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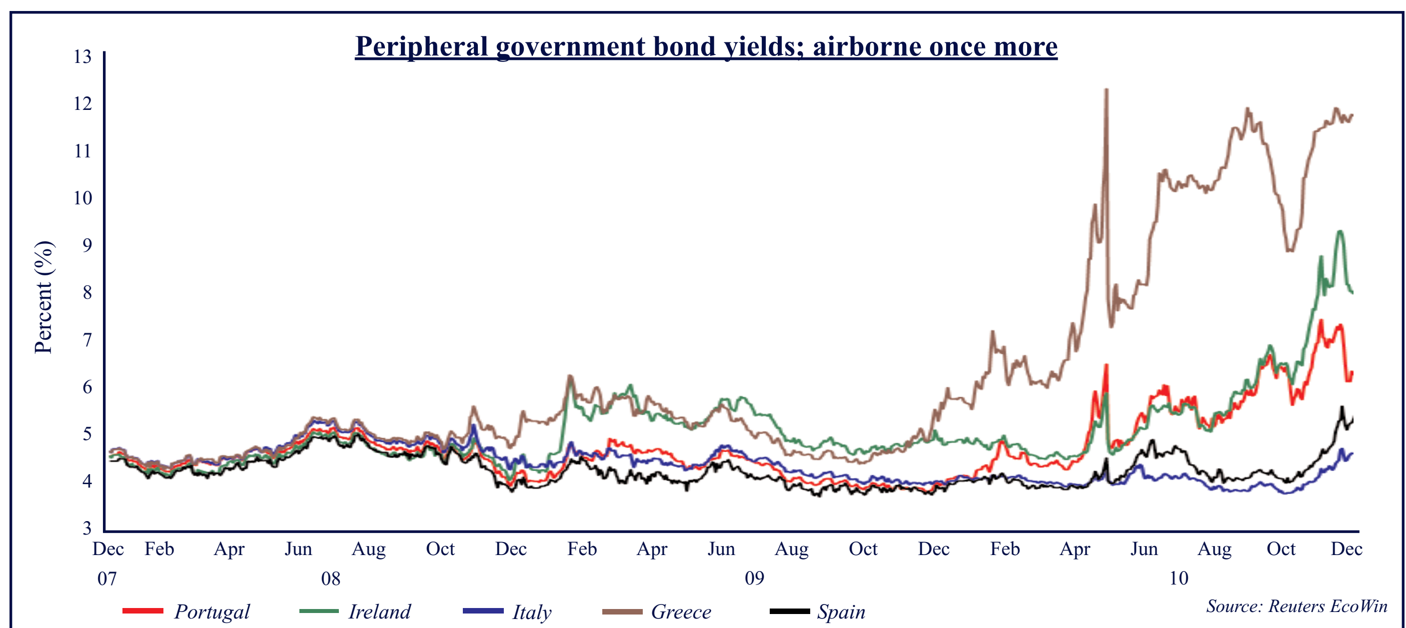
EUROZONE - THE DRAWBACKS OF A SINGLE CURRENCY

For the second time this year, turmoil in the eurozone has triggered concerns that the global financial system is plunging back into crisis. In a near re-run of the Greek crisis in April, yields on government bonds issued by nations on the periphery of the eurozone have risen sharply (see chart) and debt markets have iced-over, necessitating another emergency bail out. This time the recipient is Ireland, but the greater concern is the likely contagion to other indebted countries, notably Portugal and Spain. In this note, we look at the causes of the latest crisis and explain why, in our view, bail outs cannot address the structural issues. However, we do believe that the European authorities are politicking their way towards a long term solution and that, therefore, renewed financial crisis is unlikely.



Without doubt, Europe's single currency project was poorly designed, conceived as it was by politicians who did not pay sufficient regard to economic reality. A shared currency with almost no element of centralised fiscal policy, poor wage flexibility and little geographical mobility of labour was doomed to run into difficulties at some stage. That stage arrived in 2010. Aided by the one-size fits all monetary policy, inflation-prone peripheral nations, such as Ireland, enjoyed inappropriately low interest rates and a ten-year economic boom. The vigour of the Irish economy even earned it the label, 'Celtic Tiger'. As always, after the boom, came the bust.

