



# Special Report

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March 5, 2012

## The Netherlands & The Euro

**Statement of Purpose:** The Eurozone crisis proves the single currency is flawed. It must change or fragment. The Dutch government faces a momentous national decision – whether to accept change and stay in a possibly shrunken Eurozone or opt out, alone or with Germany. The choice is political, affecting The Netherlands and Europe's future for generations. It needs to be well-informed.

Lombard Street Research was honoured to be commissioned by the Dutch Freedom Party (Partij voor de Vrijheid, PVV) to analyse the consequences for The Netherlands from staying in or leaving the euro. LSR is an independent international research and advisory company based in London. It has no political or commercial affiliations and no conflicts of interest in accepting this task. The analyst team was led by Charles Dumas, LSR Chairman and Chief Economist, supported by Jamie Dannhauser, Michael Taylor, Dario Perkins and Brian Reading, none of whom is a member of any political party. We hope our objective analysis helps in the choice to be made. We do not advocate any of the alternatives. Our task is to inform and not to decide. We have received no guidance as to any preference the PVV may now have.

Our full report contains a great deal of statistical material. This digest hopefully helps the reader to understand our arguments and conclusions without having to go into all the details, which are available in the full report.

We first consider the benefits The Netherlands has *so far* enjoyed within the euro and the costs incurred. Our analysis demonstrates costs that have seriously outweighed the benefits. We then consider how the Eurozone may evolve if all current countries stay in. This involves costs to all members from resolving problems of competitiveness, imbalances, deficits and debts. The euro cannot survive unless costs are shared by strong as well as weak.

Fragmentation may take different forms. We look at break-up scenarios in which:-

1. Greece followed by Portugal opt or are forced out
2. All other 'Med-Europe' countries follow suit – notably Italy and Spain
3. Germany and The Netherlands decide to leave EMU jointly
4. The Netherlands leaves on its own.

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# The Netherlands & The Euro

## Summary & conclusions

While the euro has advantages that in principle are worth a once-off 2-2¼% of GDP to The Netherlands, these have been heavily outweighed by disadvantages. Growth of Dutch GDP has slumped from its pre-euro rate, as well as falling well short of growth in comparable non-euro countries, Sweden and Switzerland. Moreover, the sacrifice of wages and salaries has deprived Dutch people of virtually all of the income resulting from such meagre growth as has been achieved. Under the pre-euro benign regime, wage and salary restraint was rewarded by the income gains flowing from a rising currency in a very open economy.

Divergence of inflation and growth between countries in the Eurozone has led directly to the current debt crisis in Mediterranean Europe (Med-Europe) as well as feather-bedding Dutch industries in a comfort zone of low labour costs, taking away the spur to innovation and productivity gains. Even before The Netherlands is presented with the potentially enormous bill for bailing out Med-Europe, it has suffered a substantial shortfall of net overseas assets.

The losses already suffered by the Dutch economy and people under the euro include:

1. **Shortfall of growth** – Dutch GDP in the ten years to 2011 grew at 1¼% a year, versus 3% in the previous 20 years, and annual rates in 2001-11 of 2¼% in Sweden and 1¾% in Switzerland, neither of them slowing from the previous decade
2. These latter two economies also performed better in terms of inflation, employment growth, budget balance and overseas surplus
3. **Shortfall of consumer spending** – if Dutch consumer spending growth, a feeble ¼% a year in the ten years to 2011, had matched its GDP growth (as did Sweden's and, nearly, Switzerland's) its 2011 consumer spending would have been €30 billion higher, €1,800 per person. Had GDP growth in addition matched the Swedish & Swiss experience the extra consumer spending would be a further €15bn, €900 per person per annum.
4. Wage and salary restraint was supposed to build up foreign surpluses to provide future income as working-age population falls, but the shortfall of investment returns on Dutch surpluses has accumulated to €115 billion, close to €7,000 for each person

Membership of the euro locks The Netherlands into a system in which cost competitiveness is matched by massive structural overvaluation of costs in Med-Europe, resulting in deficits that will suck cash out of the core Eurozone. The Greek crisis has been made worse by the austerity programme, as Greek budget deficits are higher than before, not less, and its debt is soaring. Current plans for a "voluntary" write-off are insufficient – only a 100% write-off of all its debts will suffice if Greece stays in the euro. The combination of huge Portuguese business debts with government debts close to Italian levels means that its debts too will probably not be repaid if it stays in the euro. In the "All stay in" scenario both Greek and Portuguese debts will probably have to be written off in their entirety. In the

cash flow table below we assume this is done in three annual parts in 2012-14. The optimistic case for Italy and Spain assumes only their budget deficits have to be effectively funded by core Eurozone and its institutions. The pessimistic case includes refinancing of bond maturities.

**Potential cash support needed by Med-Europe,  
€ billion**

	2012	2013	2014	2015
Greece	83	94	113	12
Portugal	70	72	79.1	0
Italy - optimistic	81	95	84	72
Italy - pessimistic	386	270	224	214
Spain - optimistic	94	104	106	102
Spain - pessimistic	239	202	189	159
<b>Total - optimistic</b>	<b>328</b>	<b>365</b>	<b>382</b>	<b>186</b>
<b>Total - pessimistic</b>	<b>778</b>	<b>638</b>	<b>605</b>	<b>385</b>
<b>Potential Dutch share @ 10%:</b>				
Optimistic	33	37	38	19
Pessimistic	78	64	60	39
<b>Potential Dutch saving, immediate unilateral €-exit</b>				
Optimistic	24	37	38	19
Pessimistic	69	64	60	39

If the New Guilder (NG) appreciates or depreciates against the Euro, then the Dutch exit from the Euro will yield losses or gains respectively on net Dutch foreign assets. The policy freedom that The Netherlands would gain by leaving the Euro includes the option of shadowing the Euro, at least to start with. It follows that costs or benefits on net foreign assets cannot be specified without major assumptions as to future economic and foreign exchange policy.

If the Dutch policy were to benefit consumers by permitting some appreciation of the NG the maximum move that would be likely on past experience would be 10%. In this case the cost to Dutch net foreign assets would be approximately €75bn, assuming Dutch stocks only appreciate a portion of that 10% in Euro terms. This €75bn would turn the 2012 Dutch saving under the optimistic scenario in the table above from a saving of €24bn to a net cost of €51bn. However this short term cost will be outweighed by the savings of at least €37bn and €38bn in the next two years and €19b in subsequent years.

