

State of the union

Can the euro zone survive its debt crisis?



EIU special report

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Economist Intelligence Unit
26 Red Lion Square
London WC1R 4HQ
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London

Economist Intelligence Unit
26 Red Lion Square
London
WC1R 4HQ
United Kingdom
Tel: (44.20) 7576 8000
Fax: (44.20) 7576 8500
E-mail: london@eiu.com

Hong Kong

Economist Intelligence Unit
60/F, Central Plaza
18 Harbour Road
Wanchai
Hong Kong
Tel: (852) 2585 3888
Fax: (852) 2802 7638
E-mail: hongkong@eiu.com

New York

Economist Intelligence Unit
The Economist Group
750 Third Avenue
5th Floor
New York, NY 10017, US
Tel: (1.212) 554 0600
Fax: (1.212) 586 0248
E-mail: newyork@eiu.com

Geneva

Economist Intelligence Unit
Boulevard des Tranchées 16
1206 Geneva
Switzerland
Tel: (41) 22 566 2470
Fax: (41) 22 346 93 47
E-mail: geneva@eiu.com

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Foreword

Europe—not an afterthought for the global economy

When China's economy took off in the early 1990s, joining Asia's well-established "tigers", a new centre of global growth began to take shape. Asia's bottomless labour force, high savings rate and freewheeling business environment combined nicely with America's footloose capital, culture of innovation and insatiable consumerism to create a new axis for the world economy—with the pole running straight through the Pacific. Europe was an afterthought: too slow, rigid and distant from the new centre of the world.

That calculus did not add up then—and it doesn't now. Europe's weaknesses, to be sure, are there for all to see; the euro area's debt woes are the reason for this special report. Yet, this vulnerability matters because western Europe remains so important to the global economy. The euro area comprises nearly 20% of global GDP—more than twice as much as China and only slightly less than the US. Not that size alone matters: despite higher rates of taxation and a more burdensome regulatory culture, the euro zone recorded faster rates of GDP growth than the US in each of the three years before the recent recession hit.

These figures hide what has clearly become a two-tier Europe: the periphery, which spent much of the last decade on a spending binge fuelled by cheap money, and the northern economies, led by Germany, which mostly managed their finances well and lubricated the rustier parts of their economies. Indeed, Germany has emerged from the 2008-09 recession looking far healthier than the US: better public finances, less debt, a trade surplus and a lower unemployment rate.

Europe matters to the rest of the world and so, hence, do Europe's efforts to contain the debt crisis. US companies rely on European markets for a significant share of their profits; that's one reason why US equity markets fall so far and fast when a debt shock rattles the euro zone. The first euro area solvency scare, which forced Greece to its knees in early 2010, was the catalyst behind the loss of US\$2.5trn in US stockmarket capitalisation in May and June. (US markets recovered, but they were twice more pounded by European debt scares in 2010, and will be again this year when the next euro victim—probably Portugal—goes to the authorities cap in hand.) However, if Europe's solvency crisis has at times damaged US portfolios, Europe's direct investors have been eager to put their money to work in the US: more than half of the foreign direct investment in the US in 2009 came from west European countries (including the non-euro UK). China also has reason to care about what happens in Europe. The EU—not the US—was China's largest export market in 2010. Chinese firms also apparently like what they buy from Europe: Chinese imports from Germany doubled in the last five years, led by the high-quality capital goods for which Germany is best known.

The seemingly endless efforts by euro area leaders to resolve their debt woes are both a sign of determination to get ahead of the issue and evidence of how dysfunctional relations among the countries can be. The rest of the world has a strong interest in hoping they have found the answer, and that it works.

Introduction—the sorry state of the union

The euro area's crisis is part political, part economic

The roots of the crisis

In the run-up to the global financial crisis, the euro area looked very much like a microcosm of the world economy. The region as a whole grew in line with its long-term trend, and its trade position with the outside world was broadly in balance. However, the euro area's aggregate position masked large variations across the member states. In some parts of the region (notably countries on the geographical periphery), demand grew consistently faster than output; in others (like Germany), the reverse was the case. Profligacy in the periphery was funded by thrift in the "core". This arrangement suited both sides—for a time at least. While countries in the periphery enjoyed debt-fuelled booms, countries such as Germany, where domestic demand was weak, could rely on exports to keep growing.

