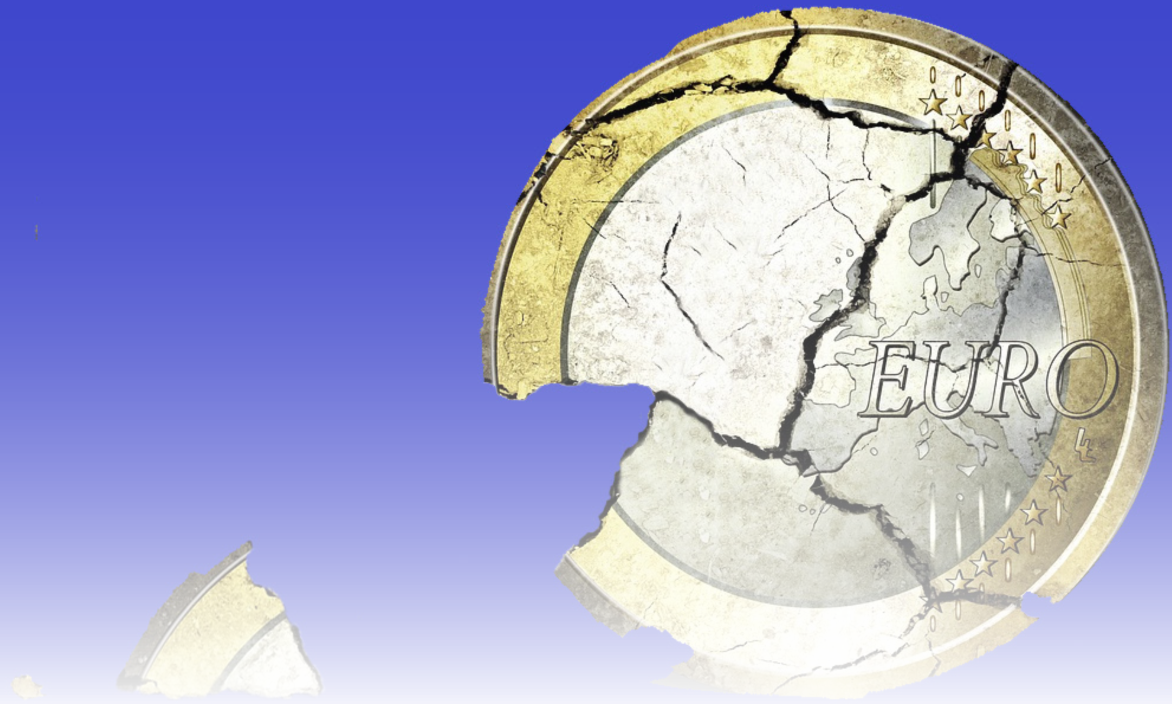


Euro notes and coins began circulating in 2002.

Innealta
CAPITAL

Contact us:
consulting@innealtacapital.com
855.994.2326
innealtacapital.com

THE EURO
WILL IT SURVIVE?

KEY TAKEAWAYS

1. The stability of the euro has been at risk since 2009, when many eurozone countries started to experience, among other negative events, sovereign-debt crises.

2. The euro area has since survived through bailouts and cheap money from the European Central Bank.

3. Further integration, which could strengthen the euro, looks unlikely -not to say impossible- at this time.

4. The shock of brexit, after years where no one expected a country to withdraw from the EU, should make investors question their faith in the future of the common currency.

5. Investors with allocations to eurozone countries should be aware of the potentially catastrophic losses associated to a collapse of the euro area, and be mindful of those when making asset allocation decisions.

European integration has been a lengthy process, one that started only a few years after the end of World War II and continues to this day. For many casual observers, it is regarded as a unidirectional process that will slowly but surely end up with a supranational government, akin to the "United States of Europe" Winston Churchill once famously called for. However, a closer look at integration efforts during the last three decades yields a very different picture. Further integration, at both the political and economic level, has suffered severe setbacks. Most of the times, voters themselves have stalled progress (Brexit being the most prominent example). The bedrock of economic integration, the euro, has been shaken more than once by crises in different countries. Calls for withdrawal are now louder than ever, even if they do not enjoy majority support yet. The common currency stands on shaky ground, and it is very likely that the euro area, as we know it now, will cease to exist within the next decade. This will, obviously, increase volatility in the region (in turn providing opportunities to savvy investors). The fact that the eurozone is not a fiscal union —like the U.S.— will constitute another hurdle for the common currency. We believe the dream of a European Union like the one the 50 American states have in place is pure utopia.