The Dutch share of future subsidy costs for Med-Europe is set at 10%, its GDP being one tenth of the core European members that will finance Med-Europe: Germany, France, Benelux, Austria and Finland. This 10% ratio is clearly an approximation.

This digest is organised as follows:

- 1: The Eurozone so far**
- 2: The euro with all current members**
- 3: EMU members leave**

# 1. The Eurozone so far

## Benefits

The more visionary see the single currency as a further step towards a 'United States of Europe'. The preamble to the 1957 Treaty of Rome made explicit the commitment to "an ever closer union amongst the peoples of Europe". The countries of Europe are deeply different in their legal systems, languages, and national habits on a scale unknown in the United States, which was formed by the occupation of the bulk of an entire continent by a single polity with, after 1787, a single constitution. Partly as a result, the flawed single currency has proved a retrograde step, dividing rather than uniting Europe.

Nonetheless benefits from the euro cannot be dismissed. The four benefits we have examined are to transactions costs, trade, travel and capital markets. The best estimate of these one-off benefits is around 2¼% of The Netherlands's €600bn GDP, €13.5bn or some €800 per head of the population.

Transaction costs have unambiguously been reduced. Guilders need no longer be exchanged for Deutschmarks. Eurozone banks need hold less money balances to effect foreign exchange transactions. The European Commission estimates this benefit added a once-off 0.3% to the area's GDP. In Dutch terms this is some €2bn.

The single currency has enhanced the trade benefits from the single market. Exports were 62% of GDP in 1998 and are now 83%. Imports were just under 58% and are now 75%. But the single currency cannot take all the credit for trade growth. And trade growth alone overstates the economic benefit thereby derived. A significant share of increased exports has entailed increased imports. The extra value added is what matters most. The Dutch Central Bureau for Statistics has pointed out that "the share of GDP employed producing exports has remained a relatively constant 29% of GDP since 1990", citing competitive Chinese imports as a cause of the higher gross export and import shares. While the export share of GDP has increased by 20%, the 29% of Dutch product, ie, value added, used in producing exports has not: what has increased is the import content of exports. The gain from increased exports and rapidly rising import content of exports is difficult to estimate and certainly only a fraction of the 20% of GDP involved.

Taking account of these factors, an EC commissioned study by the British *National Institute for Economic and Social Research* gives an order of magnitude of the gains from EMU for large core countries. It concluded that it was some 2% of GDP. This is equivalent to €12bn for The Netherlands, the bulk of the €800 per head of the Dutch population cited above.

The European Commission has looked at the gains from deepening capital markets, concentrating on the benefits from lower government bond yields for most Eurozone members during its first ten years. Sadly this has proved to be a spurious and ephemeral gain, more than wiped out by greatly increased spreads during the current crisis. Indeed the near-elimination of interest rate spreads was a contributory factor to the crisis and should now be regarded as a cost.

## Consequences and costs – inflation

It was hoped that the euro would promote convergence. Instead the single monetary policy caused divergence – reinforcing divergent national inflationary behaviour patterns. Individual economies went their own separate ways. Labour costs rapidly diverged. Amongst the six largest economies, at the extreme Spanish costs rose 37% more than German in the euro's 'good years', 1999 to 2007. Italy's went up 29% more. In the 'bad years' since 2007 Italy has lost more ground, now up 34% but Spain has pulled back to 31% up. Meanwhile the European Single Market has helped restrain consumer prices. On the eve of the Great Recession and crisis, Spanish consumer prices were up 20% on German. When costs rise faster than prices, profits and sales suffer. Lost competitiveness undermines growth.

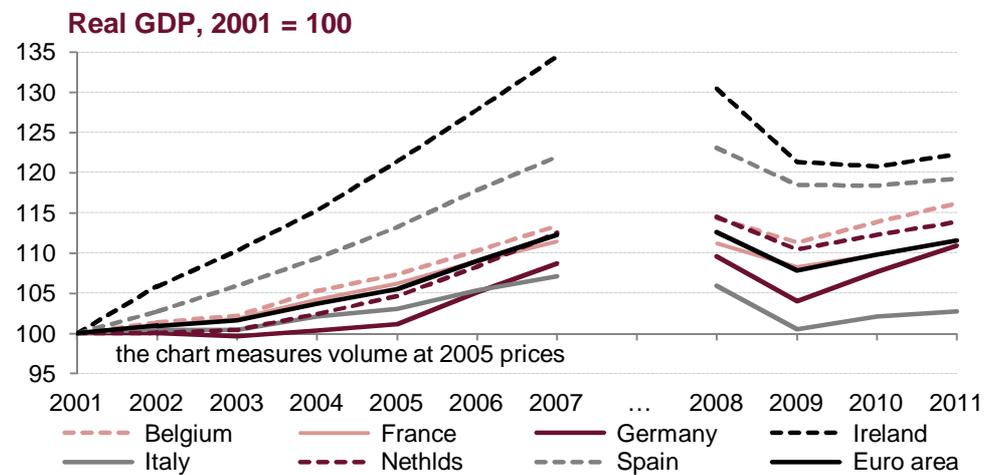
This has been manifest in trade performance. While the euro's nominal exchange rates are the same for all members, real rates are not. The growing German and Dutch cost advantage has translated into a real effective depreciation. While advanced countries' share of world export markets has fallen by 11% points during the euro's lifetime (thanks largely to China), The Netherland's share fell by only 1% and Germany's rose by no less than 12%. By comparison Italy's real effective exchange rate appreciated and its world export share fell by a disastrous one-third. Austerity cannot reverse such real rate and cost differentials, except over a similar time-scale of well over a decade (if at all).

## Growth

Eurozone growth has slowed dramatically since 2001 (allowing for the lagged effect of entry). Every major member's output has grown less rapidly during the past decade. Even in the good years to 2007 Eurozone growth was marginally slower. The Eurozone shrank in the bad years that followed. The pattern of relative growth in 2002-07 was affected by three factors. The first is the much greater, "catch-up" growth potential of poorer countries like Spain and Greece. The second is the distortion arising in the Eurozone from the common interest rate, "one size fits none". The third was the fierce austerity programme adopted in Germany in 2002-05 allegedly to recover competitiveness of costs, though export market performance clearly indicates Germany had no relative cost problem in 1999-2001.

