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REMEMBERING THE FUTURE

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The Dysfunctional Euro: The Currency that Europe Cannot Afford and the Rebalancing Acts in the Midst of Global Geostrategic Changes

Introduction

We live in a time of flux. The US elections may prove to be a watershed moment of what will follow in the next three-four years. "The times they are a changing" in terms of geopolitical and geoeconomic strategic power plays. Global imbalances and the amount of debt accumulated in developed countries point out to credit and currency misalignments. As we wrote in a recent commentary the current geostrategic environment cannot afford two main currencies (the USD and the Euro) as alternative global reserve currencies. One needs to go, and the Euro as the dysfunctional one is the prime candidate. The economic dynamics call for major geostrategic shifts in association with global currency and banking adjustments, given the projected slow growth – if not stagnation – in major developed countries and the apparent growth saturation in the BRICS (Brazil, Russia, India, China, S. Africa), with only the African region to present a good growth potential.

Our analysis has three main parts: In the first one, we explain the reasons that make the Euro a dysfunctional currency. In the second part, we discuss why the Euro is no longer affordable by even Germany. And finally, in the third part we discuss how some countries can jump off the Titanic called the Euro zone (while maintaining their EU membership), anchor their national currencies to the US dollar and thus anchor their renewed monetary sovereignty while not creating any major financial disturbances in their local economies.

The implication for investors of the introductory section above is quite obvious: Switch to dollar-denominated assets, hedge Euro-denominated holdings, and potentially make allowances for shorting the Euro if appropriate with your risk profile.

The Unaffordable and Dysfunctional Euro

Here are some of the main arguments regarding the fact that Euro is a dysfunctional currency.

- It was designed without the support of a common Treasury (Ministry of Finance). In contrast to when the US adopted a central bank it concurrently adopted a common Treasury and thus imposed federal income taxes.
- The US accomplished a political union several decades prior to enforcing a monetary union.
- The European Central Bank (ECB) has no mandate to act as a lender of last resort, which is the classic definition of a central bank (this is not the place where we can debate the need or not for such institution).
- The EU tried to converge and dictate unilateral monetary policy for countries that may have been undergoing completely different growth patterns (one in an upswing and the other in a downturn).
- Countries "cooked their books", consistently violated – without any penalization - the Maastricht criteria

regarding deficits and debt (including Germany and France), and thus created a "Union" that tried to have its feet in two boats simultaneously.

- The convergence of interest rates and the overextension of credit that took place between 2002-'07 allowed countries (especially club Med i.e. southern countries), corporations, and households to burden themselves with too much debt that nowadays is more than obvious as unsustainable.
- Countries lost their monetary sovereignty without any alternative mechanisms in case of major economic problems.
- Countries adopted the Euro at exchange rates that were completely misaligned with their trade positions, consumption patterns, growth potential and banking dynamics.
- The result of the point above was that countries lost their competitiveness, some were de-industrialized while consumption became much easier due to lower interest rates. Hence, trade deficits start accumulating, while politicians' main concern of power allowed them to burden their countries with too much debt.
- The ill-designed monetary convergence and its currency allowed the EU banks to circulate trillions of dollars in unsecured debt that is burdening the Euro zone and is shaking its foundations, while the financial institutions themselves have been converted into forces of destabilization.
- The structure of the Euro policies was such that the EU could not address imbalances in payments among members and impose self-limitations.
- The absence of debt mutualization does not allow the countries to pass the criteria for an optimal and sustainable common currency area.
- The centralization of power pushed by some in the Euro zone is done without any respect to history, culture, idiosyncrasies and education of the people regarding a common destiny and identity (some would call this utopian EU dream).
- There is no real leadership in the EU that can articulate a vision capable of pointing a way out of the crisis. On the contrary, the primacy of politics and the need to run for a public relations campaign - without any substance - reigned supreme over basic arithmetic. EU politicians seem to be masters in taking bondholders' money to finance their excesses. They saw the Euro as an end in itself rather than a means to an end, and that untreated myopia has blinded them by now. The Financial Times might have said it best: "Throughout the financial crisis, Europe's elected leaders have rarely missed an opportunity to disappoint".
- When the first problems appeared in late 2009 and early 2010, the designated prescriptions made the situation worse, as the most important indicators (debt, deficit, unemployment, GDP, production levels, etc) demonstrate nowadays.
- Germany's position and the ECB's policies have exacerbated liabilities and made the whole structure much more dangerous for the global economy when the bond market implodes.
- The Euro zone could not turn out to be an optimum currency area (OCA) based on wishes, hopes, and dreams. By turning a blind eye to the EU-wide imbalances, they transformed a dream into a nightmare, since they kept refusing to address the fundamental problems.