The beginning

The political and economic integration of Europe is an ongoing process that can be traced back to 1949, with the creation of the Council of Europe (still in place). The first major step towards what we now know as the EU was taken in 1957, when the Treaty of Rome laid the ground for the **European Economic Community** that started operating the next year. The founding members were (West) Germany, France, Italy, Belgium, the Netherlands, and Luxembourg. This organization would expand, until it became the European Union in 1993. It has continued growing since then, currently listing 28 member states.

Economic integration

The **European Union** is a political and economic union. Being a member requires certain requirements to be met in both the political and economic arenas. We will not discuss political integration —e.g., foreign policy, defense— in this paper. In terms of economic integration, the most salient feature of it is the **single market**, which guarantees the so-called "four freedoms:" free movement of goods, capital, services, and labor (i.e., citizens are allowed to settle and work anywhere within the EU). Only the 28 members of the EU fully participate in the single market.[1]

The **European Union Customs Union** includes all EU members, as well (plus a few other countries, most notably Turkey). This agreement precedes the EU, being a main feature of the European Economic Community. It is relevant because member states cannot negotiate international trade policy —including free-trade agreements— individually, handing over the responsibility to the European Commission to conduct trade policy on behalf of the bloc. Obviously, a customs union cannot work if goods pay different levies in different countries.

Much of the recent discussion about how to implement **Brexit** —the departure of the UK from the EU, the first member state to request it— revolves around trade policy. The UK would like to negotiate trade deals on its own, and, at the same time, remain in the single market. This has been completely ruled out by the EU. The UK is still trying

[1] Four other countries participate in most aspects of it. This forces them to comply with all EU rules regarding those areas. These countries are Norway, Iceland, Liechtenstein, and Switzerland.

to find a way to remain a part of the market in some way, centering its efforts in finding a formula that will preserve some form of customs union. So far, the EU has dismissed the UK government's proposals. The EU negotiators have repeatedly stated that countries cannot pick amongst the "four freedoms." It is reasonable to believe the UK would be willing to keep the first three, but definitely not the fourth, regarding the free movement of EU citizens.