Given differences in inflation, "real" interest rates, ie interest rates minus inflation, diverged between countries, even though they all had the same nominal short-term rates, set by the European Central Bank (ECB). Thus Germany's average real short-term rate in 2002-07 was 2%, versus the Dutch 1.5%, and Spain's 0.6%. Slow-growth, low-inflation Germany had high real short-term rate of interests, likely to inhibit growth and inflation even further; fast-growth, high-inflation Spain had the opposite, overheating artificially its growth and inflation. The structure of the euro worsened divergences naturally arising from the differences between the countries. The Dutch and Germans felt poorer than they actually were, the Spanish richer – and the low interest rates that were perceived as a benefit became a curse.

The effects of the perverse interest regime were naturally most evident in capital markets and housing. The natural buoyancy of housing and house prices was hugely boosted in Spain, and in Greece, Portugal and Ireland, into a housing bubble. Had they been outside the euro, these economies would quickly have seen this boom curbed by higher interest rates in their separate currencies, while Germany and The Netherlands would have enjoyed lower interest rates than those experienced under the euro. Instead, the common interest rate, and the delusion that differences between countries would be ironed out quickly by natural economic forces, underpinned unbridled housing bubbles. Ireland's had already started to collapse before the US subprime crisis stopped the whole process from mid-2007 onward. In Spain, Greece and Portugal the damage would have been even more extensive had not the US bubble collapsed.



German policy reinforced already dangerous divergences. Severe wage restraint in 2002-05 held down labour costs – with labour cost deflation – and cut into consumer incomes. With a separate currency, its appreciation would have rewarded workers for their restraint with cheaper imports and foreign travel, as happened in the 1980s and 1990s. Likewise with separate currencies, the fast-growth countries like Spain and Greece, as well as having appropriate interest rates, would have been curbed by rising import costs, and would have had more cost-competitive exports and buoyant core European consumer markets to sell into. The crisis simply would not have occurred: individual country adjustment would have been forced by financial markets at a much earlier stage. But with the euro the problems were both aggravated and masked by a fallacious, *laissez-faire* belief in the Eurozone as a self-correcting continental economy like the United States. The euro added to the natural divergences between countries, as well as distorting their growth patterns.

### Swedish and Swiss success

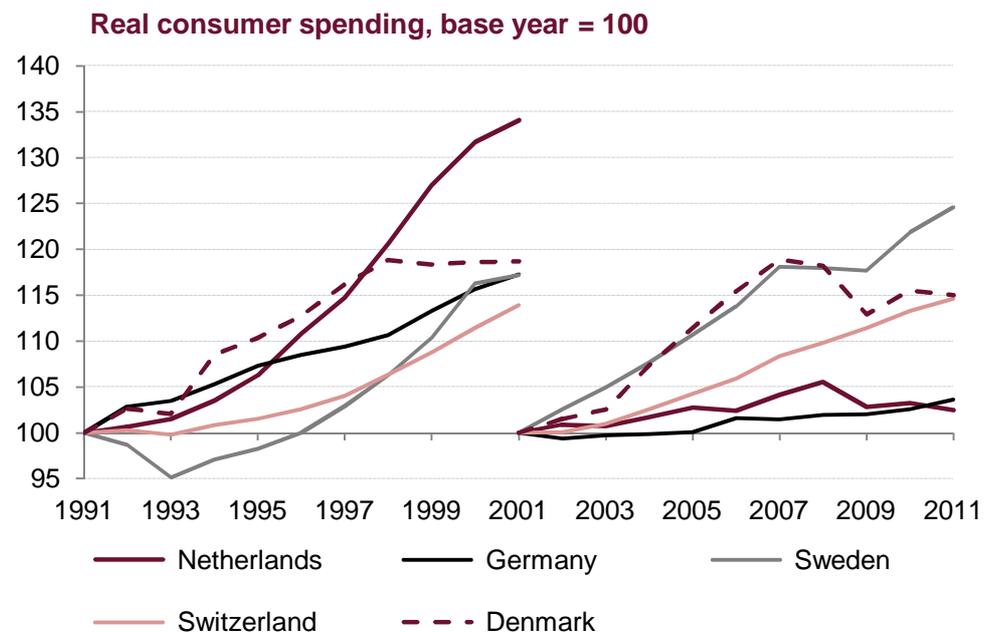
The Euro's baneful impact can also be assessed from experience in other countries. US and UK growth also slowed down in the new millennium as a result of debt crises after 2007. The root cause was similar, fixed and dirty floating by China and Japan which gave an illusion of moderation that led to artificially low

interest rates. Sweden and Switzerland were high savings surplus countries like Germany and The Netherlands, but they retained their own currencies and policy freedom – and the benefits were large.

Increased competitiveness spared Germany and The Netherlands the worst consequences of sluggish consumer spending. Export-led growth came to their rescue thanks to the run-up of deficits and debts in southern Europe (China was similarly rescued by the US and UK). But the imbalances did not conceal much worse overall performance. While Dutch growth more than halved following the euro's birth and Germany's already slow growth became more sluggish, Swedish growth was unaffected in 2001-2011 compared with 1991-2001, and Swiss growth accelerated. Only wishful thinking could absolve the euro from blame.

### Dutch and German citizens sowed but did not reap

Export-led growth is at the consumers' expense. Current account surplus countries earn more than they spend. Their savings enable deficit countries to spend more than they earn (or vice-versa). Dutch and German household expenditure virtually stopped dead: real consumption growth slumped more than GDP to a stagnant ¼% a year in 2001-11. Swedish consumption matched GDP growth at 2¼%, while Swiss consumption grew less than GDP, but still notched up 1¼% a year. As the Dutch population increased by 0.4% a year, real consumption per head actually shrank. Had Dutch real consumption grown in line with GDP, every Dutch person would now be €1,800 better off. Had The Netherlands matched Sweden, the increase would have been €3,500 per head.