- The diverging productivity growth rates and the wage discrepancies were intimate ingredients for a crisis when external financing shocks would have appeared.
- The declining savings rate along with easier credit and an appetite for spending and investments was a recipe for higher risks, misallocation of resources, bad investments and a cover up of true costs, including the cost of financing public deficits.
- While the benefits of a monetary union are obvious (price transparency, lower transaction costs, more integrated financial markets, stable exchange rates, etc), the a priori conditions for such were overlooked. The result was that the risk of a financial crisis made the whole project uncertain that jeopardizes now the global economy.
- The lack of institutional infrastructures in case of asymmetrical shocks undermined the long-term viability of the project, while it increased the risk that disintegration may result in major global instability. This is exactly what the fear is nowadays.
- The miscalculations listed above and the myopia in designing the Euro were such that - given the absence of fiscal transfers and stabilizers – they were destined to create an asynchronous trade cycle which in turn has exacerbated non-synchronized business cycles.
- Technocrats were used to manufacture theories that satisfied politicians' goals. Hence the absurdity circulated by Brussels' technocrats of the Euro's endogeneity, meaning that the EU will turn into an OCA after its effective launching, something that flies in the face of theory and reality. A pertinent report stated: "Countries which join the EMU, no matter what their motivation, may satisfy OCA criteria *ex post* even if they do not *ex ante*"!
- The EU leaders refused to comprehend after the launch of the Euro that no progress or plans for addressing the non-adherence of pre-conditions for an OCA (such as lack of fiscal and political integration as well as price and wage flexibility) had been made. They had been successful in manufacturing a car, but forgot that it needed brakes.
- The whole structure provided incentives for greater risks, and thus moral hazard was penetrating every aspect of EU policies. The big daddy was assumed to be there in order to bail out the misbehaved kids. As a first example we will refer to the SGP (stability and growth pact), which turned out to be a joke given the absence of an authority that could impose the penalties to those that violated the pact. As a second example we will refer to the Lisbon Act which was supposed to bring about policy convergence among the EU members. Needless to say that no more convergence within the EU was achieved than the convergence observed between the EU and the rest of the developed economies.

In conclusion of this first part, let us simply state that the trajectory for such a dysfunctional currency is that the hero of the early 21st century could turn out to be the villain of financial stability and therefore the sooner this nightmare ends the better off we will all be.

<u>The German Situation</u>

Germany's ultimate desire is economic (in terms of the fiscal and employment picture) and financial stability (in terms of stable prices and healthy financial institutions). The last thing they want to see is another Weimar

Republic. We believe that the German Constitutional Court said it well in 1993 in its ruling regarding the proposed European monetary union: "the aim of stability as the benchmark of the monetary union". It further emphasized that "in the case the stability of the community fails, a disassociation (of Germany) from the community" is warranted.

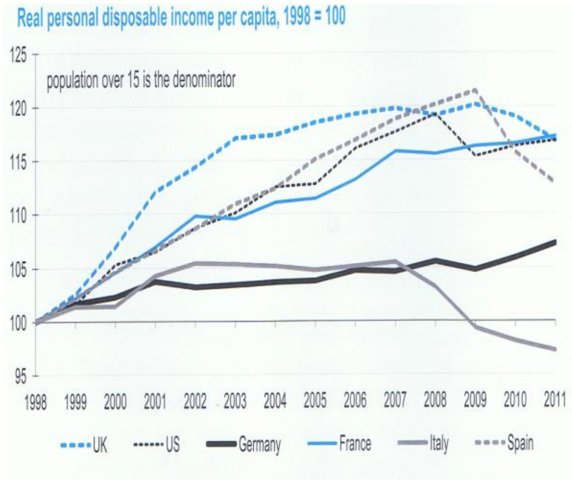
This is exactly our point. Germany may choose to dissolve the Euro experiment by disassociating from it, given that staying in it - when the tremors convert to an imminent earthquake – may cost her the stability that she desires. A sign of the imminent earthquake is when Spain requests a full bailout. A second is when the tremors start in France. A third is when its own shaky US-based bank called Taunus and its domesticated Landesbanken institutions start experiencing some shocks. The latter are the equivalent of the Cajas in Spain. Both are over-leveraged and with questionable assets incapable of matching their liabilities. When additional problems show up, it will become evident that the EU is facing a solvency crisis rather than a liquidity one.

