WILL THE EURO ULTIMATELY COLLAPSE?

The current crisis involving Greece has served to highlight the stresses within the European Union and, in particular, to illustrate how tenuous a currency the euro is. The importance of the euro is evident to those with even the most casual interest in economics, so some comments about its past and future seems appropriate. It is likely that considerable gains and losses will be tied to the fate of the euro.

It has not taken long for problems with the euro to manifest themselves. The euro is only 16 years old. That problems have arisen should surprise no one. The euro is one of the most contrived financial concepts ever implemented. It is a product of good intentions. A consensus arose in Europe in the aftermath of WW2 that steps must be taken to prevent further wholesale slaughter and destruction. Efforts to forge a bond among Western European nations based on common interests began in the 1950s with the Common Market. The relative success of the Common Market provided momentum for the establishment of the European Union and ultimately the euro in 1999.

The reasons for the need of a European Union, the very different cultures, economies and interests that precipitated previous wars, are also the reasons why implementing a common currency is so difficult. The European Union, and hence the euro, is a political construct. Otherwise, a nation with the checkered financial history of Greece would never have been admitted.

If the disparate composition of the EU made the ultimate success of the euro difficult, the lack of a central treasury will likely prove to be its fatal flaw. The imposition of a common currency without control over members' fiscal policies is clearly problematic, but likely the only way the euro could have been implemented. Germany, France et al might have been willing to convert their currencies but they were not willing to surrender effective control of their economies to a centralized authority. Greece is important, not so much for its economic consequences (its economy is smaller than that of the province of Ontario) but because it represents a precedent for the euro. The most effective course for Greece is some form of debt relief combined with an exit from the euro. The new drachma would, of course, depreciate quickly but make Greece competitive again. Devaluation has been a well-used tool to reset economies. Indeed, we are in the midst of de facto competitive devaluations among major currencies, which partly accounts for the low interest rate environment. No central bank will confess to its use; it is the policy that "dare not speak its name."

It may be that some compromise is arrived at that keeps Greece in the euro. Such a solution is only kicking the proverbial can down the road. However, the Greek problem has changed the psychology within the EU, such that member nations will more quickly seize on an exit from the euro as a solution to fiscal problems. Large economies such as Italy and Spain will be quickly squeezed on almost any combination of economic slowdown or rising interest rates.

It is almost certain over the next decade that other euro countries will experience stresses similar to that of present day Greece. Ironically, since the euro was effectively a political invention, it will be political concerns that will spell its end. One can make the argument that Germany benefits the most from the euro because it provides a competitively priced currency with which to sell its many exports.

However, as is already the case, many Germans are already disgruntled by the prospect of subsidizing southern Europe. That attitude would increase geometrically should a large economy such as Italy be the subject of a bailout. Ultimately, the political backlash would be so great that that no German government could agree to a bailout. It would not be the Germans alone that would end the euro, but northern European nations as a whole if the potential liabilities grew too large. The collapse of the euro will occur more quickly than most assume, as these things tend to do.

The return to the mark, franc, and lira et al would allow historical norms to reassert themselves, with the mark quickly appreciating versus the franc, lira etc. The return to sovereign currencies would produce great opportunities for investors, and traps for the unwary. Once individual currencies began trading, the inevitable currency readjustment would cause high volatility that would produce opportunities in currencies, bonds and equities. For example, if an investor must invest in Europe and was concerned about the demise of the euro, exposure to German equities is indicated given the expected appreciation of the new mark. An investor might then want to redistribute holdings to other more attractively priced European currencies and industries that could best benefit.

The collapse of the euro is not expected in the short term, but the macro situation of sovereign debt makes it likely that the euro will not last more than another 10 years. The death of the euro will not mean the death of the European Union, but an opportunity to reset the continent's finances. The Common Market and European Union are noble efforts that deserve to succeed. Aside from the euro, the EU has succeeded; there has not been a war and member states co-operate in many ways.

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