central Bank (ECB), which administers EMU monetary policy and is supposed to look something like the German Bundesbank -- a model of conservatism and discipline, born from the agonizing history of past German hyperinflation; they vowed never again. Because Germany is the Big Dog in Europe, the richest and by far the strongest industrialized nation among the members, the euro would not have made it to fruition without Germany rubber stamping the development every step of the way.

There had to be major German incentives in place for Germany to abandon its currency, the D-mark. And there were. But the current shock to the global system, and its impact on the incentive systems throughout the Eurozone, tells us German incentives for EMU are waning fast. For some of the other key countries it's already more advantageous to leave the EMU than to stick around.

Before we get too far into that, let's first examine the inherent contradictions of the euro in light of the basic conditions necessary for a successful common currency.

Core requirements for success of any common currency:

1) Common culture and political unity
2) Synchronized business cycles
3) Harmonized fiscal discipline

The euro fails the test on all three counts to date. And the by the way, no common currency used by different countries that has lasted even a handful of years was ever based upon pure fiat currency, i.e. paper money. Those that did have staying power historically had a metallic backing—gold and/or silver.

The EMU is lacking in each of these areas:

1) **Common Culture and Political Unity.** Despite much power being shifted to Brussels and the Union, member countries to the EMU still retain a great deal of sovereignty in areas of financial regulation and ability to issue bonds, among a host of other non-financial areas. And because business cycles among members are not synchronized (the next topic below), countries will do what is best for them first, rather than the Union as a whole. National politics trump ties to the Union when push comes to shove. And because of the local sovereignty of each member, there is no single, cohesive, cross-border mechanism available to the European Central Bank (ECB) to handle a crisis when one arises.

   As financial pressure grows and rising unemployment leads to increasingly austere measures across the Eurozone; it has already sparked social unrest (Greece, France, and Ireland, for example). Here is how *The Independent* newspaper described the vicious riots in Greece in December 2008 [our emphasis]:

   > "After firing 4,600 tear-gas canisters in the past week, the Greek police have nearly exhausted their stock. As they seek emergency supplies from Israel and Germany, still the petrol bombs and stones of the protesters rain down, with clashes again outside parliament yesterday.
   >
   > "**Bringing together youths in their early twenties struggling to survive amid mass youth unemployment** and schoolchildren swotting for highly competitive university exams that may not ultimately help them in a treacherous jobs market, **the events of the past week could be called**

> **the first credit-crunch riots**. There have been smaller-scale sympathy attacks from Moscow to Copenhagen, and **economists say countries with similarly high youth unemployment problems such as Spain and Italy should prepare for unrest."**

Interesting terminology used by *The Independent*, the first "credit crunch riots."

The issues of individual country sovereignty are now front and center. Citizens look to local politicians to solve real problems associated with the inherent problems of the European Union, highly inflexible labor markets and concerns sparked by the credit crunch.

And recent news on the employment front isn't going to make your average protestor very happy: "The 16-country euro zone lost a record 1.22 million jobs in the first quarter of 2009, highlighting the depth of recession and boding ill for any quick turnaround," Reuters reported.

Increasingly the blame for the economic troubles of individual states, by both citizens and local politicians, is being cast at the edicts flowing from central power wielded in Brussels and the policies of the European Central Bank. Political pressure is growing, as evidenced by the recent European Union elections.

This was a summary of the 2009 European elections by Heritage Foundation – disillusionment within the EU:

> "This weekend's EU-wide elections for the 736-seat European Parliament generated the lowest turnout in the legislative body's 30-year electoral history.[1] Less than 43 percent of approximately 375 million eligible voters went to the polls.[2]
>
> "Despite the low turnout, center-right parties across Europe--especially in France, Germany, Spain, Italy, and Britain--were the biggest winners. The rise of fringe parties, including several extremist parties, was another notable trend. Overall, the European electorate sent a clear message of dissatisfaction with the European project and opposition to further European integration."
>
> Besides the many new states beyond the original core of Europe, added to the EMU in the past few years, many more Eastern European countries are rushing to be part of Union as the financial pressures from the credit crunch invade; these new countries want euro stability and monetary aid.
>
> Analysts suggest this is a sign of strength for the euro. But is it? How much more diverse financial, political and cultural baggage can EMU handle? Already there is a major concern new states will not abide by debt and federal budget requirements. And beyond that, how will the EMU ever achieve political unity with a myriad of new cultures and systems being introduced to the union? Short answer: they won't!