Swedish and Swiss consumer gains were not bought at a cost for the rest of their economies. They created more jobs than the Dutch and especially the Germans.

They enjoyed lower inflation. They were more successful in balancing their budgets. And they have run larger current account surpluses!

### **A poor investment in the future**

Both The Netherlands and Germany are aging rapidly, facing future declines in the working-age population. Today's pre-emptive restraint was supposed to create a treasure chest of foreign assets to be drawn upon tomorrow. This treasure has not been invested well and wisely. The Eurozone has not run a commensurate current account surplus. Their euro surpluses have been largely matched by euro deficits, Italian, Spanish and Greek. Non-euro foreign assets are mainly claims on the UK and US. Dutch and German thrift have supported consumption in 'thriftless' nations whose aging problems are similar. Their treasure is fools' gold. It will not buy the expected future income as much has been wasted on Greek and others' junk sovereign debt and US sub-prime mortgages.

The Dutch have been particularly hard hit. While adding to their foreign fortune it has been leaking away. In 2000 The Netherlands was an international debtor to the tune of €64bn. Since then it has earned a cumulative foreign surplus, including interest at the ECB's repo rate, of €343bn. But it has lost, one way and another, a third of this, €115bn. Its net foreign assets have risen to €165bn instead of €279bn. For every €100 saved out of income, €34 have been wasted or nearly €7,000 per head.

### **It was not all to do with budget deficits**

Euro-spawned divergent growth and inflation caused external payments imbalances. Government profligacy did not divide 'saints' from 'sinners'. In the good years Germany was a near-sinner. Its budget deficit exceeded the Eurozone average and was a whisker below the 3% Maastricht limit. Spain and Ireland were saints with budget surpluses. Greece and Italy were the most wayward. Even so, the burden of their pre-euro debt, over 100% of GDP, was more important. They failed the 60% Maastricht test and should not have been allowed in. Current account, not budget, deficits indicated the onset of crisis.

When private sectors save a lot, governments can spend a lot (but less) and avoid foreign debt difficulties. Their nations lend rather than borrow. German households and businesses are great savers, 8% more of their joint incomes than they invest. Germany can afford 3% budget deficits while running substantial current account surpluses. Budget surpluses did not save Spain or Ireland. Their private sectors borrowed and spent extravagantly. Slashing excessive budget deficits may be necessary, but it is no solution to the current debt crisis in Med-Europe, where debt-satiated households and/or companies seek also to retrench.

The Dutch fiscal position is unique. Dutch households owe almost three times their annual disposable income, though largely offset by life-assurance policies linked to mortgages and other accumulated savings. Government debt is not a problem, around 70% of GDP gross and 40% net. But the 4% budget deficit still requires

pruning to preserve the Dutch AAA rating, given that current austerity programmes in Med-Europe are worsening the debt crisis. With deep recession in Med-Europe, weakness in core Eurozone and elsewhere in the world, cash will continue to be drained from surplus countries. The pressure for easier fiscal policies in the core will also mount. As long as Med-Europe remains in the euro it will be difficult for the Dutch to balance their books. France's downgrade may not be the only one – other countries could soon follow and the cut to AA+ only may not be the end of the story.

### **Conclusion**

**While unquantifiable, no spurious counterfactual story is required to show that EMU membership to date has imposed substantial welfare losses on Dutch citizens. Their own superior pre-euro performance, coupled with their subsequent inferiority compared with Sweden and Switzerland, is undeniable. Wasteful investment and intractable Med-Europe deficits, with continued dependency, make for a stressful future. It is difficult to see what explanation there could be other than the euro.**

## 2. The euro with all current members

This is unlikely to be achievable: Greece may default, opt out or be forced out within months. Including it in this analysis however demonstrates the costs of maintaining the euro intact. The costs are not limited to Greece. It may be a stretcher case in need of life-support, but Italy, Spain and Portugal are walking wounded that need support. In theory they will contribute cash to bail-out funds provided by the EFSF, IMF and indirectly by the ECB and shoulder their share of the losses. In practice they will need to take rather than give. The bill will be shared amongst northern surplus countries – Germany, The Netherlands, France, Belgium, Austria and Finland – “Neuro” Europe for short. Their total GDP is €6 trillion, ten times the Dutch €600 billion. The Dutch putative EFSF share is 5.7%. But with walking wounded excluded, its share rises to 10%.

How long it may take stretcher cases and walking wounded to return to full health? When will they be able to eliminate budget deficits, which meanwhile require help in financing? When can they return to markets at affordable interest rates to roll over maturing debt? Until these tasks are accomplished, their continued Eurozone membership will require unlimited overdraft facilities from surplus countries, with much of the debt never to be repaid.

Current account deficits are only a part-measure of post-crisis external funding needs. Now that the credibility of Med-Europe government debt is on the line, it is government deficits that will necessitate financing assistance: as long as “All stay in” the euro, private sector surpluses, which are likely to be large in depressed Med-Europe, will probably not be altruistically lent to their government, but shifted abroad to such “safe havens” as exist. Keeping all the Med-Europe countries in the euro will require financial support from Neuro Europe for both government deficits, and the refinancing of maturing government debt.

The future change of exports and imports is more important for its effect on growth than on Med-Europe’s financing needs. Improved competitiveness would stimulate demand for exports and domestic production at the expense of imports. But, absent devaluation or massive domestic deflation, improved competitiveness depends on faster demand growth and inflation in the surplus countries, notably The Netherlands and Germany. If this is excluded, the adjustment in Med-Europe will consist entirely of deflation of output and real incomes, reducing demand for both home production and imports, and lowering relative wage costs by slashing incomes. Prolonged recession or depression could then make worthless most of their debts to Neuro partners.

In this “All stay in” scenario, the costs to surplus countries such as The Netherlands are taken initially through the ECB, the EFSF, the IMF, etc., which have been busily using their strong credit rating, owed to the underlying credit of surplus countries in the Eurozone, to buy Greek, Italian, Spanish, etc., government bonds

and support their banks. In the scenario for Med-Europe debt presented in this report, this temporising process will soon give way under the pressure of Greek failure to achieve its deficit and debt reduction targets, banking crisis in Portugal and probably Spain as the recession arising from excessive austerity intensifies into Med-Europe depression, and mounting debt, of not deficits, in Italy.