Ireland's boom saw its banks grow out of all proportion to the size of the country's €175bn economy. By the peak of Ireland's bubble, its banks had extended c€420bn of loans secured against property. When the recession bit and property values fell, defaults rose steeply. At the depths of the global banking crisis in 2008, Ireland's government, perhaps heroically, guaranteed all Irish bank deposits. It proved a promise too far; Ireland has effectively been bankrupted by its own banks.

The medicine for Ireland, as it was for Greece, includes loans from EU institutions, the IMF and other European nations, together with an unhealthy dose of austerity for the population. However, while the prescription is similar to that imposed on the Greeks, the plight of the two nations is quite different. Greece's public finances were out of control, with excessive spending compounded by unreliable national accounts and woeful tax collection. Ireland's plight has more in common with Iceland, the UK and the US in that they all had to rescue their banking sectors.

So why are Ireland's problems so interwoven with the eurozone, and why are there now suggestions among commentators that the eurozone is in danger of collapse? The answer lies in the inflexibility of monetary union. For Ireland, this means that, after a decade of inflation, wages are now too high and the Irish economy has become fundamentally uncompetitive. Outside the straightjacket of euro currency membership, Ireland would have seen its currency devalue and thereby price competitiveness regained. Inside the eurozone, devaluation is not an option and Ireland can only achieve the necessary adjustment through a painful internal devaluation: wage cuts and price falls.

International bond investors are probably correct in doubting that Ireland's population has the stomach for a prolonged bout of austerity. This week's public outcry about bonuses at Allied Irish Bank, which has already received €3.5bn in state aid, demonstrates the depth of concern among taxpayers. They believe they are footing the bill for the failure of others. Clearly, the Irish government agrees; it has intervened to forbid the bonus payments. Despite the doubts of investors, €85bn of new funds have been made available. These loans cannot provide a long term solution; Ireland seems unlikely ever to be able to repay them in full. They have been made instead to save European (including British) banks, which hold Irish bonds as assets, and to buy time. An Irish default now could trigger a second Europe-wide banking crisis and would, as debts are written off, result in an immediate transfer of wealth from other European nations to the indebted periphery. The €85bn in new loans delays this process.

Jean-Claude Trichet, President of the European Central Bank (ECB), gave us a glimpse of the long term solution earlier in the month. First, the ECB must make purchases of peripheral nation government bonds, using newly created euros if necessary, in the same way that the Bank of England and Federal Reserve Bank of New York have created new pounds and new dollars. These purchases should ensure that bond markets remain open to embattled governments as they attempt to put their finances back on an even keel. There is a reasonable chance that both Spain and Portugal will avoid following the Irish into the bail out camp. While this week's downgrade of Spain's credit rating was clearly unhelpful, it is clear to us that, if help is needed by the Iberian nations, or even Italy, it will be forthcoming in the shape of further bond purchases and loans.

Looking further ahead, some form of debt rescheduling may eventually be required. This will amount to the inevitable wealth transfer from the centre to the periphery. As part of this process, eurozone participants need to create institutions with centralised fiscal powers to match the ECB's centralised monetary policies. Without this, future crises are inevitable. If member states are not prepared to cede such powers, they should leave the single currency area.

Finally, we should consider the current winners within the single currency area. The shadow cast over the eurozone by sovereign debt crisis in the peripheral nations has caused the euro to fall in value. A cheap currency has been very helpful to Europe's exporters, and particularly Germany, where business confidence recently hit its highest level since reunification. This perspective is also relevant when considering holdings of European equities. Many major European companies are global businesses with world class products. These are prospering, benefiting particularly from strong Asian demand. The eurozone crisis is unlikely to cause such companies any harm. Any weakness in markets as a result of eurozone-related sentiment may provide an attractive entry point.

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Saunderson House Ltd, Independent Financial Advisers, 1 Long Lane, London EC1A 9HF
tel: 020 7315 6500 - fax: 020 7315 6550 - web: www.saunderson-house.co.uk