2) **Synchronized business cycles.** This is so critical because there is one central bank monetary policy for all of the members of the EMU. Thus, if country A is entering recession and country B is growing and experiencing inflation pressures, the monetary prescription is completely different for each of the two countries. Country A needs lower interest rates to spur growth and country B requires higher rates to cool off inflation. Despite some convergence of business cycles, there is still discrepancy. And because the euro is modeled after the German Bundesbank, and Germany is the engine of growth for the EMU, guess which country drives interest rate policy? That's right, Germany.

   One central bank effectively dictating policy for 16 different countries suggests to us an inherent flaw. Granted, globalization has led to more synchronized business cycles among all countries, but there will always be discrepancies. With so many differing situations, and the ECB effectively focusing on Germany's needs first and foremost, there are bound to be tensions. Up until very recently these tensions have been muffled. But no more. We are now – finally -- starting to see public bickering among the various ECB council members.

   Not surprising given the asymmetrical shock is upon us.

   The bickering is about how loose ECB policy should be going forward. The Germans want more austerity and conservatism (always afraid of stoking the flames of inflation), while others want more ease and liquidity as financial pressure build across the zone. In addition to an easier ECB, many states want increased aid from Germany.

   Before we go further here, it is important for us to emphasize that Germany has been more than happy to provide more than its share of subsidization to weaker states in the European Union. It is a quid pro quo -- Germany effectively controls monetary policy and the creation of the EMU gives German industrialists a captive common market to dominate. But now, as we told you in the introduction to this report, the game is changing and Germany is no longer receiving its benefit from the Union as demand for German goods plummets across the region.

   Juergen Stark, the Bundesbank's ECB Council member issued a public warning to the German government that bailouts of other weak EU Members would be a violation of European Union Law, specifically prohibition against monetary financing of government expenditure.

   These comments come on the heels of recent calls by Athanasios Orphanides of Cyprus (with deep connections to the U.S. Federal Reserve), George Provopoulos of the Greek central bank and Ewald Nowotny of Austria for near-zero interest rates and quantitative easing by the ECB. Bundesbank President and ECB Council member Axel Weber came down hard against both central bank purchases of assets from banks as well as against policy interest rates below 1%. This incident was reported this way: This is the first time in the history of the European Central Bank that its Council members are engaged in a major dispute over policy in wide open public view, as reported by Leto Research:

"One major problem with the proposal for the ECB to purchase bank assets not hitherto qualified to be held at a central bank's balance sheet is the fact that each Eurozone member country has its own national regulator who determines asset qualities and characteristics: a portfolio of loans by Greek banks does not have the same regulatory characteristics as a portfolio of loans by German banks. If the ECB were to purchase bank assets, what quality of assets would it be purchasing? The banks that need the most help are in poorly regulated countries and in countries with the largest exposures to Eastern Europe and Latin America. This means that Greece, Cyprus and Italy are likely to form an alliance on this issue with Austria, Sweden and Spain. That would constitute a strong voting bloc that Germany would have difficulty overruling.

"If Germany loses the vote, eventually, would it resign itself to subsidizing the prodigals or would it pull out?"

Criton Zoakos, Leto Research

As you can see, one size monetary policy does not fit all. Now, if each of the member states had their own currency, with the ability to adjust upward or downward to various economic conditions, there likely wouldn't be so many concerns about ECB policy now that things are tight. But they don't have that luxury **as they are stuck in the straightjacket known as the euro currency.**

Back to Milton Friedman; he long argued for the advantages of flexible exchange rates and pointed out that it was not available to members of the EMU.

Exchange rate fluctuations naturally offset inflation and productivity differentials with much less friction than adjustments in nominal wages and prices under fixed rates. The inflation and productivity differentials across the EMU vary widely. Thus a one-size fits all monetary policy, with the additional disadvantage of one inelastic currency to which all are anchored, means high-inflation and low-productivity countries bear a bigger brunt domestically when the business cycle turns down. As a result they have increasing incentives to leave the euro should an asymmetrical shock occur.