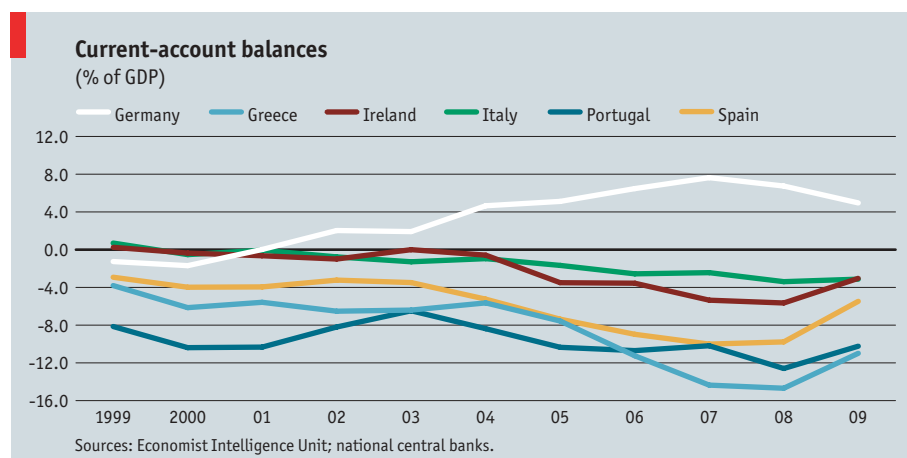
It is tempting to ascribe the euro area's problems to fecklessness and irresponsibility in the periphery. In reality, things are more complicated. The truth is that virtue in the core was dependent on vice in the periphery: rising indebtedness in the periphery was simply the reverse side of export-led growth in the core. Or, to put the matter differently, it was precisely because peripheral countries lived beyond their means that countries such as Germany were able to live within theirs. The relationship between the euro area's core and periphery can be compared to that between China and the US—but with two differences. First, the flow of capital from core to the periphery was the result of private-sector behaviour, not official intervention. Second, capital flows in the euro area generally went downhill, from wealthier member states to poorer ones, rather than uphill (as has been the case between China and the US).

The euro area's problem was not so much the existence of macroeconomic imbalances, or the direction of capital flows that accompanied them. It was perfectly reasonable for capital to flow to generally poorer countries where investment opportunities ought to have been greater. The trouble was the scale of the imbalances and related capital flows, which exploded in the run-up to the global financial crisis in 2007-08. In 2008 Germany ran a current-account surplus of almost 7% of GDP, while some countries in the periphery ran current-account deficits in excess of 10% of GDP. Imbalances on this scale could not keep growing forever. Given the staggering amount of capital that was flowing from the euro area's geographical core to its periphery, there was always a risk that some of it would be wasted on unproductive investments in the periphery. And so it turned out. The countries that sucked in capital from abroad misallocated it on an epic scale.

In Greece, the leading agent of waste was the government, which mismanaged the public finances for a decade (and simply concealed its behaviour by cooking the official data). Because Greece was the country that first unsettled financial markets in late 2009, there has been a tendency since then to equate the crisis with the way countries managed their public finances in the run-up to it. This tendency is unfortunate because Greece is unrepresentative. In other

peripheral countries—particularly Ireland and Spain—government profligacy was not to blame. The main culprits here were in the private sector: banks, in core and peripheral countries, that funded poor investments in over-inflated property sectors. The deterioration of Ireland's public finances since 2008 did not reflect long-standing government profligacy, but the huge "clean-up" costs that followed the bursting of a credit-fuelled private-sector property bubble.