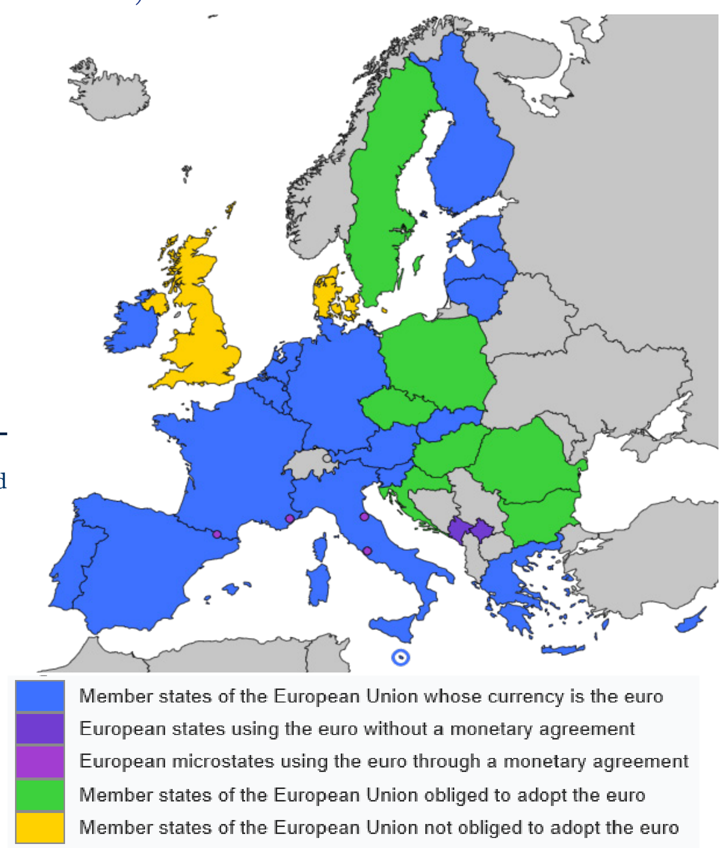
The euro

A step further in terms of economic integration is the **monetary union**, that is, the adoption of a common currency. The euro was launched in 1999, and notes and coins were available in January of 2002. However, the common currency only applies to a subset of members —currently, 19 out of 28. Joining the euro is mandatory for members once they meet the requirements —which many of the economically weaker members currently do not (six of them, to be precise). Yet Denmark and the UK were given an opt-out, with the former rejecting the common currency in a 2000 referendum. Another country that could join is Sweden, which found a clever way to avoid adopting the euro: one of the requirements to be in the euro is being part of the **European Exchange Rate Mechanism system**,[2] so the Swedes have decided not to join it, therefore bypassing the mandate to join the euro area. The remaining six countries are expected to adopt the euro at some point in the future, but that will take years. (These are Poland, Czech Republic, Hungary, Romania, Bulgaria, and Croatia.)

Figure 1

THE EUROPEAN UNION AND THE EURO AREA ARE NOT THE SAME: ONLY 19 OF THE 28 EU MEMBERS CURRENTLY USE THE EURO.

Map created by Marcin Floryan. Used with permission.



The benefits of the euro are a matter of contested debate. For weaker members, the common currency helped, at least, to stabilize and lower inflation (partly because it was a requirement to join the eurozone, and afterwards because

[2] The ERM, established by the European Economic Community in 1979, had the goal of reducing exchange-rate variability by semi-pegging currencies to a common unit. Semi-pegging means currencies were allowed to fluctuate within a range. The common unit was a first step towards the euro.

those countries started using a stronger currency). Furthermore, the common currency should also help to lower debt levels: being in the eurozone carries limits to budget deficits (3% of GDP) and government debt (60% of GDP). However, whether this is good or bad is itself subject to debate, given that it does not allow governments with high levels of debt to use fiscal policy as they might want to in times of economic contraction, making matters worse. This is the debate around austerity measures that has lingered for many years in countries like Greece, Spain, Italy, the UK, and others. Moreover, enforcement has not been strict. Italy's government, for example, has a debt of approximately 130% of GDP.

Another benefit that weaker economies enjoyed was the reduced cost of borrowing money. Spain, for example, saw rates on its debt plunge to a third of what they were in the 1990s only a few years after the euro began circulating. The risk premium over German bonds was reduced drastically. Other benefits include reduced transaction costs and risks (e.g., exchange-rate costs and risks), and more transparency, all of which have been a boon to trade. Capitals started flowing to the relatively poorer countries once the euro became the common currency. Spain and Greece are two states that benefited immensely from this. However, some economists have argued this helped to create bubbles, like the real-estate bubble that brought Spain's economy to the brink of collapse (they had to bail out banks). The case of Greece is well known, with a recession so deep that it turned into a depression. The economy has not, to this day, fully recovered. GDP per capita is still far below 2008 levels.

Another minus of a common currency is that each country loses monetary-policy independence. That might translate into discipline, but at the same time prevents different monetary approaches across countries when they are needed. After the sovereign-debt crisis that followed the financial crisis, countries like Greece would have probably benefited enormously from allowing their currencies to depreciate substantially. This would have made those economies more competitive (increasing exports) and flexible in the new scenario, without the swell in unemployment levels and the contraction in economic output that they experienced. In the Greek case, things were so bad that many investors were worried the country would be forced out of the euro area. The concern now is that they may never be able to repay their debts. More generally, the terms of trade become less flexible with a common currency. If each country had its own free-floating currency, the German mark would have appreciated in the post-crisis years. The euro has prevented this, and this is usually cited as one reason for Germany's big current-account surpluses. Actually, Germany has had the highest surplus in the last two years ($287 billion, almost 8% of GDP, in 2017).

Additionally, these countries could have used more reflationary policies than those followed by the European Central Bank (ECB). Only in 2015 did the bank adopt an aggressive quantitative-easing program, coupled with already existing zero rates, to help embattled countries recover. All of these disadvantages have led Nobel-laureate economist Paul Krugman to label the euro a "disastrous decision."

How strong is the Union?