Below is a chart comparing the labor productivity among the southern tier states known as the PIGS -- Portugal, Italy, Greece, and Spain. They have always lagged behind Germany in terms of productivity and have always been the weak fiscal underbelly of the euro (next section).

But one of the publicized advantages of the euro before adoption was its ability to equalize labor productivity among the member states by allowing for the free flow of both capital and labor across borders. In fact, labor markets have remained rigid throughout Europe, and, other than some migration from Eastern European workers to Western Europe, labor mobility hasn't happened. This goes to the earlier point we made about culture, how people in Western Europe still maintain strong national identities and are mostly reluctant to move from their home countries.

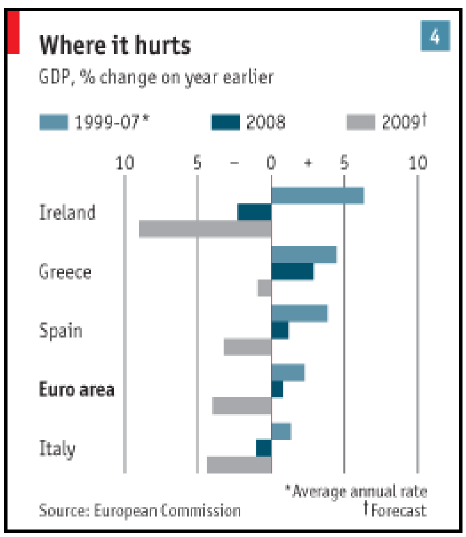
Table 1: 2007 Unit Labour Cost Index (2000=100)

Germany	98.4
Portugal*	**116.5**
Italy	**120.9**
Greece*	**113.9**
Spain	**122.7**
Denmark	122.9
Ireland	125.3
UK	119.3
Total Euro Area	111.4
Total EU	116.1
Brazil	97.5

*Notes: *2006. PIGS countries in bold. Source: http://stats.oecd.org/*

Source: Absolute Return Partners

At some point, because there is no currency to adjust for these productivity disparities, the adjustment must come from a cut in nominal wages and significant austerity. This is politically dangerous with the rising social unrest across the Eurozone, as discussed earlier in this report. Of course the other means of escape from this problem is for the PIGS to grow themselves out of it. But, given the sharp decline in exports globally which we believe will be a long-term structural reality, growing out of this situation seems hardly an option. The GDP plunge is depicted in the chart below:



Source: *The Economist*

Thus, the incentive for these countries to remain with the euro is declining dramatically; the euro leaves them bound in an economic straightjacket.

3) **Harmonize fiscal positions**. Despite treaty obligations and plenty of money distributed to the fiscally challenged countries affectionately known as the PIGS (Portugal, Italy, Greece, and Spain), there has never been fiscal harmonization. And in the midst of the very nasty downturn in the business cycle, the fiscal position of the PIGS is deteriorating rapidly and now represents the biggest single threat to the EMU.

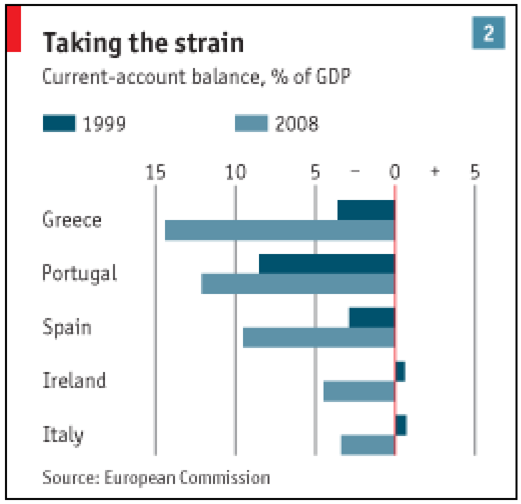
> *"Past experience therefore tends to suggest that asymmetric fiscal problems—often, but not necessarily generated by war—quickly cause monetary unions between politically independent states to dissolve. In the case of present-day Europe, it seems quite possible that the strains caused by unaffordable social security and pension systems could have a similar centrifugal effect: the Hasburg scenario, with welfare substituting for war as the fatal solvent."*
>
> Niall Ferguson, Cash Nexus

Welfare state guarantees coupled with a rising demographic pension nightmare for several key EMU countries is the ticking time bomb to a euro breakup. This is precisely why we are seeing the bickering among member states within the European Central Bank for the first time in history; the fiscally weak states within the EMU, and those with massive exposure to the rising banking crisis (Austria in particular) within the Eurozone are in desperate need of liquidity; they have no other way out.