### **Greece – Sisyphus is no longer a Greek legend, it is today's reality**

Sisyphus was compelled to roll an immense boulder up hill, only to watch it roll back down, again and again in perpetuity. Austerity, intended to cut Greece's budget deficit, is actually increasing it, as the economy and tax base collapse.

Private creditors already face 'voluntary' default on Greek sovereign debt with nominal haircuts of over 50% and present-value losses much greater. These will mount to 100% for someone if Greece stays in the euro. There will be no return to market finance and further official loans will be called for. Government debt is €360bn, over 170% of the recession-shrunk Greek GDP.

Austerity-stricken Greek government deficits and debts are growing. Tax hikes and spending cuts have deflated the economy, shrinking the tax base and raising the costs of unemployment and other relief. Last year Greek real GDP collapsed by 7% and nominal GDP fell 5½%. Greek ministers, international and European officials said the budget deficit would be cut to 9% in 2011 (the original target in the May, 2010 bail-out being 7½%). Preliminary returns suggest that in fact it was up 1% in euros, and from 2010's 10.8% of GDP to 11½%, reflecting the slide in GDP. Greece has been forced to embark on further retrenchment this year. World and European growth prospects are less healthy. The deficit could again be worse.

Optimistic projections and impossible targets continue to emanate from those who assert that the euro will be saved intact "whatever it takes". The "primary" budget deficit – which excludes interest payments – was 5% of Greek GDP in 2010, and about 4% last year (versus the IMF target of 2.3%). The IMF predicts a surplus of 4½% by 2014. Improvements of over 3% of GDP each year for three years are no more likely than a man walking on Mars in 2014. A 120.5% of GDP government debt by 2020 is equally implausible without default and would anyhow be insufficient to resolve the Greek debt problem.

Notionally, private haircuts will knock €100bn off Greek debt. But Greek banks who own most of the debt would need to be recapitalised and a €30bn cash sweetener will have to be paid. The net debt reduction could be as little as €35-45bn. Greece will still need loans to pay €3bn a year interest on swapped bonds and a further €10bn a year in the interest due on some €225bn debt already held in official hands. Moreover the swapped bond capital will have to be paid on maturity and subsequent maturing debt rolled over. Annual debt service costs will be around €13bn. A further €10bn will be needed to fund continued primary deficits and none of the existing official debt holdings will be repaid. The running costs of €23bn mean a €2.3bn a year cost to Dutch taxpayers. But Greek sovereign debt is

worthless if it remains in the euro, so the cumulative and ultimate cost will be horrendous.

The table below assumes that the final data for 2011, and worsening numbers in 2012 as a result of the renewed collapse of GDP at the end of 2011 and onward, convince Neuro countries to recognise their losses on Greece. The €100 billion of written-down debt in private hands is left in place, with its low interest rate, but the €225 billion of remaining debt is written down over three years, from end-2012 to end-2014.

### Greek projections

	2011	2012	2013	2014	2015	2016
GDP, €bn	215.3	204.5	200.4	200.4	206.5	212.7
Gross gov't. debt, € bn *	325.0	349.5	288.6	213.1	112.3	110.4
Total budget balance, € bn	-24.8	-24.5	-22.3	-18.7	-12.3	-10.4
- % of GDP:						
Gross gov't. debt *	151.0%	170.9%	144.0%	106.3%	54.4%	51.9%
Primary budget balance	-4.0%	-4.5%	-5.0%	-5.0%	-4.0%	-3.0%
Interest on gov't. debt	7.5%	7.5%	6.1%	4.3%	1.9%	1.9%
Total budget balance, € bn	-11.5%	-12.0%	-11.1%	-9.3%	-5.9%	-4.9%
Maturing debt **		83.2	94.3	113.1	12.3	10.4
Total required aid Eurozone		83.2	94.3	113.1	12.3	10.4

\*2011 debt of €360bn, 167% of GDP, less "voluntary" write-off being negotiated now

\*\*Assumed write-down of remaining debt not written down in "voluntary" write-off

### Italy – walking wounded

Italy does not have a run-away budget deficit. At 4% of GDP in 2011 it was moderate and the primary budget, which excludes interest payments, was ½% in surplus. Its malignancy is in government debt, 128% of GDP on a gross basis (100% net) and rising. Italy has a history of large budget deficits and debts. But Italian households and companies are big savers. They help finance deficits and hold much of the government's debt. Before the euro, debt interest costs were high to compensate for inflation and currency depreciation which moderated the debt burden relative to GDP. The euro closed the depreciation fire escape and until the crisis compensated for this by reducing interest rates to near-German levels. The inflation escape route remained partly open with respect to Italian holders, but with pernicious results. The current account was in significant surplus from 1993 to 1999, but moved into a deficit in 2000 which steadily increased to 3½% last year. Italy's dependence on foreign lenders to finance deficits and roll over maturing debt has thus been increasing.

Italy is solvent, as things stand, but suffers a liquidity problem. While it retains access to capital markets the cost is no longer restrained by near-German interest

rates. Such penal market interest rates may be demanded that the liquidity problem mutates into a solvency crisis. The primary budget surplus required to stabilise the Italian debt/GDP ratio at its current level depends on the interest rate it pays on its debt, its nominal GDP growth rate and the current debt ratio. Last year's government interest bill was 4½% of GDP. This means it was paying on average a 3½% interest rate on its existing debt. Today Italy pays 5½-6% on new and rolled-over bonds. It had to pay much more before the European Central Bank launched its Long Term Refinancing Operation (LTRO). More expensive borrowing will increase the government's interest bill to around 5% of GDP this year.

If debt is to be stopped from rising and creating a downward spiral of Italian finances, the growth of debt must be less than that of GDP, so the deficit must be less than Italy's nominal GDP growth rate (the sum of real growth and inflation). But Italy's growth trend has been nil over the past ten years, and the parallel requirement within EMU of becoming cost-competitive again means its inflation will have to be close to nil in future. So the target budget deficit has to be at most 1-2% of GDP (assuming a small amount of real growth and inflation). With interest of 5% of GDP this year, these numbers mean a primary surplus of 3-4% is needed just to stop debt rising: nobody seriously expects Italy's debt ratio to fall significantly.