Outside of Europe, the integration process was seen for a long time as unstoppable. With time, more countries would be added to the EU and the euro area, and more issues would be dealt with at a supranational level. Just as southern Europe had joined in the past, so would central and eastern Europe at some point, including many former Soviet republics. Even Turkey was mentioned as a potential future member, not least because of the latter's own interest. However, this level of progress has not materialized.

The Brexit vote sounded the alarm in 2016 for many U.S. investors. They started to wonder whether the union itself was going to hold. The annexation of Crimea in 2014 had presented an earlier warning, but markets seemed less concerned when that event unfolded. However, international observers have been asking the same question long before the 2016 vote in the U.K. People in Europe, when given the chance to vote, have rejected different forms of further integration since, at least, the 1990s. Support for European institutions has been the minority's position in various referenda. Amongst them we can cite:

- Switzerland rejected becoming a member of the European Economic Area (EEA) in 1992;
- Denmark and Sweden voted against joining the euro in 2000 and 2003, respectively;
- French and Dutch voters said no to the European Constitution project in 2005, effectively killing it.
- Norway voted against joining the European Communities (EU precursor) in 1973 and the EU proper in 1995.

The debt crisis that affected Greece, Portugal, Ireland, Spain, and Cyprus at different points after the global financial crisis of 2008 has done major damage to integration. In many countries we can find important political parties calling to leave the euro (even in Germany). If people had a vote, the outcome would be hard to predict. Many in northern Europe believe they have bailed out other countries that irresponsibly managed their economic affairs, spending more than what they had. At the same time, many people in the less-developed countries think the euro has mostly benefited Germany, the main exporter to countries outside of the EU, by allowing it to keep a devaluated currency relative to where the old Deutsche Mark would be —enjoying a fixed exchange rate within the euro area.

However, the euro and the EU should be analyzed separately. Beyond the euro, we believe people in all EU countries —with exception of the UK, of course— would still vote to remain in the union, if asked. Nevertheless, it is worrying that European institutions are now so distrusted by large swaths of the population, meaning the tide of public opinion could very well change in the future. This is partly a consequence of the debt crises in many member states. Austerity policies, seen by many as imposed by Germany, have angered many EU citizens and political leaders. Moreover, the 2015 refugee crisis inflicted further damage. The latter was used as a main argument for the Leave campaign in the UK, and has fueled the prospects of its critics, some of which have won power at the national level (e.g., Italy and Hungary).

The euro, on the other hand, presents a much darker outlook. A couple of questions help to sum up our view. What if instead of bailing out Greece, a larger economy, like Italy or Spain, had needed those levels of assistance? What if that were to happen now? Would the voters be willing to rescue another country, at a much higher cost? What could the ECB do, if it has already set interest rates at zero, and embarked on an asset-buying program even larger (as a percentage of GDP) than the one undertaken by the Fed? We summarize our view in the conclusions.

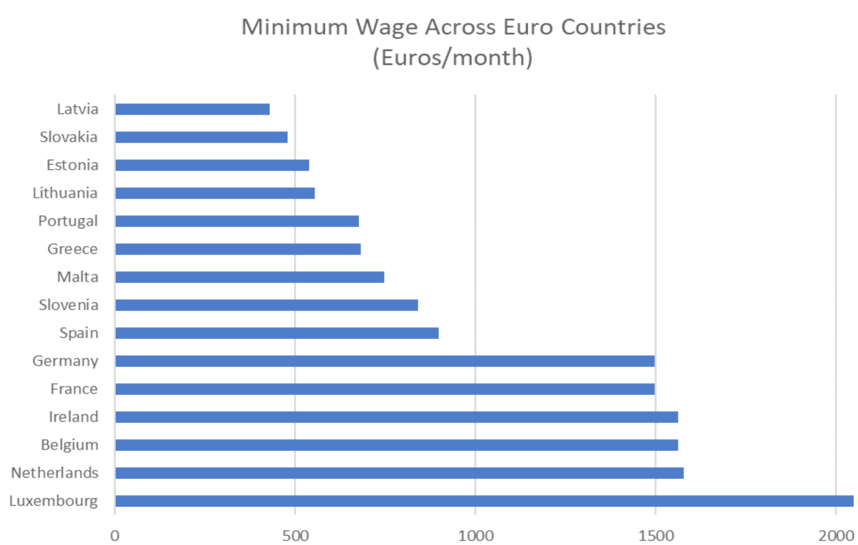
What would a breakup of the eurozone entail?

