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Europe: 2020 The Year of Living Dangerously (02/01/20)

> *'In economics, things take longer to happen than you think they will, and then they happen faster than you thought they could.'*
>
> Rudi Dornbusch

The struggle to create a single currency in Europe has now entered its fifth decade, since the launch of the ERM in March 1979. Over the past forty years so many battles have been fought and won to turn nineteen currencies into one. How could so many battles be won and yet the war still be lost?

If the economic reality is that slowly, sometimes quickly, the cost base of each of the constituent nineteen economies has been brought closer, relative to the underlying productivity of each, then surely success must be almost assured? This process of levelling out has ground down some economies and tipped them into bankruptcy yet provided others, notably Germany, with a highly competitive exchange rate. With this economic process so advanced, why is it increasingly likely that the euro will fail?

It is the nature of the incentives for investors and even economists, that flows, the shiny things of daily headlines, attract all the attention while stocks are largely ignored. How many hours are wasted in forecasting quarterly GDP growth, while almost nobody bothers to forecast debt-to-GDP levels for instance? The rationale for such a focus is compelling to those who chose flow forecasting as a career. It is the flows - let's just call that the profit and loss account - that are likely to have short-term impacts on the prices of financial assets. Traders do need some reason to trade and there is still, just, commission to be earned when they do so. Stock analysis, let's call that the balance sheet analysis, rarely makes any difference to the price of financial instruments… until it does. So for those who believe that the war to create the euro is almost complete, it is time to stop looking at the P&L and focus on the balance sheet. The debt-to-GDP gap between France and Germany has reached a new record high of 149% of GDP!

When the euro was formed, the balance sheet focus, such as it was, rested squarely on government debt-to-GDP ratios. Then, as now, little heed was paid to private sector debt-to-GDP. As it happens the total debt-to-GDP ratios of France and Germany were very close together at the founding of the euro, with France at 195% of GDP and Germany at 183% of GDP. At the peak of the last business cycle in December 2007 the gap between the total debt-to-GDP ratios was still small, with France at 223% and Germany still at 183%.

The most recent data, to June 2019, shows that France now has a total debt-to-GDP ratio of 329% while Germany remains at 181% of GDP. Does it matter that France and Germany now have a debt-to-GDP level gap of 148% of GDP? Or to put it more eloquently, using Rudi Dornbusch's phrase, after a long and major divergence in the balance sheet of the two countries when will things 'happen faster than you thought they could'?

The problem with debt-to-GDP levels is that it is never clear when they have reached a level that spells danger. Subscribers will know that on the two objective measures for when too much debt is too much debt, then France is flashing amber warning signals (see *When Debt Matters: Where to Expect Credit Crises in the Next Recession*, Q3 2019). The rapid growth in French debt-to-GDP in the second quarter of 2019 is likely to move France into the red for danger zone when we would expect, with a 50/50 probability, a systemic banking crisis within three years. This is clearly a problem when France is using the same currency as Germany - a country with a stable debt-to-GDP ratio. It is an even bigger problem when we consider that nominal interest rates in the Eurozone are below the zero bound. France is now the fifth most highly geared country in the world, according to the Bank of International Settlements database. The market seems not to care.

While the relative growth rate of debt-to-GDP in France is at levels associated with systemic banking crises, the bigger problem is the country's high leverage relative to Germany. We have seen before how

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large gaps in debt-to-GDP ratios in the Eurozone can create solvency problems when recession strikes. At the end of 2007, at the peak of the business cycle, the so-called PIGS economies also had much higher debt-to-GDP ratios than Germany - Portugal 88%, Ireland 68%, Spain 60%, and Greece 25%. This turned out to be a debt burden that led to mass bankruptcy when the Eurozone economy last contracted.

Today France has a debt-to-GDP gap with Germany of 149%! That is a level not even surpassed by Spain and Greece at the height of their debt crisis in 2012. While a flow analysis celebrates how the French economy is faring better than Germany's, a stock analysis reveals that France has reached a debt-to-GDP level previously associated only with severe credit crises within the Eurozone. Those who think that the single currency is grinding down economic differences in the Eurozone simply refuse to look at the growth in the debt-to-GDP ratio between France and Germany from just 12% of GDP to 149% of GDP over the past twenty years. If that is what success looks like in creating a single currency, your analyst will be hard pushed to define what failure looks like.

While this debt schism at the centre of the Eurozone is an accident waiting to happen, your analyst is just as worried about the political and social crisis growing in Europe. In one of his last interviews as ECB Chairman, Mario Draghi made a truly incredible statement about the political conditions in Europe.

