Lincoln Private
Investment Office

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Europe: Testing the Limits of Monetary Union

We woke in the early hours to an extraordinary result. Those in the ‘leave’ camp cited a long list of issues: economic underachievement, immigration, lack of transparent democratic processes; they highlighted their frustration with challenges seemingly beyond the control of local governments. Oddly, however, the structure of the union itself rarely came under fire in the mainstream media.

Just after the outbreak of the 2008 financial crisis, euro-member countries were congratulating themselves about the relative protection that the region had provided them. Fast forward to 2016, and this optimism has waned. The Eurozone and its banking system have appeared particularly fragile in coping with economic turmoil ever since - particularly evident during the multiple Greek sovereign-debt crises. That said, it is certainly not the size of government debt and budget deficits of the region *as a whole* that is the problem. The debt:GDP ratio in the Eurozone is now lower than that of the US, and it is increasing at a much slower rate. At first glance, it would be reasonable to conclude that if a sovereign-debt crisis were likely to break out somewhere, it would be in the US, not the euro area. But looking through the data, the reason that it was the Eurozone that buckled first under pressure becomes clear: the average debt:GDP ratio of the region hides very large differences between that of its individual members.

Greece, Italy, Spain, Portugal and France have very high public-debt levels, raising concerns about their capacity to service their obligations in an environment of low economic growth. Eurozone detractors believe that the region has a serious sovereign-debt problem. However, this is not the case; in fact, Eurozone nations like Germany, Finland, and The Netherlands have some of the lowest levels of debt:GDP in the developed world. But then surely, given the relative overall strength of government finances, it should be possible to deal with the problems such as the excessive debt accumulation in Greece, which represents only 2% of the region’s GDP?

Yet it appeared impossible to do so. As a result, Greece’s woes in 2011 and again in 2015 triggered contagion. This contagion threatened to spread to other countries within the region that the market perceived to be next in line for a possible default. Currently, the region lacks the necessary mechanisms to deal with this kind of issue due to its common currency, the Euro. This complicates matters for governments; while they have borrowed in Euros, they are not free to print Euros to backstop their own banks. This makes it impossible for individual countries to adapt to changing circumstances. And circumstances always change; countries need flexibility, and the ability to adapt to world events. Countries with extremely high levels of debt which have their currencies pegged to the Euro are most at risk from these design flaws.

And so while markets have been solely focussed on Brexit, in our view the real issue has never been whether the UK votes to stay or go: rather, it is what happens to the rest of the indebted Eurozone countries that no longer have their own currencies. The UK, by keeping the pound, has avoided this flaw in the Eurozone’s construction. By contrast, countries like Italy, Spain and Portugal are struggling with their inability to control their own currencies. Ultimately, the Euro is still too strong for countries struggling under mounting debt burdens. And this year, a number of elections are scheduled, with the spectre of political unrest looming throughout the Eurozone periphery. The split between Germany (and the region’s other creditor powers) and the weaker debtor nations in the south is becoming increasingly demarcated. Citizens living within angry debtor countries, feeling oppressed by what they perceive to be harsh austerity measures forced upon them by German-led creditors, are leaning further and further towards socialist and anti-establishment political parties.

Of course, there are similar deficit-and-surplus economies around the world. So why has the Eurozone ended up with such a currency mismatch across its member countries? The answer lies in the type of union the member countries have signed up to. Take the US as a contrast. There are similar deficit-and-surplus regions there, too. But here these divergences are alleviated by automatic redistributions from the centralized federal budget to the deficit regions, without anyone noticing. This is the issue at the heart of the Eurozone’s problems: it is a monetary union without a political union. In a political union, there is a centralized budget that provides for an automatic financial-solidarity mechanism in times of crisis. This is completely absent in the euro area. Instead, when a crisis erupts, economic and political strife unfurls with little hope of resolution. Discord flourishes, with wealthier nations outraged at having to provide financial support to their irresponsible, profligate counterparts.

A political union helps to ensure that budgetary policies are more coordinated, preventing large differences in fiscal outcomes. Without this, a monetary union is under threat: it will stagger from one crisis to the next.

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An analysis of other monetary unions of large sovereign nations during the 19th and 20th centuries implies the same thing. The German Monetary Union (1857-WW1) and the Soviet System (1913-1993) provide perfect examples; in these cases, once the political system binding the areas together broke down, the monetary union failed. In contrast, surviving monetary unions other than the Eurozone *all* exist within a political union – the US Federal Reserve (from 1913), the British monetary union (from 1707), and German unification (from 1990) to name a few.

Greece was the first major test case for the Eurozone, its undercapitalised banks, and its weaker sovereign governments. Greece suffered capital flight, bank runs, bank closures, capital controls and the forced recapitalization of Greek banks following massively diluted capital raises. The following chart says it all: the value of The National Bank of Greece, the country's largest bank, has fallen 99% from its peak. At the point of writing, European bank stocks have fallen 20% YTD, and 69% since their 2007 peaks; perhaps other investors are beginning to price in the flaws of the current monetary union.

Performance of National Bank of Greece vs. STOXX Europe 600 Banks Index since October 2007.

Without political commitment to a common fiscal destination, the long-term instability and market distortions within the Eurozone's capital markets are likely to intensify. The ECB can buy time, engineering lower and lower interest rates in an attempt to stimulate growth. But the historical precedents in Europe guide the way. To preserve the euro, the Eurozone must develop fiscal policies that tackle the significant economic, cultural and societal differences. They must define a credible roadmap to achieving structural reforms, a banking union, fiscal union and political union. But with political strife unfolding from the South, whether a political union is still on the cards remains to be seen.

Even ignoring the fundamental problems built into its structure, the Eurozone is still undergoing the same type of recession that Japan experienced, with low growth and record levels of debt. And, ultimately, all of the Eurozone's issues will take many years to wash out. For this reason, we have held a defensive stance in Europe long before a potential exit was on the cards.

Today's Referendum result will change the landscape but this will give rise to opportunities. As ever, we will retain our focus of protecting value and driving returns as long term investors.

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