Tony Barber wrote on April 18, 2011 in the Financial Times that the rescues of Greece, Ireland, and Portugal were basically rescues of financial institutions in Germany and France. The German surpluses had been channeled into Mediterranean and Irish loans, and those banks stood to lose the most out of the Club Med crisis, which would have destabilized the whole German economy and thus the Euro experiment.

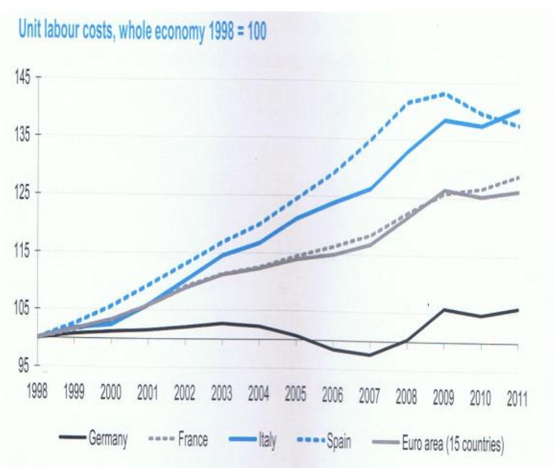
Our point of view is that the overextension of credit by German and French banks – with the assistance of London and the Wall Street – based on questionable collateral, will soon come back to haunt those institutions since the manufactured "solution" is expiring soon. The shock to the financial system that German and French banks need to be recapitalized through public money will reveal the emperor's nakedness.

Germany faces a cost of over 700 billion Euros – through the Target 2 EU central banks' payment system - when Club Med starts unraveling. Germany cannot afford to pay such an amount, especially with the additional costs affiliated with an uncontrolled disintegration of the Euro zone. Moreover, when someone examines its export growth markets – and given the EU economic stagnation – the observation becomes clear, that is non-Euro zone countries have started playing a more important role for its export industry than the Euro zone itself. Germany accounts for close to 45% of EU exports to China. The German industrial sector has started entertaining the idea of returning to a national currency, which they could devalue and control if needed, without having the burden of committing German funds to the rescue of other EU countries.

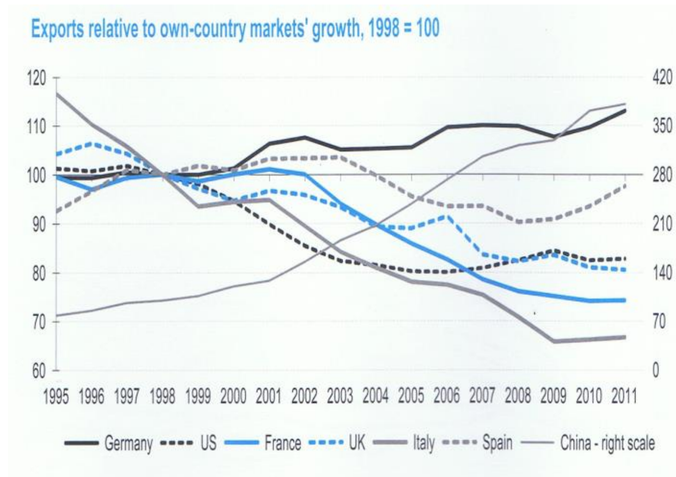
It is the position of this analysis that Germans themselves are not better off since the introduction of the Euro. Lombard Street Research Group has completed an excellent report dated August 31st, 2012, in which it clearly demonstrates that it is Germany that cannot afford the Euro, and the sooner it leaves the Euro zone, the better off Germany will be. From that report we will discuss five key graphs. The figure below shows that the real personal disposable income per capita in Germany has barely moved in the last fifteen years.