> *"The fact remains that history offers few examples of democratically agreed budget adjustments on the scale necessary in certain European between sovereign states disintegrating when the exigencies of national fiscal policy became incompatible with the constraint imposed by a single international currency."*
>
> Niall Ferguson, *Cash Nexus*

What's interesting to keep in mind is the fact that the PIGS were given ample opportunity to get their fiscal house in order. As part of the prize for initial entry into the EMU the PIGS were able to issue government bonds, denominated in euro, at about the same interest rate as Germany. Think of that: these fiscal basket-cases borrowing at German rates simply because of the EMU backing. This provided a massive tailwind of liquidity for many countries—part and parcel to the powerful last upswing in the cycle. Designed this way in order to buy time for the PIGS to use these funds to reform, but they didn't.

The budget of the PIGS is expected to well exceed the 3% of GDP Maastricht Treaty requirement for EMU membership. And now the "emergency wiggle room" provided by the Union will come into play. The current account deficit for these countries is soaring, with Greece leading the charge approaching a whopping 15% of GDP!



Source: The Economist

Adding to the budget and current account strain is the demographic nightmare. Demographically, Europe is in bad shape. They are aging and not replacing themselves. This means fewer working age population of these major welfares states are supporting a growing amount of retirees. It is a pension liability nightmare. Take a look at the numbers:

Table 2: Actual Debt & Age Related Contingent Liabilities

	Debt in 2007 % of GDP	Debt in 2050 (unchanged policies) % of GDP
Germany	65.1	49.2
France	63.9	233.7
Italy	104.1	130.5
Spain	36.2	70.5
Netherlands	45.7	182.4
Belgium	83.9	142.8
Austria	59.5	46.1
Greece	94.8	554.6
Ireland	24.8	140.3
Finland	35.1	-59.1
Portugal	63.6	210.6
Eurozone	**66.3**	**131.8**

Source: Goldman Sachs, European Weekly, 22/01/2009

Source: Absolute Return Partners

Greece contingent liabilities at a whopping 554% of GDP by 2050! Yikes! What is required to solve this growing problem? Stringent fiscal discipline and austerity measures are required. Not something these countries are politically predisposed to do in the midst of this nasty downturn.

Given this backdrop of fiscal turmoil, it should be no surprise to learn that finally the market is pricing in risk to the sovereign bonds of these countries relative to Germany. At the moment, the risk priced in still doesn't reflect what these countries would pay to borrow on the international market if they weren't part of the euro, but it is an interesting and, we think, ominous development for the EMU. It means for the first time since introduction the market is telling us the risk of a breakup is rising. And given the incredible fiscal exposure of these countries, the rising political risk and the incredible exposure of the entire Eurozone banking systems, we expect spreads to widen further as more players begin to understand the incredible exposure taken on by the banks.

Banking exposure is the icing on the cake

Besides creating a captive common market for German exports and industrialists, the other dirty little secret of the EMU is that it was designed to enrich the powerful banking interests across the European continent. Banking is one area where Europe can compete with the rest of the world. So it should be no surprised this was one of the objectives of EMU. And those objectives seem to have been achieved. But you know what they say, be careful what you wish for.

Eurozone bank-controlled assets since inception of the euro grew three-and-a-half times faster than GDP. Extremely aggressive lending at low rates because of the euro itself, and the corresponding backdrop of massive global liquidity added to this disparity in banking growth. And the market is just beginning to realize how incredibly exposed the Eurozone banking system has become to this crisis.

To understand why the Eurozone banking system became so incredibly exposed during this cycle, which we will get to the ugly numbers in a second, you must fist keep in mind that the business cycle upswing from 200-2007, coinciding nicely with the euro introduction as a currency, was the perfect storm of liquidity we have never witnessed before. And we likely never will again in this lifetime given the expected change in the global regulatory environment, sentiment toward debt and expected return to the virtues of savings.