The euro area's current quandary can be summarised as follows. Much of its geographical periphery is highly indebted and must "deleverage". Yet, financial markets fear that this may prove extremely difficult within the straitjacket of the euro. One reason is that all the indebted countries lost competitiveness during the good times by allowing wages to grow faster than productivity; none can now restore their external competitiveness by letting their currencies depreciate against their major trading partners. The crisis, however, is not confined to the periphery. The sovereign debt crisis in the periphery is bound up with a banking crisis across the euro area as a whole. That connection is overt in the periphery, but suppressed in the core. Some German banks are currently among the sickliest in the region. As such, they are poorly placed to withstand any default on peripheral debt (to which they have large exposures).



The policy response to the euro area crisis

A casual observer might still wonder why the euro area is in crisis. After all, if the region is treated as a single entity, its position looks no worse—and in some respects, rather better—than that of the US or the UK. In 2010 the budget deficit for the euro area as a whole is estimated at 6.2% of GDP—admittedly high, but much lower than the budget deficit posted by the US (an estimated 8.9% of GDP) and the UK (10.1% of GDP). The euro area's government debt/GDP ratio was around 86%—about the same level as the US. Moreover, private-sector indebtedness across the euro area as a whole is markedly lower than in the highly leveraged Anglo-Saxon economies. Why, then, have financial markets lost confidence in the euro area? The short answer is: because the euro is a currency without a state. Were the euro supported by the institutional paraphernalia (and mutual bonds of solidarity) of a state, its economic problems would be more manageable. But it is not.

The crisis, it follows, is as much political as economic: the question facing the euro area is whether the governments will take the political steps necessary to

address the economic strains within it. The answer to that question partly turns on money. Who should pick up the bill for all the capital that was wasted in the peripheral countries: feckless borrowers or reckless lenders? Creditor countries, unsurprisingly, believe that the bill should fall largely on deficit countries. In Germany, the largest creditor country, opposition to bailing out the indebted periphery is particularly acute. German workers, whose wages have stagnated in real terms for the best part of a decade, resent any suggestion that they should be called upon to rescue a periphery that has lived beyond its means. For its part, the German constitutional court has made it clear that budgetary assistance to the indebted periphery would be incompatible with German law.

Germany has therefore resisted any demands to turn the "monetary union" into a "transfer union" and opposed any proposals that would effectively put its own strong credit rating at the service of the greater European good. It did agree in May 2010 to the creation of a European Financial Stability Facility (EFSF) to provide financial assistance to governments encountering funding difficulties in the government bond markets. However, the EFSF can hardly be described as a bailout mechanism for sovereigns in the periphery: the EFSF dispenses loans, not transfers; and it earns a sizeable spread on its lending to euro area sovereigns. If anything, the EFSF is better described as a covert bailout of banks.

Germany's view is exercising a decisive influence on the way the governance of the euro area is being reformed. The new framework, which EU leaders are discussing as this report goes to press, will consist of several pillars. The first will be a new set of budgetary rules, more stringently enforced. If these rules are complied with, the euro area as a whole will embrace a prolonged period of synchronised fiscal austerity. The second pillar will focus on competitiveness—a code-word for ensuring that the peripheral countries, in particular, push through supply-side reforms (and reduce unit labour costs). The final pillar is a reformed EFSF with greater lending capacity and an ability to purchase bonds in primary debt markets (but not in secondary markets, as some, including the European Central Bank (ECB), had called for).

The question is whether this new governance framework will succeed in restoring confidence in the euro area. The creditor countries, Germany among them, believe that it will. On their reading, the crisis was the product of irresponsibility, so the road to redemption passes through fiscal consolidation and structural reforms (especially in the periphery). The problem with this reading is threefold: its diagnosis is too simplistic; the medicine prescribed may fail to work; and there will be limits to how much punishment the deficit countries are able to inflict on their own populations—particularly if the latter conclude they are effectively being asked to rescue poorly managed foreign banks. It is possible, then, to conceive of a number of broad scenarios for the evolution of the debt crisis—to which we now turn.

Part I—Whither the euro zone?