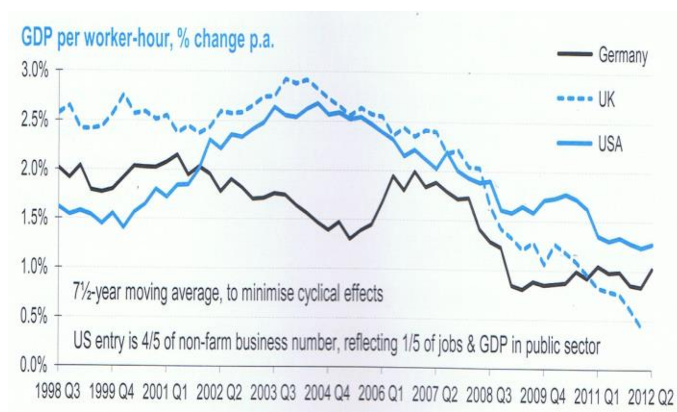
Therefore, the purchasing power of Germans remains stagnant since 1998. Thus, while German finances have improved – through the export engine – the German people do not seem to be better off. This implies that Germany rode on the wings of other countries' appetite for its exports, and on a Euro that allowed other countries' labor costs to rise while Germany constrained its labor costs through internal devaluation. Therefore, as the figure below demonstrates, other major EU countries experienced declining competitiveness – due to higher labor costs - while Germany rebuilt its unified economy on a classic recipe of mercantilism.



This mercantilistic approach to growth stimulated growth and "prosperity" based on credit in the Club Med, while it undermined their own competitiveness and long term stability.



The problem however, is that as the foundations of the Euro zone are shaken even Germany's productivity – and hence long term desired stability – has been following a downward trend as it is evident in the figure below.



Given the analysis above, one might be thinking that it is to Germany's benefit to leave the Euro intact, otherwise an overvalued new Deutschmark will kill its growth prospects, since the German economy benefits from the subsidization it enjoys from the rest of the Euro zone. However, as the following graph shows while the Deutschemark was rising from the 1970s to the 1990s, Germany's growth and fortunes rose along with it, pointing out to the fact that only real things such as productivity can affect real things such as employment.

In closing this second section, it is our estimate that Germany may choose to let the Euro disintegrate simply because it can no longer afford it.

The Road to Controlled Disintegration: Dollarizing Club Med

We are closing this analysis by presenting a path of dollarizing Greece, as the initial step of a controlled disintegration of the Euro zone. The lack of liquidity in the Greek economy is suffocating its life. Its debt is unsustainable and its competitiveness is nowhere to be found. The inefficiencies of the public sector end up taking the life out of the private sector. At the same time, the shaky banking system cannot fund business endeavors. There is a need for radical measures related to the unsustainable debt and the inability of households and businesses to breathe fresh financial air. It should be emphasized that the proposal below in no way implies that the cancerous cells that exist should remain and that current reforms efforts should be abandoned.

The following facts seem to be undisputable:

- Austerity packages have transformed a structural recession into a cyclical depression.
- All measures taken since 2010 have deteriorated public finances.
- Unemployment is already at a level that can destabilize the social and political course of a civilized society.
- The country has lost its sovereignty.
- Competiveness cannot be restored due to a very expensive currency.
- The funds assigned with each austerity package go to the repayment of loans that have unacceptable terms and conditions, and no money circulates in the real economy to advance liquidity that is so much needed.
- Monetary autonomy has been sacrificed for the sake of worshipping at the altar called the Euro.
- The Euro-worship does not serve the national interest and undermines the growth potential since it does not allow competitive advantages to thrive.
- A dollarization of the economy will automatically anchor monetary expectations and will improve competitiveness significantly within a very short period of time.
- Capital flight would be reversed while foreign investments would be attracted since the currency risk would be eliminated.

The geostrategic position of Greece allows her to enjoy a unique position that connects the West to the East via its seas' routes. In addition, the unexplored but potentially very valuable energy sources should be used to anchor its future growth. However, for the latter to take place, the cancer needs to be removed. The symptoms of the cancer include unsustainable debt, declining incomes and industries, lack of liquidity, rapidly rising unemployment and inability to meet obligations. Another symptom of the cancer is that the current monetary regime does not allow her to regain part of her lost competitiveness. All these mean that Greece cannot afford the Euro, which in any way is a very expensive and dysfunctional currency, as recent years demonstrate. The dollarization proposal removes

Greece from the Euro zone but retains its membership into the EU.