The perfect storm of credit started in 2000 when the Nasdaq tech bubble burst and China began pouring massive amounts of low priced goods onto the market. This sparked concern about the potential for global deflation among the major central banks. Thus it led to the emergency 1% Fed Funds Rate in the US, while the ECB cut rates to around 1.5% and the Bank of Japan held rates near 0.25% (being already in deflation at the time). The world's three major central banks were pumping out liquidity all across the globe. Credit was virtually free and the world's banks responded by taking this raw material from the Federal Reserve, ECB and Bank of Japan and creating a massive amount of fresh new lending and a colossal amount of derivatives -- trillions and trillions of dollars worth. And remember, this was also the time when the countries of Europe were able to borrow at Bundesbank-level interest rates—providing even more liquidity and lending "opportunities" for Eurozone banks.

Now, with the credit crunch inflicting its blow, we are left to examine the gaffe that is Eurozone banking:

1) Banking liabilities as a percentage of Gross Domestic Product (GDP)

- US bank liabilities about 69% of GDP
- British bank liabilities about 213% of GDB
- **Eurozone bank liabilities about 335% of GDP** [proves the point of the relative size and importance of banking across the Eurozone relative to other industrialized regions]

2) **Eurozone banks have $7.7 trillion of toxic asset exposure!**

"As of February 2009, the Eurozone banking system had $**7.7 trillion of toxic assets** ... well beyond the scope of any bailout pledge and beyond the ability to quantitatively ease away.

- $1.6 trillion to Eastern Europe
- $2 trillion to other export-driven emerging economies
- $4.1 trillion to Eurozone's own endangered PIGS—plus Ireland and France."

Leto Research

[Note: Eurozone emerging market banking exposure is $3.6 trillion; the US banking exposure to emerging markets was about $425 billion for comparison. It again points to the fact that Eurozone banking was a growth industry for the continent.]

3) The Europe Commission has estimated the Eurozone banking exposure at an incredible £14 trillion, or about $20 trillion dollars. And the weakest link of this exposure is in Eastern Europe, a place ripe for sovereign default.

Anatole Kaletsky financial columnist for The Times [UK] summed it up very well recently in a piece titled, "Europe waits for Germany to come to the rescue," here is an excerpt:

> "That continental Europe — and Germany, in particular — has suffered far worse from the credit crunch than the US or Britain should come as no surprise. I have described repeatedly the three interacting elements now hitting Europe in a "perfect storm".
>
> "The first element is Germany's dependence on exports, especially of capital goods, cars and other consumer durables. The vaunted strength of Germany's export industries has turned out to be its Achilles' heel, at a time of contracting global demand. To make matters worse, the mercantilist assumption in Germany that exports are somehow more virtuous than housebuilding or domestic consumption has left it entirely dependent on cycles of consumption and housing in other countries, while making German politicians unwilling to stimulate their own domestic demand.

"The second element of the perfect storm has been the reckless lending to Central Europe and the Baltic States, especially by banks based in Austria, Sweden, Greece and Italy, which in turn have been large borrowers from German investors and banks. Countries such as Latvia, Estonia, Hungary and Romania have been borrowing between 10 and 20per cent of their national incomes each year — largely in euros and Swiss francs, rather than their local currencies. As a result, their businesses and homeowners will suffer a tsunami of bankruptcies if their currencies ever fall. Eastern European governments are, therefore, desperate to avoid devaluations. But the actions they take to "protect" their currencies — for example, cutting public sector wages — only deepen their recessions and magnify the mortgage defaults.

"The third component of the economic hurricane is the euro itself. In its first decade of existence, the euro contributed to continental Europe's growth by allowing Spain, Greece, Portugal, Ireland and Denmark to run enormous current account deficits and enjoy housing and mortgage booms far more extreme than anything seen in Britain or the US. These booms provided markets for Germany's production of cars and other consumer goods. In the past few months, however, the single currency has changed from a stabilising factor into a new source of vulnerability for members of the eurozone. The reason is that eurozone governments are no longer risk-free "sovereign credits", like the governments of the US or Britain, or smaller countries, such as Switzerland, Australia or New Zealand. A government that borrows in its own currency will never default because, in extremis, it can always instruct its central bank to print money to pay its debts. But governments in the eurozone cannot do this. They are in the same position as US state governments or as Argentina, Indonesia and Russia when they borrowed in dollars.