Economic policies across the region will remain in crisis-management mode in the period up to 2015

Policymakers must simultaneously tackle three broad challenges if confidence in the long-term future of the euro area is to be restored. First, they must address worrying dynamics of public debt in some member states. Second, they must confront fragilities in the region's banking system. Third, they must implement bold structural reforms to improve economic flexibility, while also correcting the institutional weaknesses that allowed the crisis to take root in the first place. The scenarios outlined below assume different degrees of success in each of these three areas in 2011-15, although there is no neat division.

Scenario 1: The central forecast (50% probability)

The most indebted and least productive economies in the euro zone's periphery swallow their medicine, cut their deficits and take steps to restore their external competitiveness. The region's politics are fractious, but the creditor countries provide enough financial support to contain the crisis until orderly restructuring of some sovereign debt is carried out in 2013.

Scenario 2: The main risk scenario (25%)

Weak growth and rising unemployment in the periphery sap the willingness to implement austerity plans. Bank bailouts place more strain on public finances. Financial markets begin to doubt the ability of stronger member states to provide liquidity support to the periphery. Containing the crisis requires previously unthinkable steps to be taken, shaking faith in the euro project.

Scenario 3: The ultimate risk scenario (15%)

Domestic pressures for member states to leave the euro become irresistible. One possibility is that weak countries in the periphery walk away. Another possibility is that Germany decides to leave.

Scenario 4: The golden scenario (10%)

Strong growth in the core assists a rebalancing of demand inside the euro area. Peripheral countries make impressive headway with implementing fiscal and structural reforms. As investor confidence rises, the value of the euro soars.

The assumptions underlying scenario 1 are the basis of the Economist Intelligence Unit's regular publications, and we provide a broad overview only here. Scenarios 2 and 3 sketch out how events could unfold if the economic and political environment in the euro area in the period up to 2015 turns out to be much less favourable than we have assumed. The relatively low-probability scenario 4 is dealt with briefly.

Scenario 1: Muddling through—with a default or two

Europe is likely to see its first sovereign default since 1948

The central forecast (50% probability)

At the European Council in December 2010, the heads of state and government of the euro area stated their "readiness to do whatever is required to ensure the stability of the euro area as a whole". The Economist Intelligence Unit's central scenario is that the stronger euro area countries (notably Germany) find the political will to make good on this promise, and that the more vulnerable countries (Greece, Ireland, Portugal and Spain) find not only the political will, but also the economic flexibility and social resilience to overcome the difficulties they face. In short, we believe that the euro zone will hold together in the period up to 2015, although the task ahead is not easy. We believe that Portugal will need to seek financial assistance, but that Spain will not. The biggest test is likely to be when member states finally face up to the need for debt relief. One member state, Greece, is almost certainly insolvent, while another, Ireland, will be also so long as the government continues to guarantee the debts of the country's banks.

Germany and the other creditor countries

Germany's policymakers are under pressure from two directions regarding membership of the EU. The first is the public perception that Germany is already paying too much to help poorer member states and that weak politicians are agreeing to provide ever larger amounts. The second is Germany's longstanding commitment to the EU, of which economic and monetary union (EMU) is now a key part. There is awareness among most politicians—although less so among the general public—that Germany's prosperity is dependent on being part of a large single market, and that the ability of companies to plan all business within the euro area on the basis of a fixed exchange rate is a distinct advantage. The fact that in May 2010 the German government and parliament agreed—in the face of public hostility and legal challenges—to the Greek rescue package and the creation of the EFSF was an affirmation of Germany's enduring commitment to the euro area.