To get to +3-4% from 2011's small primary surplus, the new Monti government proposes austerity measures amounting to 4% of GDP over two years, mostly tax increases. But this drives Italy toward the Greek trap. GDP was already falling in real terms in the second half of 2011. It could fall sharply this year, even in nominal terms, as inflation is likely to be minimal. The primary balance could only improve a little, and rising interest payments mean the continuing budget deficit will add to debt. Meanwhile GDP is falling, raising the deficit and debt ratios. This could be repeated in 2013. Net debt by end-2013 could be heading towards 110% of GDP, gross debt 140%. Austerity will drive Italy into the Greek debt trap.

Eurozone policies to deal with the Greek crisis have had other adverse side effects. The 'voluntary' debt write-off plan, designed to prevent triggering credit default swaps, made CDS insurance suspect. Together with 'subordinating' private investors' claims on sovereign debt to official holders' claims, these actions helped push market interest rates for Italy to debt-trap levels. **At present and prospective rates, Italy is being priced out of capital markets. It is a slow-motion version of the Greek debt-trap and means that, to stay in the euro and avoid default, official financing must replace all private. This year Italy needs to borrow €305bn to cover its budget deficit and maturing debt and another €175bn next year. Most, if not all, must come from official lenders, effectively Neuro Europe.**

Maybe the ECB's LTRO programme will buy time, indirectly helping to finance Italian debt by bailing out banks (who can make a substantial profit from investing cheap ECB finance in high yielding bonds). On this favourable scenario bail-out funds will be needed to cover Italy's budget deficit, some €80bn this year rising to €95bn next. If the worst comes to the worst, a bail-out would need to cover maturing debt. The table gives optimistic and pessimistic estimates of required

official support. These are immediate cash-flow costs not economic costs (ultimate losses) that cannot be projected.

### Italian projections

	2011	2012	2013	2014	2015
GDP, €bn	1578	1546	1516	1516	1538
Gross gov't. debt, € bn	2026	2107	2202	2286	2358
Total budget balance, € bn	63	81	95	84	72
- % of GDP:					
Gross gov't. debt	128%	136%	145%	151%	153%
Primary budget balance	0.5%	0.0%	0.0%	1.0%	2.0%
Interest on gov't. debt	4.5%	5.2%	6.3%	6.5%	6.7%
Total budget balance	-4.0%	-5.2%	-6.3%	-5.5%	-4.7%
Maturing debt		305	175	140	142
Total support from Eurozone					
- optimistic		81	95	84	72
- pessimistic		386	270	224	214

### Spain – banks in big trouble

The Spanish government's 8% of GDP budget deficit is worse than Italy's. Its public debt, 75% of GDP (less than 45% net) is better: the major debt problem lies in business. Spain had a comfortable budget surplus in the good years before the crisis – 2% of GDP in 2007. But the current account deficit (foreigners' surplus) was 10%. This 12% government plus foreigners' surplus equalled the private sector's deficit, nearly all in business, fed by a tsunami of cheap and plentiful foreign credit.

Non-financial companies' debt **on average** climbed to 12 times net cash flow (pretax profit plus interest) above the 10% "junk" threshold. The new government has promised 4% of GDP budget cuts this year under the Eurozone pact, almost certainly leading to a sharp recession. Company profit will suffer – it always goes down most in recessions. Average debt-to-cash-flow ratios will climb. Still elevated real estate prices will continue to fall. Banks' loan losses will escalate. Additional capital requirements, set to be met by July (and onerous Basle 3 obligations) will not be met. To prevent systemic collapse, banks will need official bail-outs. This is how private sector losses translate into increased government deficits and debts. (Ireland's budget was balanced in 2006. Bank bailouts pushed this to a 31% of GDP deficit by 2010).

Markets are unlikely to lend (at other than short-term at penal debt-trap rates) the Spanish government the funds to finance a €80bn budget deficit this year, roll-over €145bn of maturing debt and whatever is needed to recapitalise Spanish banks. Much or all the cash-flow bill will end up with the Neuros, whether through the

dependence on them of the EFSF, ESM, ECB, etc, for capital to support financial operations, or directly. This is reflected below.

### Spanish projections

	2011	2012	2013	2014	2015
GDP, €bn	1096	1074	1053	1053	1068
Gross gov't. debt, € bn	796	890	994	1100	1202
Total budget balance, € bn	-86	-94	-104	-106	-102
- % of GDP:					
Gross gov't. debt	73%	83%	94%	104%	112%
Primary budget balance	-6.4%	-6.5%	-7.1%	-6.7%	-5.6%
Interest on gov't. debt	1.5%	2.2%	2.8%	3.4%	3.9%
Total budget balance	-7.8%	-8.7%	-9.9%	-10.0%	-9.5%
Maturing debt		145	98	83	57
Total support from Eurozone					
- optimistic		94	104	106	102
- pessimistic		239	202	189	159

### Portugal – banks in even bigger trouble

Two parts of debt-trap arithmetic are the same for all supplicant countries: austerity-induced recession and penal market interest rates. The Portuguese budget deficit is near 6%. Government debt is over 110%. Business debt is 16 times cash flow. Banks face onerous losses. The government deficit and debt is poised to explode as Ireland's did.

Debt interest already costs 4¼% of GDP in 2011, meaning a primary deficit of 1¾%. Given the current 11% cost of 10-year bonds, debt interest this year is set to approach 6% of GDP. Real GDP is slumping – Portugal is already in recession, with real GDP down 1.6% in 2011 from 2010, and even nominal GDP down 0.4%. Assuming a 2½% nominal GDP contraction in 2012, debt must fall by the same amount to prevent the debt ratio from rising. Starting from 2011's 6% deficit such a required shift into budget surplus is inconceivable, quite apart from the likelihood of a banking bailout that will cause government debt to soar further. Such are the fatal consequences of fiscal retrenchment.