In a nutshell, the proposal is made up of four key components executed simultaneously:

a. Internal collateralization and securitization of dormant assets that result in Finance Ministry Treasury Credits(TCs).
b. Assignment of Ministry of Finance Treasury Credits (TCs) to a new bank (see pertinent point later) and to domestic banks while the state obtains proportional equity interest based on TCs as well as based on previous credit and cash injections that it made to the those banks since 2009. Once each of those banks is properly restructured, it will be privatized again via IPOs. Bank mergers since 2010 are revoked for proper re-examination.
c. All Euros in the financial system are converted into US dollars at current exchange rates.
d. The country issues new currency tied to the dollar at a fixed rate. The country commits not to print any new drachmas unless it has in its reserves the equivalent amount in USDs. All exchanges can be done in the new currency or in dollars.

The immediate benefits of the above (when we take into account the more detailed steps) are:

- Improved competitiveness by at least 25%.
- Significant debt relief for companies, households, and individuals.
- Primary surplus within one year.
- Lower deficit and debt within a year.
- Liquidity in the marketplace.
- National sovereignty and monetary flexibility.
- A genuine restart of economic activity.
- Focusing on those sectors that can revitalize the Greek economy.
- No speculator can bet against the new currency regime (dollar).
- No shortages will be observed and no major negative consequences are expected. Any inflationary pressures can be absorbed due to excess and non-utilized capacity, and thus inflationary pressures will be subdued.
- Transaction costs do not increase while dollarization opens additional markets.

Here are additional more detailed steps that need to be taken:

1. Negotiations with US for a line of credit and swaps with the US central bank. The goal is to have enough reserves in the system. At this stage $100 billion should suffice.
2. NATO and the US guarantee the security of Greece's borders in exchange for long-term military cooperation beyond the existing agreements. The net effect would be a significant reduction in military expenditures (hence billions of savings in the annual budget) and donations of military equipment and training.
3. Existing corporate and households' debts are denominated into USDs. This is an automatic relief of more than 25% of debt burden.
4. Negotiations with creditors as to repayment issues of loans provided since 2010. Those negotiations should focus on contrasting the implications of what the consequences would have been if Greece had resorted into unilateral suspension of all payments which would have cost the ECB and Germany at least € 130 billion. All payments are suspended until negotiations are finalized and in the interim the P&I payments are used for the capitalization of a new bank that will buy out distressed portfolios which in turn will discount the loans for the borrowers (see also #6 below). Such debt relief will automatically enhance incomes and advance liquidity.
5. Greece makes a unilateral line-item entry into its budget of $80 billion per year for the next five years as reimbursement of

Germany's WWII loans, gold, antiquities, and art confiscations. Such an entry balances out loan repayment issues since 2010.

6. Part of the TCs is assigned to the capitalization of the new bank that buys out the non-performing loans of existing banks. The result is a win-win for the new bank, the existing banks, and the borrowers.
7. Emphasis is placed in developing the areas where the country has competitive advantages. Tourism and exports are targeted for immediate results. Aggressive efforts are made so that within one year Greek export-oriented companies are targeted and assisted. Public sector employees in redundant sectors are temporarily assigned to export-oriented companies so that pertinent costs for both the private and the public sector are reduced, while productivity is enhanced.
8. The eastern part of the Aegean, Crete, all the states that neighbor other countries, and the Ionian islands are declared tax-free zones and companies domiciled there pay a tax rate of 8%.
9. Repatriation of funds is encouraged and is taxed at 8%, no questions asked.
10. The combination of tax-free zones and of the tourist industry can revitalize the real estate sector by making Greece the retirement destination of Europe in association with the health care industry.

We believe that if Greece chooses to dollarize, others countries will follow, a smooth disintegration will take place, and if at the same time the US chooses to start working on a new international monetary architecture that will anchor fiat reserve currencies to real hard assets, then catastrophic chaos can be avoided and long term stability be achieved.