That commitment will need to be maintained in the face of further tests during the coming years. Our forecast for favourable economic conditions in Germany will help contain political pressure on the German government. The main German opposition party, the Social Democratic Party (SPD), has also given its backing to measures designed to support weaker economies. Nonetheless, the position of the German chancellor, Angela Merkel, has weakened since the coalition between the Christian Democratic Union/Christian Social Union (CDU/CSU) and the Free Democratic Party (FDP) came to office in 2009. In the run-up to the federal election in September 2013, the FDP will try to recover its support by appealing to the public unpopularity of the financial assistance packages. However, the FDP's pronouncements have not so far translated into higher support, which should reduce the temptation for the party to seek to force a crisis over the issue of bailouts (it would probably lose seats in an early election). For this reason, we expect the coalition to hold together (just) and the

FDP to agree to the necessary measures. This will include ratification of a small amendment to the Treaty on the Functioning of the European Union (TFEU) to allow the EFSF's successor, the European Stabilisation Mechanism (ESM), to come into being in 2013 (a change that must be ratified in all 27 EU countries).

The euro area's emergency credit facilities

The European Financial Stability Facility (EFSF) is the current EU emergency credit facility, set up to ensure liquidity for euro area countries in 2010-13, with the support of IMF financing. The EFSF has been established as a special purpose vehicle that borrows in commercial credit markets and lends these funds to struggling member states. The EFSF's borrowing is guaranteed by the euro area members, roughly in proportion to their own borrowing capacity, but they would only have to stump up any funds themselves if the bailed-out country defaulted on its EFSF funding, an unlikely prospect in 2011-13. The EFSF's planned size was €440bn, but its real lending capacity has been restricted to around €250bn by the need for cash reserves and because countries receiving assistance are not required to provide guarantees. Euro area countries have, however, recently agreed to raise the effective lending limit to the nominal €440bn. Additional liquidity support of €250bn was made available by the IMF, with a further €60bn from the European Financial Stabilisation Mechanism (EFSM), to be raised from capital markets using the EU budget as collateral. In addition, the European Central Bank (ECB) has been buying sovereign debt in secondary markets, to try to stabilise sovereign borrowing costs.

Discussions are now well advanced to create a permanent euro area loan facility, called the European Stabilisation Mechanism (ESM), which will come into operation in 2013, when the existing facilities expire. The ESM will be modelled on the EFSF and will have an effective lending capacity of €500bn to provide financial assistance to euro area states in difficulty, subject to a stringent programme of economic and fiscal adjustment, plus an analysis by the European Commission and the IMF of their ability to meet their debts. If this analysis concludes that the country is solvent, private-sector creditors would be encouraged to maintain their exposure. If not, the country would have to negotiate a restructuring plan with its creditors on a case-by-case basis, in line with IMF practice elsewhere in the world.

The governments of other euro area countries have appeared content to accept Germany's leadership role in responding to the debt crisis, but the backing of their parliaments remains essential. There is strong political support in France for rescue measures needed to shore up the peripheral euro area countries, although the far-right Front National, under its new leader, Marine Le Pen, could gain strength in the 2012 election, in part because of the party's attempts to capitalise on eurosceptic sentiment. There is also public resentment in some smaller northern countries, such as Finland and the Netherlands, where the rise of populist, eurosceptic parties is causing difficulties for governments (forcing them to take a tough line in negotiations on the EU's future economic governance and the terms of bailouts). The issue is particularly sensitive in Finland, where a general election is to take place on April 17th 2011. The eurosceptic True Finns are poised to make big gains at the expense of the three main traditional parties, although there should still be a parliamentary majority in favour of supporting the euro zone. In the last resort, a smaller country is unlikely to risk provoking a financial disaster, although these countries will

certainly add to the pressure on the German government to negotiate tough conditions on any country forced to make use of the rescue facilities.

