

The EUR, Fusion or Fission?

Anyone hopeful for fiscal union in the EU should recall the 1992 Treaty on European Union, also called the Maastricht Treaty.

Within the Maastricht Treaty were rules governing economic convergence within the concept of European Monetary Union. These included limits on inflation rates and exchange rates, as well as government debt limits and long term bond yields. Specifically, the Maastricht criteria limited annual government debt to no more than 3% of GDP and gross government debt to no more than 60% of GDP. Today, only Germany complies with the first condition and I cannot think of any country in the EU that complies with the second condition. But the Maastricht Treaty was more than a quest for monetary union. It was an attempt at union in economic policy (clearly including fiscal policy), in foreign and security policy, in justice and home affairs. Maastricht was the culmination of a series of treaties beginning with Dunkirk in 1947 (against possible German aggression), and Brussels (against the Communist Bloc). In the Treaty of Lisbon, which superseded Maastricht in 2010, the focus is political and constitutional union. Economic union is given short shrift.

There are two options for Europe. Make a stand together, through closer fiscal union, or disband.

Those who argue that the Euro was a bad idea to begin with tend to support disbanding the Euro. The legal and logistical intractability of the process puts off the administrators in government. The signal it would send to the world about the wider union is also something regarded as highly unacceptable by a Europe where the memory of war still lingers. Yet fracture may be the most practical as well as

economically efficient route. With an economy the size and complexity (it isn't very complex) of Greece, it is the ideal test bed for a legal and logistical disentanglement. The lessons learnt could be a template for extricating Spain, Italy, Ireland, Portugal, Belgium, et al, and ultimately the French and Germans can decide if they want a common currency.

To those who would defend the Euro to the last, fiscal union appears to be an imperative. This ultimately means a central Treasury and an agreement of country level budgets within a central budget. This highlights the Herculean nature of the task. Fiscal profligacy or rectitude is often a cultural trait, as well as being dependent on historical circumstances and particular situations. No sovereign will want to abdicate control of their treasury to a central body. At best the management of the central body could become highly politicized. Fiscal union addresses the relationship between monetary and fiscal policy. It does not address the need of multi-speed economies for different monetary as well as fiscal policies.

The choice before Europe is between a highly intractable and messy disengagement that would address problems relatively more quickly (albeit at the cost of ideology and an immediate hit to Greek borrowing cost as well as substantial write downs at the bank which will probably require more capital or nationalization), or tighter union which in the long run is economically inefficient and likely to precipitate further problems down the road and which will be devilishly difficult to implement in any way which would satisfy the markets in terms of confidence.

The social and political implications are hard to imagine. Separation beginning with Greece would immediately create an impoverished nation and some very distressed creditors (yes, distressed creditors), some of which would require a bailout. Bailouts of banks are never popular and could threaten change of government. The prospects of the other walking wounded will depend on how the first separation is managed. The impact on the European psyche of the loss of an ideology over 60 years (and a dozen or so treaties) in the making, are quite unfathomable. For this reason, the expectation is that Europe will march towards fiscal union despite the short term challenges, and the long term problems.

Expect more downside in Europe and certainly more volatility. Investors should not

flee or eschew European equities, however. The downside volatility in Europe is a great opportunity, simply because many European companies have substantial exposure to emerging markets. Spanish companies have traditionally had a strong presence in Latin America. Swiss companies hardly have anything to do with the Swiss economy. UK companies have links to Asia, remnants of a colonial past.

As markets lurch it is easy to forget that the emerging markets of Asia and Latin America remain in good health. No market is without their problems, but compared with Europe and the US, the emerging markets are a safe haven and indeed, an opportunity. As prices tumble in the developed markets, cheap exposure can be bought. All it takes is a little creative research, and a bit of patience.