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EUROZONE: MUDDLING THROUGH OR DEFAULT?

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Gradually they are toppling—first Greece, then Ireland, now Portugal. Spain is rumoured to be next. There is a crisis within the Eurozone. Can it be managed? Will it have broader implications? About 10 years ago William Hague likened the Euro to a burning building with no exits. It appears that the fire is raging. Will the building be consumed? There are at least two plausible outcomes.

Speaking to an Institute of Actuaries' seminar, Steven Major, CFA, Global Head of Fixed Income Research at HSBC, said that he thought the Eurozone would "muddle through." As the name suggests, muddling through is not a well-defined policy. It implies working through each new development as it occurs on a basis that it is the most acceptable to the majority of member states at the time of the troubles and trying to take preventative measures to reduce the impact of any further challenges. Muddling through means that the Eurozone will hold together, but it certainly does not mean an equally easy or difficult ride for all participants.

In Major's view any Eurozone country that needs financial assistance to avoid defaulting on its debts, i.e., bankruptcy, will receive a bailout. However, the terms of the bailout will mean that the country will be placed in an extremely painful financial straightjacket for the next 10 years or so. This is the situation in which both Greece and Ireland now find themselves. A concern for Major though is whether, in a few years, countries requiring financial assistance may decide to take a haircut on any remaining bonds that are not due to the Eurozone or International Monetary Fund (IMF) financing. In a few years, the financing from the Eurozone and the IMF will be the majority of the outstanding debt, so any haircut on the remaining outstanding debt could be substantial. This possibility raises issues of the seniority of various debt issues.

When Greece required financial assistance, there was grumbling regarding why Germans should be lending funds so that Greeks could retire on generous state pensions earlier than Germans could retire. With the financial assistance extended to the Irish, there was grumbling that the Irish corporation tax rates were too low, giving it an unfair advantage, and that the corporate tax rates should be raised. It would seem that a consequence of muddling through will be pressure to try to harmonize fiscal policies, which includes tax rates and spending on publicly provided pensions. A monetary union without a fiscal union would encourage free-riding, of which Germany, as the strongest financial nation in the union, is aware.

The other plausible outcome is that the Eurozone will gradually dissolve. On the one hand, the financially weaker countries that require financial assistance may find the terms placed on the assistance too onerous. Both Greece and Ireland may find the demands of their creditors too unpopular with their own voters. They may wish to abandon the Euro and have more control over their financial affairs. At the time of writing this article, it is still too early to know how things will unfold in Portugal, but the Portuguese are suggesting that they would rather default than accept the type of terms imposed on Greece and Ireland. If the Portuguese decide to default, surely they would have to leave the Eurozone.

On the other hand, if the number of bailouts increases significantly or if the amount of funds required for bailout gets large, will the financially stronger nations be willing to bear the pain to support their more profligate partners. That pain may mean the inability to be elected in the home country. There may be an opportunity for politicians to promise a breakup in the Euro in return for being elected in their home country.

Regardless of which alternative outcome occurs, the investment prospects for European, not just Eurozone, countries do not look promising. Muddling through will create a seniority structure for debt, with private investors assuming a junior position; although, it may mean the worst that occurs is a haircut, not a default. But the credit rating of the stronger countries will be weakened causing prices for those countries' debt to fall. While outright default by a few countries would, in some ways, be beneficial for the credit rating of the stronger nations, the turmoil and uncertainty created would not be good for any of the European countries. Investors would flee the uncertainty seeking quality elsewhere. This situation extends beyond the Eurozone to nations such as the United Kingdom that has not adopted the Euro. The reason is such nations have strong trading relations with the Eurozone, so, for example, the United Kingdom made substantial emergency funds available to Ireland because Ireland is one of the United Kingdom's most important trading partners. With the announcement of that loan, the £ Sterling suffered some depreciation. This is a further concern for investors outside the Eurozone. Even if there is not a default, will the value of the currency in which they receive their return be depreciated when valued in their home currency?

Although Europe has survived the fall off the precipice brought on by the financial crisis, the climb back up the hill will be arduous and lengthy. Most European nations need to restructure their public finances—cutting public spending and raising taxes. Will they have the gumption to stay the course and take the bitter fiscal medicine or will free-riding within the Eurozone provide a less painful salve for the weaker nations? In which case, the weaker nations will not cut expenses or raise taxes sufficiently and the rest of the burden will be borne by the stronger nations. In such a situation the stronger nations strength will be eroded as will the value of the Euro.