The vulnerable countries

The economically stronger countries have a key role to play in preventing destabilising crises in the euro zone and have to take measures that are domestically difficult, but the countries most affected by debt worries face even greater challenges. As a result of huge government deficits, governments in Greece, Ireland, Portugal and Spain are implementing drastic measures to cut public-sector spending, slash public employees' pay, reduce public employment and curb social benefits (particularly pensions). In the coming years, these measures will have a far more direct impact on their voting publics than in the stronger member states. The need for public-sector retrenchment is coupled with the need for retrenchment (of varying degrees) in the household and corporate sectors as a result of high private debt. These two factors together are already preventing any significant recovery from the 2008-09 recession. In the case of Greece, they are causing the ongoing recession to deepen further, while Portugal is forecast to slide back into recession in 2011-12. In none of the four countries is an economic recovery in sight. Given this situation, the vulnerable countries are expected to seek to stimulate economic growth by creating opportunities for new businesses and improving competitiveness. Other than Ireland, which has a relatively liberal economy, the countries concerned all have in varying degrees restrictive labour markets, including rules restricting access to professions and trades, as well as overarching job protection laws applicable across the economy. Yet, measures to open up these sectors involve removing the privileges of "insiders" in the workforce and the professions, and are consequently being strongly resisted.

At least as important is pay. Having lost the ability to reduce the cost of employment relative to other countries through currency depreciation, the only possible way for the struggling euro area countries to regain external competitiveness is by cutting wages or employment taxes (where these are significant). Public-sector employees have already faced nominal pay cuts of 5% in Spain and Portugal and 10-20% in Greece and Ireland over the last two years. Many employees of export- or import-competing companies will also have to accept pay cuts. It is likely that *force majeure* will lead to frozen or even reduced wages and more flexible working conditions in the vulnerable euro area countries, as employees become aware that this will be essential if their employers are to remain profitable. One aspect of the situation that gives ground for cautious optimism that social stability will be maintained is that almost all social groups will have to share in the pain.

A restructuring of Greek and Irish debt seems inevitable

Under our central scenario, the most indebted and least productive economies swallow their medicine and press on down the road of fiscal austerity, characterised by unpopular reforms, wage cuts, contracting activity and persistently high unemployment. The medicine will taste bad and will be only partially effective. At the time of writing, the Portuguese government is teetering on the edge of being forced to request financial assistance from the euro area's emergency liquidity facilities similar to that provided to Ireland. Longer-term bond rates are no longer affordable, although Portugal is still just able to

refinance its government debt and fund its deficit with shorter-term instruments, although these are also paying high rates. We expect that Portugal will be forced to apply for financial support during 2011. It will also have to follow Greece and Ireland in implementing a severe austerity programme.

The difficult question is whether Spain will be put in a similar position. Its government debt, at around 60% of GDP at end-2010, is significantly below that of Portugal and its efforts to cut public-sector spending look more credible. Nevertheless, its debt has risen more rapidly, and its fiscal deficit is estimated at just over 9% of GDP in 2010. The dependency of Spanish banks on ECB liquidity provision is also lower than for Portuguese and Irish banks. However, caution remains over the underlying condition of the savings bank sector, which accounts for about half of total banking assets in Spain, after significant losses as a result of the collapse of many property and construction companies. Still, our baseline assumption is that Spain remains fundamentally solvent and will not have to request emergency funding.

Public deficits & debt

(% of GDP)

		2007 ^a	2008 ^a	2009 ^a	2010 ^b	2011 ^c	2012 ^c	2013 ^c	2014 ^c	2015 ^c
Greece	Deficit	-6.4	-9.4	-15.4	-9.7	-8.1	-7.5	-3.0	-2.8	-1.2
	Debt	105.0	110.3	126.8	143.7	155.8	165.1	96.3 ^d	92.0	88.0
Ireland	Deficit	0.0	-7.3	-14.4	-34.2	-9.9	-8.1	-7.2	-4.3	-2.2
	Debt	25.0	44.3	65.5	93.9	110.4	125.0	97.0 ^d	91.4	85.7
Portugal	Deficit	-2.8	-3.0	-9.4	-7.3	-7.0	-6.1	-5.1	-4.3	-3.5
	Debt	62.7	65.3	76.1	81.3	87.7	93.4	96.8	98.9	99.9
Spain	Deficit	1.9	-4.2	-11.1	-9.2	-6.7	-5.4	-4.2	-3.3	-2.9
	Debt	36.1	39.8	53.2	60.0	69.6	71.1	72.5	72.6	72.2
Italy	Deficit	-1.5	-2.7	-5.3	-5.0	-4.6	-4.4	-4.0	-4.1	-4.5
	Debt	103.5	106.1	115.8	119.9	121.2	121.0	120.3	119.7	119.7
Belgium	Deficit	-0.4	-1.4	-6.1	-4.5	-4.0	-3.6	-3.3	-2.9	-2.7
	Debt	88.0	93.4	100.4	100.4	100.9	102.9	104.8	105.3	106.4
Germany	Deficit	0.3	0.1	-3.0	-2.9	-0.5	0.0	0.5	0.6	1.0
	Debt	64.8	66.3	73.5	81.8	77.4	74.3	70.8	66.7	62.6
France	Deficit	-2.7	-3.3	-7.5	-7.5	-6.4	-5.5	-4.1	-3.3	-2.8
	Debt	63.8	67.5	78.1	84.1	87.4	89.6	89.8	89.2	88.1