> *'Opponents of the euro - the sovereigntists - have lost, he says. They were defeated in the battle for the euro in the Greek crisis and they lost the political battle in the European Parliament elections this year.'*
>
> *FT*, September 20th 2019

This is a remarkable statement because it is a comment by an unelected and supposedly independent central banker proclaiming a political victory. The 'defeat' of the sovereigntists as proclaimed comes with the far right the biggest party in France and Italy, running Poland and Hungary, rising to be the third largest party in Spain and leading the opinion polls in Sweden. One has to presume that Draghi's peculiar assessment of the political victory in the Eurozone is meant to clear the way for his successor to do whatever it takes to complete the creation of the euro. If so, it is a premature declaration that puts the ECB in the front line of a political conflict with the growing forces in the Eurozone who are against further centralisation. To see how this conflict manifests itself in the year of living dangerously, we need look no further than Spain.

On December 19th the European Court of Justice (ECJ) ruled that Spain should release Catalan politician Oriol Junqueras, who has been tried and sentenced to thirteen years in prison for his role in the Catalan independence referendum. Junqueras is now supposed to be freed as he has immunity from prosecution as an elected member of the European Parliament. While this ruling relates to the immunity of one of the imprisoned Catalan politicians, other politicians, mainly elected to the Spanish parliament, are also appealing their convictions to the ECJ. Given that the European Union was created by a treaty that guarantees the right to self-determination, it is very likely that the ECJ will rule that all the Catalan politicians convicted of organising a referendum seeking independence cannot be convicted of sedition and should be released. Such decisions will not sit well with the rapidly growing sovereigntist parties of Spain.

The ruling by the ECJ to release Junqueras puts into stark terms the loss of sovereignty by Spain as part of its membership of the EU. It is a stark loss of sovereignty that is particularly offensive to Vox, the extreme right party that has rapidly become the third largest political party in Spain. Indeed, it is a ruling that so enraged Vox and its members that they have raised the spectre of Spexit - Spain's departure from the EU. The likelihood of such an exit is small, but the ECJ decision is likely to lead to an increase in the power of Spain's sovereigntists, not the defeat that Mario Draghi has already proclaimed.

At a time when Spain does not have a government, when there are riots in Catalonia, and the government has not yet released Junqueras, it would seem a very dangerous time to use the ECB

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balance sheet to push the centrists' cause, having unilaterally announced the defeat of the sovereigntists. In Spain, as in many other countries of Europe, it is political change that it ultimately threatening the continued centralisation within the Eurozone and the final victory in creating a single currency.

When the end of the euro is finally written up by historians, it is likely that its dissolution will be dated before 2020. The introduction of capital controls in Greece and Cyprus ended the single currency, although with the end of those capital controls it has been re-constituted. More importantly, it has been the behaviour of financial regulators in the Eurozone that has already marked the end of the free movement of capital cross the Eurozone: one of the key four freedoms. With the Italian regulator forcing commercial banks to hold outsized positions in Italian government debt, not the euro-denominated debt of any Eurozone government, can the euro be said to still exist?

Once upon a time a capital control stopped any citizen or institution moving all but a very limited amount of capital across borders. Such very public and swingeing limitation was very necessary in an era post-WWII when the bulk of wealth was in the hands of individuals. Today most wealth is in the hands of institutions and no such regulatory blunderbuss is necessary to restrict the free movement of capital. Today, by simply using regulatory tools, the savings of a country can be successfully locked up domestically and in the asset class of choice of the regulator. This is not a de jure capital control, but it is de facto. Such de facto capital controls are already in force in the Eurozone and are only likely to grow in importance.

Soon it might be very necessary for the French regulator to work overtime to make sure that credit continues to flow to a very over-geared French economy at the expense of capital allocation in other Eurozone countries. The retreat of savings, forced by regulatory action, to a home bias is already under way and will accelerate. Historians will relate that it was this shift that marked the first stages in a capital nativism signifying the beginning of the end of the euro. It is already clear that the centre is unlikely to hold, despite Mario Draghi's assertions to the contrary.

The first past the post system combined with fixed term parliament law has finally brought political stability to the UK and an answer to the debate between the federalists and the sovereigntists. That struggle happened without violence on the streets. The rest of Europe has yet to settle its constitutional destiny and will have to do so through the messy business of building coalitions or, as we currently see in Spain and Belgium, failing to build such coalitions. Your analyst will stick with his forecast published in the FT in January 2019 that the UK will thus increasingly benefit from capital flight from the rest of Europe. A strong and stable government committed to defending property rights will be in ever greater contrast to the rest of Europe where the greatest issue of the day, whether the sovereign state survives, is still yet to be settled.

The euro was never an economic construct but a political construct designed to force the fiscal and political centralisation that leads to a united states of Europe. It has not created such fiscal integration and the political conflict between the federalists and the sovereigntists is now really heating up. Forecasting when balance sheet weakness finally counts is difficult enough but forecasting when social forces threaten economic stability and ultimately the survivability of the euro is even more difficult. Your analyst is prepared to forecast that in 2020 the Eurozone will face both a balance sheet crisis and a social crisis in the form of conflict, hopefully in only democratic forms, between the federalists and the sovereigntists. The socio-political forces bringing the economic reality of a move away from a single currency have taken longer to happen than most of us thought. Will 2020 be the year when they happen faster than we thought they could?

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