"The default risks are particularly serious for governments that are deeply embroiled in the banking crisis. In Ireland, Greece and Spain, governments have been forced to guarantee banks whose liabilities are greater than the entire state budget. In Austria, Greece and Italy, financial risks have been magnified by bank exposure to Central Europe, which in the case of Austria is equivalent to 70 per cent of GDP.

"Now consider how the three elements of this perfect storm have begun to converge. The plunge in the German economy has devastated the manufacturing industries and wage remittances in Central Europe, with output in several countries falling at annualised rates of up to 40per cent, never before witnessed in any capitalist economy.

"The economic collapse in Central Europe almost surely implies a tidal wave of loan defaults. These, in turn, will wreak havoc in the European banking system and could raise the possibility of sovereign defaults in Greece, Austria, Ireland and other eurozone countries. Finally, efforts by governments to maintain their credit ratings and to control deficits by slashing wages and imposing other deflationary measures will push down house prices and the ability of local borrowers to service their debts, a process that is already alarmingly visible in Ireland. The

> ultimate result is that the European economy will be caught in a 1930s-style deflationary spiral of deteriorating credit, deflationary government policies, falling wages and even further declines in credit."

The risks of default are rising. Latvia, a small country in Eastern Europe, but one that was riding high on western bank loans during the boom, is on the edge of devaluing its currency relative to the euro in order to avoid draconian austerity measures and sovereign bankruptcy. Swedish banks were big lenders to Latvia, and this latest news is hitting Swedish banks very hard. This we believe is the canary in the coal mine for many of the Eastern and Central European countries that relied so heavily on western lending that has dried up.

The ECB has made available emergency lending to try to stem this crisis, as they understand the danger and possible domino-effect across the region.

But what the ECB will not be able to contend with is the reality of one of the core EMU countries deciding they want to leave the EMU—and most have handicapped Italy as the first country that may decide to say goodbye.

And Italian Divorce from the Euro

> *"The problem is that, in a world of floating exchange rates, as Italy was before the euro, if one country is subjected to a shock which requires it to cut wages, it cannot do so with a modern kind of control and regulation system. It is much easier to do it by letting the exchange rate change. Only one price has to change, instead of many."*
>
> Milton Friedman

It's believed the no-breakup clause members of the EMU signed is enough to keep them in Union. But others argue differently. Here is a look at why Italy is the top candidate among the original core members to run and why it now makes increasingly good sense for Italy to do so.

This information comes via GaveKal research in a book titled, *The End is Not Nigh*, back in early 2007.

> "…the charge that the euro is responsible for Italy's economic problem is superficially quite easy to sustain (even if it's not actually true.). Until 1997, when the socialist government (led by Prodi) took Italy into the euro, Italy was the fastest growing major economy in Europe, consistently outperforming both Germany and France. Since 1998 it has lagged in every single year behind France and in all but two years behind Germany.
>
> "…Interestingly, if Italy left the euro, the government's long-term bonds would continue to pay the present interest rate of just 3.5%, but now in lira instead of euros. Italy's liabilities would be converted from a strong currency over which it had no control, into a weak currency which it can print at will without any cost to the government or compensating payments to creditors.

> This may seem unfair and even fraudulent, but such are the prerogatives of sovereign governments—legal opinion and historical precedent are both quite clear on this point.
>
> "…Now imagine that the Italian government managed to fix all of its debts for 10 years at 3.5%. It would then face an almost irresistible temptation to ditch the euro. For that long-term rates on the 'New Lira' shot up to 10% immediately after devaluation. The market value of the government's 3.5% debt would instantly be reduced to just 59 cents on the dollar. The market value of Italy's government debt would fall instantly to a manageable 70% of GDP and Italy's fiscal problems would be solved at a stroke.
>
> "…In sum, the potential benefits of existing the euro are quite substantial—and the direct costs may well be smaller than generally believed."