In the following table, the cash-flow consequences from keeping Portugal in the euro do not include the large but uncertain costs from the banking crisis. But with minimal long-run real growth and the need, in a euro context, for deflation, its debt capacity is confined to what can be supported from a primary surplus. Such a surplus is unlikely, given the starting point of 2011 primary deficit and recession, and even with a surplus high nominal interest rates on Portugal's debt would confine its debt capacity to a very small amount. It follows that, as with Greece, Portuguese debt will at some stage, probably quite soon, be recognised as worthless. So the cash flows below have it written off over three years, as with Greek debt.

### Portuguese projections

	2011	2012	2013	2014	2015
GDP, €bn	172.0	167.7	163.5	163.5	166.8
Gross gov't. debt, € bn **	192.5	205.1	145.6	79.1	0.0
Total budget balance, € bn	-10.1	-12.6	-10.4	-5.5	0.0
- % of GDP:					
Gross gov't. debt	112%	122%	89%	48%	0%
Primary budget balance	-1.7%	-1.8%	-1.8%	-0.9%	0.0%
Interest on gov't. debt	4.2%	5.7%	4.5%	2.5%	0.0%
Total budget balance	-5.9%	-7.5%	-6.4%	-3.4%	0.0%
Maturing debt & write-offs *		70.0	72.0	79.1	0.0
Total required aid from Eurozone		70.0	72.0	79.1	0.0

\*assumes 3-year write-off of current & accruing debt

\*\*assumes write-off in footnote above, and excludes large expected bank recapitalisation

### 3. EMU members leave

Cash-flow costs by country and total give the price Neuro must pay in future years to keep the euro intact. But within the euro most of the debts will never ultimately be repaid and subsidies will need to continue, year in and year out. Indeed the euro can only survive if it becomes a fiscal transfer union with national sovereign debt subsumed in Eurozone bonds. Moreover structural change must not be confined to crisis-stricken economies. Given the need for domestic austerity and lower relative wages in Med-Europe, growth can only be enjoyed in the Eurozone as a whole if the surplus countries, notably The Netherlands and Germany accept the need for consumption growth faster than GDP, and higher inflation than the Eurozone average, presumably at least 3-4%. Failing this, Neuros will be condemned to waste their savings on worthless assets, and Med-Europe to depression.

Our view is that, assuming The Netherlands stays in EMU for the time being, the dawning of realism about Greece will cause it to make a negotiated exit – willed, if regretted, on both sides – later this year. And that Portugal will have to leave shortly thereafter. The political thought behind this is that loss of Med-Europe countries from the euro is most problematic for France of the Neuro countries, its competitive position being much weaker than The Netherlands and Germany. So a Greek exit before the French elections are over is unlikely. But Germany has major elections in autumn, 2013, and would like a “clean run” for the previous year. That means settling the “Greek problem” for once and for all. However, as we have demonstrated, the Greek problem will not go away as long as it remains in the euro. So it will have to go – and will be glad to go, given the virulence of the recession.

Once Greece goes, with severe recession meanwhile sapping Portuguese business and banks, the full force of the financial markets’ perfectly proper scepticism will drive Portugal out in short order. At that point, if not before, attention will turn to Spain and Italy, both likely by then to be much weakened by the savage austerity programmes now being implemented. At that point, the Neuro countries will actually be forced to make the decisions they have ducked in the two-year crisis so far. The Netherlands and Germany, if they wish to preserve the euro with Italy and Spain in it, will have to accept deficit budgeting and relatively high inflation for the foreseeable future, as well as indefinite subsidies of Italy and Spain via fiscal union and Eurobonds. The alternatives will be exit, either by Italy and Spain, or by Germany and The Netherlands in tandem. The former would create the Neuro, the latter would mean a return to the rationality of floating exchange rates.

At any stage in the above possible course of events, it would be open to The Netherlands to leave the euro unilaterally – on the upside, so to speak. Such a decision would clearly be more profitable the earlier it is taken.

### Break-up scenarios for the euro

- (a) only Greece and Portugal leave
- (b) “contagion” then forces Italy and Spain to leave, leaving behind the “Neuro”, centred round Germany, France, Benelux and Austria
- (c) “contagion” after Greece and Portugal leave creates such large prospective subsidies to Med-Europe that The Netherlands and Germany decide to quit EMU, effectively returning Europe to floating exchange rates
- (d) The Netherlands leaves alone

### Only Greece and Portugal leave

Aside from the technicalities of treatment for each category of euro obligation vis-à-vis Greece, its exit would involve a bridging loan to the central bank to get the new currency started, presumably (as with IMF-type financing) senior to all existing loans. It is only reasonable to assume this would eventually be repaid if much of the remainder of existing Greek debt, including those now mostly to official institutions, were both written down and denominated in new drachma. This could be expected to fall drastically, though not the 80% assumed in some quarters. So for practical purposes, the financial impact of Greek exit later in 2012 would be little different from the cash flows shown above in connection with keeping it in EMU, an unchanged negligible present value but with a more immediate write-down. This is simply the price of having accepted Greece into EMU in 2001 and then treating its galloping imbalances with complacency for eight years.

Portugal's gross government debt would probably not be a complete write-off if it leaves EMU this year. The risks from its huge business debt would have to be kept under some form of control by denomination in new escudos, as with government debt, at least for that portion owed to Portuguese banks. But a banking crisis is still likely to require major recapitalisation at government expense. The relatively small primary deficit means a devaluation could yield primary surplus quite quickly. Government debt capacity would certainly not be more than half GDP, however, and half of that might be taken up with bank recapitalisation. In order of magnitude, Portugal's near-€200billion debt, would be cut by three quarters, and then subject to whatever devaluation proved necessary for the new escudo, probably in the 25-40% region. That would only leave €30 billion out of the original €200 billion, but most of that would be borne by existing holders, not Neuro countries. So it would be much less costly than keeping Portugal in.

This scenario of Greek and Portuguese exit could become more costly in relation to Italy and Spain, however: financial contagion as exit from the euro becomes demonstrably feasible. At the least this could bring forward the date at which Neuro countries would have to finance the gross borrowing requirements of these two countries, including refinancing of maturing debt. **This is one factor behind current Eurozone policy paralysis.**

## Spain and Italy leave

In this scenario, the Greek and Portuguese exit costs are the same as in the previous one. Italy and Spain suffer acute contagion and exit the euro. Sizeable bridge loans to facilitate exit would be needed. Nonetheless, if implemented quickly, Italian and Spanish exit from the euro would offer major savings compared to keeping them in – especially after Greek exit. Italy's exit would be more easily managed than Spain's, as its overall debt ratio is not high, only its government debt. In Spain, exit involves the double problem of a higher budget deficit and the danger from a banking crisis induced by huge company debts.