^a Actual. ^b Economist Intelligence Unit estimates. ^c Economist Intelligence Unit forecasts. ^d Decline in debt incorporates our expectation of a debt restructuring.

Source: Eurostat; Economist Intelligence Unit.

We expect that both government and current-account deficits in the periphery will narrow in 2011-13. GDP growth is forecast to turn positive in Spain from 2011 and to be weakly positive in Greece, Ireland and Portugal by 2013 (although it will be several more years before GDP exceeds pre-crisis levels). As a result of the stagnation of GDP and falling incomes in the interim years, debt ratios for households and sovereigns are likely to worsen in all countries. Despite the peripheral countries' plight, fear of encouraging moral hazard will make the creditor countries reluctant to give them any further respite by easing the terms on which the EFSF lends. As these countries struggle to service their debts, the official "no debt restructuring" line currently being peddled by governments in the creditor countries will look increasingly untenable.

Indeed, in the cases of Greece and Ireland, the primary surplus—the excess of tax revenue over spending on public welfare and services—required to service their rising debts would be too much to afford. Either these countries would be economically crippled by excessive taxes, or public welfare and services would be reduced to levels no longer compatible with maintaining stable and consensual societies. The issue is likely to come to a head when the ESM becomes operational in 2013. Given that neither Greece nor Ireland will be in a position to access financial markets on sustainable terms by then, we expect them to request a continuation of emergency funding from the ESM. This would require the creditor countries to confront the issue of their solvency: either they agree to allow Greece and Ireland to restructure their debts or they agree to an indefinite provision of funds that would be unlikely ever to be repaid in full. Previous assurances that haircuts on existing debt would not be allowed will look increasingly untenable, and therefore forbearance on the part of creditors will be unavoidable.

By this time, debt restructuring should be able to be managed in an orderly fashion within a pre-established framework that imposes haircuts on private-sector creditors. Our baseline assumption is for agreed reductions in the debt of Greece by 42 percentage points, to 96% of GDP, and of Ireland by 23 percentage points, to 96% of GDP. Given the consequences that restructuring would have on European banks, EU countries would also need to have regimes in place that allowed insolvent banks to be recapitalised or wound up in a controlled manner. However, we believe that the majority of banks will be in a strong enough position to be able to absorb these losses.

The situation in 2015

Debt restructuring should bring an end to the vicious cycle of weak confidence and unsustainable interest costs. It will also reduce the scale of budgetary adjustment needed to restore fiscal sustainability. This will make the process of restoring external competitiveness through wage cuts a viable strategy over the medium term. The current strong recovery in GDP growth in the core member states is forecast to moderate during 2011 and into 2012. However, at an average of around 2% during 2011-15 as a whole, it should provide enough demand growth to enable the weaker countries to stage a moderate pick-up in exports, assuming they adopt essential labour market reforms. By 2015 we forecast that Spain, Greece and Ireland will be growing at 2% a year, but Portuguese growth is forecast to remain weak at only 1%. Portugal's general government debt is forecast to edge up to just under 100% of GDP by 2013, flattening out by 2015. Financial markets should start to buy Portuguese debt once again, and we do not expect Portugal to restructure its debt (although this cannot be ruled out).