There are at least two other countries in the same boat as Italy—Greece and Spain. And you can bet if one country were to run, the others would likely follow. It would be the end of EMU as we know it.

We leave you with one last quote and one basic idea for the average investor to utilize as the euro is held to the fire. The quote comes from Criton Zoakos, a man who has an incredible depth and understanding of global macro economics and history, and is a true independent thinker -- all characteristics we worship at Black Swan Capital.

He recently wrote:

> *"The Eurozone will thus continue to drift in ad hoc policy responses, moving from one piecemeal bailout to the next, from one piecemeal tax revenue hike to the next, from one anti-popular austerity measure to the next. Piecemeal 'death-by-a-thousand-cuts' is what lies ahead for the Eurozone economy—until drastic political changes topple the decision-making mechanism of the modern European Union and replace it with something else."*

We think that "something else" is inching closer by the day.

A Target for the Euro

If the EMU were to breakup, it would be catastrophic for the euro, obviously. But if breakup doesn't occur, if all the attendant risk of breakup and the associated financial chaos fears begin to feed into the value of the currency, as we suspect they will, our initial target (guesstimate) would be for the euro to trade at parity with the US dollar—at least. Working off that scenario, it represents a --39% decline in the value of the euro from its current level of $1.39 to the US dollar. That we believe is a conservative number given the potential. If you notice in the daily chart below which shows the parity level, this is still well above the prior low of $0.8400 which is when the last major bear market cycle in the dollar began.

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How do you make this play?

There are several different ways:

1) **ETF's** - You can sell short a euro currency exchange traded fund (FXE). Or you can buy the UltraShort euro currency exchange traded fund (EUO), which gives you double leverage.

2) **Spot forex or Futures** – Because you want staying power in this trade for several months, you can use spot forex or currency futures on a low-leveraged basis. You want to keep your leverage small on a trade like this so you can "let the trade breathe," i.e. allow for backing and filling with wide stop-loss levels.

3) **Options** - The International Securities Exchange (ISE) FX Options represent one of the best single ways for an average investor to play for an intermediate- to long-tem decline in the value of the euro against the US dollar. You can buy an option on the euro going out as far as 10-months, or

anytime in between you choose. As an options buyer it limits your risk profile i.e. as a buyer of an option you can lose your entire premium, plus commissions, but no more. There are lots of strike prices to choose from and these options can be traded in a standard equity brokerage account where you currently trade stock options—it is an equity index product.

The one wrinkle that most people familiar with foreign exchange must deal with is the quoting convention used by the ISE. Below is a list of the ISE exchange traded options, quoting conventions and root symbols in order to see the options chain.

Currency	Convention	Symbol
Australian dollar	**USD/AUD**	**AUX**
British pound	**USD/GBP**	**BPX**
Canadian dollar	**USD/CAD**	**CDD**
Euro	**USD/EUR**	**EUI**
Swiss franc	**USD/CHF**	**SFC**
Japanese yen	**USD/JPY**	**YUK**

The symbol for the euro is EUI. But notice this represents USD to the Euro? That means from a charting perspective, it is opposite of what you would normally see. So, if you expect the euro to decline in value against the US dollar (same as saying the US dollar to appreciate in value against the euro), then using the ISE product you would want to buy a EUI (USD/EUR) call option. In effect, the chart of EUR/USD above needs to be reversed to USD/EUR, here is the chart below:

Source: CQG, Inc. © 2009 All rights reserved worldwide. www.cqg.com Thu Jun 18 2009 05:19:57

For example purposes only, let's say you were to buy a March 2010 80 call on EUI (USD/EUR) i.e. you expected the US dollar to increase in value relative to the euro. Assuming you paid 3.00 for that call option, each option cost you $300, not including commissions. Now Mach 2010 rolls around and the euro does go to parity against the US dollar. Under that scenario, the intrinsic value of your call would be 20 (100 – 80 strike) or $2,000. Thus, your profit on each call option purchased for $300 would be $1,700, which would represent a return on investment of 567%.

That shows you the power of leverage that one can get through options. Of course, there is never any guarantee you will see these kinds of returns, but if we do see an implosion in the value of the euro that exceeds our estimates, the example above will look quite conservative.