There are many variables at play to try to make a succinct prediction of such an outcome. A good starting point is to think of currencies themselves. If each country were left with its own currency, with them starting at a 1:1 exchange rate, which is what the euro does today, what would happen? Clearly, the 1:1 exchange rate would not last very long. Many variables play a role in the determination of exchange rates. For example, current-account balances, debt levels, interest rates, inflation rates, economic growth, gap between actual and potential output, political risk, all of them matter. Yet we can safely make a few predictions. Germany's currency would appreciate relative to the rest. Its savings levels, trade surpluses, and political stability would all push the value of the currency up. Countries in the south, with high levels of unemployment and weaker fiscal positions, would very likely see their currencies depreciate relative to the current euro. In this group we could count, at least, Greece, Cyprus, Italy, Spain, and Portugal. Other northern countries (Finland, the Netherlands, Luxembourg, Belgium, Austria) should probably also see an appreciation. France would more likely than not also join this group. Even sharing the same currency, the cost of living and wages vary wildly as one moves across the euro area. Figure 2 compares minimum wages for 15 countries.

Figure 2

TO ILLUSTRATE DIFFERENCES IN LABOR COSTS, WE CAN LOOK AT THE MINIMUM WAGE ACROSS EUROZONE COUNTRIES.

Source: Innealta Capital, using data from the European Commission. Austria, Cyprus, Finland, and Italy do not have a minimum wage.



This means the weaker economies would become more competitive in international markets: they would export more and they would attract more tourists. However, these same economies would see their yields increase, even skyrocket (Greece, maybe Italy). There would be no winners in the short run, that is for sure. The levels of uncertainty would create tremendous volatility, investors would be scared, and a sell-off would ensue. Investors would incur further losses in those markets where currencies lost value against the dollar. The single market would not be as great as it now for trade if every country went back to its own currency. The banking sector would also suffer, with each country going back to its own set of rules, and the added frictions that different currencies would impose.

Conclusion

When looking at Europe, it is necessary to distinguish between the European Union and the euro. The common currency is one of the main features of integration, of course, but the EU preceded the euro, and it comprises more countries. It is perfectly possible to have an EU without the euro. This was exactly the status quo until 1999. Our outlook on the prospects of the euro area is dim. First, the eurozone was close to breaking apart after the sovereign-debt crises that affected many members in the aftermath of the global financial crisis. The EU was able to bail out Greece, but a bigger economy, like Spain, would have been a much bigger challenge. These days, the problems come from Italy, an even worse problem than Spain would have been. Italy is the third-largest economy in the euro area, with more than twice the levels of public debt required to be part of the common currency. What would happen if Italy defaulted? To add more fuel to the fire, the EU has rejected the Italian government's recent budget, which will create even more tensions. The tugging between Brussels and Italy will continue in the future, that is guaranteed.

Moreover, the fact that the euro area is not a fiscal union — with a common budget and harmonized tax policy— will make sustaining the common currency in the future much harder. However, there is absolutely no path for a fiscal union. Voters from richer countries would surely reject it. Voters in Denmark have already refused to even join the euro, and people in Sweden are also opposed. Further political integration, also required to provide more support to the euro, is looked with suspicion almost everywhere. Voters in France and the Netherlands rejected the common constitution in 2005, before the financial crisis. It is certain that those levels of rejection would be substantially higher today. The refugee crisis has also contributed greatly to increasing levels of distrust towards Brussels.

All of these factors will continue to put pressure on the monetary union. It is more likely than not that within a decade the eurozone will look very different than it does now, probably with fewer members, if any. It may be hard to imagine a country leaving, just as it was hard to imagine a country leaving the EU until Brexit happened. Political volatility in the continent is increasing fast, casting doubt over a series of institutions that have been taken for granted for a long time. The "United States of Europe" is, currently, just a pipe dream. Thus, investors with allocations to eurozone countries should be aware of the potentially catastrophic losses associated to a collapse of the euro area, and be mindful of those when making asset allocation decisions.

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