

## Could the euro collapse?

**Euro crisis/** *The single currency is ailing. However, it is worth remembering that the euro is a political project aimed at promoting closer integration. The results achieved by the EU over many years would suffer a tremendous setback if the euro collapsed. Hence, it will be a fight to the bitter end to stick together on the euro. That said, there is no denying that the crisis is substantial and that the future of the euro is far from certain.*

***By Allan von Mehren  
Chief Analyst  
Head of International Macro and Strategy***

The European Economic and Monetary Union is in the midst of its worst crisis since the single currency was introduced in 1999. Countries such as Greece, Portugal and Spain are struggling to finance their budget deficits and are seeing interest rates surge on their sovereign debts.

Global investors are now giving these countries a wide berth out of fear that they will not be able to repay their debts – in other words suffer sovereign bankruptcy. With no sign of investors returning, the EU and the IMF have been forced to put together a loan package of EUR700bn while at the same time buying up government bonds in the market and thus in reality taking on a portion of the existing debt.

Bond purchases are being made via the European Central Bank. The loan package ensures that the above countries can finance their budget deficits for roughly the next two years – giving them a breathing space in which to get their finances under so much control that they can tempt investors to return. The ECB purchase programme also means that investors wishing to divest their bonds can do so without the market collapsing and yields exploding.

### **Competitiveness undermined**

As well as major budget deficits, the competitiveness of these countries has been severely dented by inflation running far too high for too long, which has made their goods substantially more expensive than, for example, German goods. This has led to massive current account deficits, which in terms of share of GDP add up to 15% in Greece, 12% in Portugal and 10% in Spain.

This means that every time Greece, for example, bought for DKK100 abroad, it only sold for DKK85 – the remaining DKK15 was borrowed. A long and painful period of adjustment will be needed to correct the huge deficits, as countries within a currency area can only regain their competitiveness in one way – by keeping inflation lower than, for example, in Germany for an extended period. However, Germany will very likely

continue to have very low inflation in the coming years and this will make the process very difficult for the southern European nations. In the “old days” these types of tensions prompted a devaluation that would immediately have made Greek goods cheaper abroad.

### **Abandon the euro?**

This has increased speculation about whether the politicians and populace of Greece will accept this long period of pain that lies ahead if they are to restore competitiveness – or if they at some point will throw in the towel and simply abandon the euro, and hence have the option of devaluing their currency.

A second scenario that could push Greece out of the single currency is a bank run. If people and companies fear that Greece will pull out of the euro and devalue, they will try to move their money out of the country before it happens out of concern that their savings could drop in value.

Indeed if this fear is great enough it could become a self-fulfilling prophecy. Meanwhile, a third scenario could be that Greece finds itself incapable of rebalancing its state finances, as the austerity plan it would have to follow could in itself undermine the economy and erode its tax base.

### **Prerequisites not met**

A fundamental problem is that some of the prerequisites for an optimal currency area have not been met. Economic developments in the EU member countries have been too divergent for a single policy interest rate to suit all countries and, furthermore, budgetary discipline has been far from sufficient. The absence of an economic union with the option of transferring resources to countries in need would make it difficult for a country to get back on its feet once its competitiveness has been eroded and its debts grown so large that creditors lose faith in the government.

Is the euro likely to collapse? One must remember that the price of dropping out of the euro would be almost incalculable. Greece would first of all have to reintroduce its own currency, which would be a huge logistical operation. Second, the country would be thrown into economic and political chaos, which would also undermine any economic recovery. Third, it could set off a chain reaction whereby fears that, for example, Portugal and Spain might abandon the euro could become self-fulfilling due to a run on these countries.

### **Political project**

Finally, it is worth remembering that the euro is a political project aimed at promoting closer integration. The results achieved by the EU over many years would suffer a tremendous setback if the euro collapsed. Hence, it will be a fight to the bitter end to stick together on the euro. That said, there is no denying that the crisis is gargantuan and that the future of the euro is far from certain.