To estimate the cost savings from Italian and Spanish exit is hazardous, as they get rapidly greater the longer the exit is delayed. It is not realistic, in the current condition of European politics to expect either country to take a Greek exit later in 2012 as a signal to get out. The whole tenor of recent policy discussion and action has been to treat Greece as an exception – which it is, in that its problems are more acute. If a Greek exit is followed by these two countries “hanging on”, the cost of supporting them rapidly escalates to the upper end of the ranges presented above for their finances. Continuing for some years, followed by “throwing in the towel” and exit, this would become a very expensive scenario, as the badly injured economies would need to be nursed back to health at major Neuro expense.

Immediate Italian exit would not be very expensive. Foreign banks and other institutions owning Italian government bonds would lose money as the new lira descended, and might need some bail-out by the governments. Euro institutions that have recently loaded up with Italian paper to try to fix the market would lose some money. But with currency freedom, Italy would quickly enhance its primary surplus, return to moderate growth, and regain debt servicing capacity, if at the expense of ongoing inflation and devaluation – back to the old days, in fact, and very welcome for that compared to the past 10-11 years.

Immediate Spanish exit would be more problematic. Its primary government deficit is nearly 7% of GDP, reflecting the private sector's need for a huge financial surplus to permit deleverage after the debt orgy in the run-up to 2007. A major devaluation might put things right, given good export performance in recent years. Spain needs a large current account surplus (= foreigners' deficit) to provide its private sector with financial surplus without the government having to run the offsetting deficit. But Spain is highly internationally connected and a major devaluation could worsen the banks' difficulties with their assets – ie, the excessive debt load of business. Clearly the sooner Spain exits the better, as going into severe recession without leaving the euro would bring on a bank crisis anyhow, without the possibility of putting right the primary budget deficit.

For all these advantages of early exit, which would minimise the cost of Italy and Spain leaving the euro, this remains improbable, so a high-cost, long-drawn-out struggle would be likely before the simple realities of recession and massive unemployment forced exit. This prospect gives rise to the alternative scenario ...

### **The Netherlands and Germany leave**

Here again, the sooner the better in terms of total cost. Realistically, at the earliest it could be reactive to Greece and Portugal having left later this year, and the massive contagion in financial markets threatening to raise sharply the cost of keeping Italy and Spain in the Eurozone. Given the German electoral calendar, however, and the absence of scepticism about the euro in any major German political party, it is hard to imagine this option being undertaken this side of autumn 2013 elections – even though it would be popular.

In this scenario, the costs for launching independent currencies and monetary systems in Italy and Spain could be the same, but incurred earlier, much reducing the total costs, given the large potential annual fiscal support for those two countries.

The chief point of this scenario is that it amounts to a return to floating exchange rates. In no way would it be likely that France, Italy and Spain would wish to maintain a common currency. The German and Dutch exchange rates, whether fixed together or floating separately, the new French franc might be little changed against the dollar, while the Med-Europe currencies would fall sharply.

For The Netherlands, this would involve the equivalent of strong-euro experience before the world moved on from the subprime crisis to the Greek start of the euro-crisis. Relative to the dollar, the Dutch currency would be up, but also relative to much of former Eurozone, France and possibly Belgium included. In trading terms, Dutch firms would feel a (possibly badly needed) stiff breeze. In price terms, consumers would benefit.

When it comes to net Dutch foreign assets, the dissolution of the euro would require a legacy currency, and role for the ECB in managing it and maintaining markets and liquidity. Against that benchmark, The Netherlands, if its currency rose with Germany's, would gain in respect of its non-equity position, which is a net obligation of €250 billion, with government debt, denominated in euros being about the same. Pension funds, on the other hand, with net equity positions abroad, could suffer losses. But such losses would be qualified by the shifts in stock markets, which tend to offset currency movements. In any case, the government's gain on its liabilities should be available to compensate pension funds for losses incurred by a policy serving the general good.

### **The Netherlands quits EMU unilaterally**

To the extent The Netherlands stays in the euro before drawing the conclusion it ought to leave, it will incur costs, most likely under the "All stay in" scenario. Further exit costs could also arise if, by the time of Dutch exit, formal commitments to meet long-term Med-Europe financing needs have been made under the intended ESM agreement, currently intended for later this year. This timetable argues for early action if this policy option is preferred. Aside from representing action to deal with a

threat to Dutch finances, it more generally gives The Netherlands freedom of action in economic policy.

No more than anywhere else can The Netherlands independently set inconsistent targets for the three chief demand-management policies: budget balance, interest-rates/monetary, and exchange rate. The risk that most observers would probably emphasise is a rising new guilder (NG). But it must first be observed that previous episodes of Dutch real exchange rate strength have not taken it out of a fairly narrow band of +/- 10%. Nor is this likely to happen in future. The sheer open-ness of the Dutch economy argues against it. While this is clearly not the equivalent of the euro rising 10% (to \$1.45, say) as that would take up other EMU countries too, the relatively recent experience of the euro at \$1.60, leaving the Dutch economy unscathed – unlike Med-Europe – suggests little threat. And a 10% rise is the extremity of past experience, not the norm: it would almost certainly settle down again – with Dutch consumers gaining all the way through, of course.

Should The Netherlands, at least at the start of unilateral euro-exit, shadow the euro? If you want budget balance and to shadow the euro, monetary policy will be forced on you, not freely determined. If the NG were to be strong, that means interest rates at or close to zero (no great sacrifice perhaps) and possibly quantitative easing too (buyback of existing securities in the market, eg Dutch government bonds, financed by, in effect, "printing money"). This policy choice seems reasonably manageable.

In this scenario as in leaving with Germany, the valuation of foreign assets would be an issue. But the limitation of any NG move means that at the worst the problem would be little different from having the euro shift to \$1.45, well within recent experience. Excluding government bonds, net non-equity positions will be close to zero, the possible losses on net equity assets largely offset by valuation shifts.

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