However, debt restructuring is no cure-all. These countries must still cut public spending and raise taxes to balance their budgets. Unemployment will remain over 10% in all the vulnerable countries by 2015. This will have adverse social consequences, but all four countries will be helped by strong family and community structures and should remain politically stable. Dissatisfaction may be expressed by voting out incumbent governments. In our central scenario, the euro area survives, but the euro and possibly EU membership may be more unpopular than ever in some countries (both in the core and the periphery), providing fertile ground for new eurosceptic parties to gain currency.

Scenario 2: Bonds of solidarity

The euro zone may have to consider even greater pooling of sovereign debt risk

The main risk scenario (25% probability)

The Economist Intelligence Unit's main risk scenario is that the policy and institutional framework established in the response to the debt fails to restore confidence in the euro area's long-term survival. Under this scenario, economic growth in the periphery is much weaker than expected. The willingness to implement austerity plans and structural reforms wanes, while bank recapitalisations place additional strain on public-sector balance sheets. The date at which vulnerable member states expect to achieve primary budget surpluses recedes further into the future. With Spain requiring some financial assistance, financial markets increasingly doubt the ability of stronger member states to continue providing liquidity support, further encouraging a flight out of the debt of all but the safest sovereigns. As policymakers are overtaken by events, they are forced to take previously unthinkable steps to contain the crisis. The euro zone holds together, but in poor shape. Its future remains more uncertain than ever.

Is a run on peripheral debt already under way?

The euro area's policy response in the wake of the crisis has focused on three aims. The first is to ensure the provision of liquidity to chronically indebted states and prevent contagion to other vulnerable economies. The second is to delay any restructuring of unsustainable debts—both sovereign and private-sector—until European financial institutions are in a position to withstand any losses. The third is to implement ambitious economic and social reforms to ensure a return to primary budget surpluses and put all member states on a sustainable medium-term growth path. This strategy risks being derailed.

The clearest threat to an orderly resolution of the euro area's difficulties is that liquidity support facilities do not live up to their billing. The EFSF's *raison d'être* is to act as a lender of last resort to any euro area country that finds itself unable to access commercial financial markets on terms that could be sustained over a prolonged period. This guarantee is also meant to deter a withdrawal of funding in the first place, as a result of risk aversion or speculative attacks. However, deterrence is only effective when it is credible: if market participants believe that the euro area member states are not fully committed to meeting all possible financing needs, raising the risk of default, then yields on sovereign debt of vulnerable countries will stay high. As the bonds of risky countries face increasing competition in the form of AAA-rated bonds issued by the official bailout facilities, a vicious circle could develop whereby investors shun direct purchases of risky debt in favour of EFSF bonds. As higher interest rates on newly issued peripheral debt feeds through, the overall cost of servicing debts could rise further above nominal GDP growth rates, ensuring that debt/GDP ratios continue to rise, further increasing the likelihood of default. In short, there is a possibility of a full-scale run on the debt of risky states.

So an important question is whether liquidity support facilities will in fact be able to meet all potential demands that could be placed on them. So far, a total of €17.5bn has been committed from the EFSF as part of Ireland's €85bn rescue package—with the European Financial Stabilisation Mechanism (EFSM, an EU-wide credit facility) and IMF making up the bulk of the remaining funding. Based on our assessment of Ireland's total funding needs, we expect that Ireland will need to tap the EFSF again in 2012. Greece is expected to be in a similar position, with its EU/IMF rescue package likely to run out well before 2013. We also expect that Portugal will request assistance during 2011, with the EFSF asked to provide around €25bn (one-third of Portugal's total funding needs during 2011-13, assuming the remainder is shared between the EFSM and IMF). We therefore estimate that total disbursements from the EFSF will be a little over €100bn in 2011-13.

In March 2011 euro area heads of state and government agreed to modify the system of guarantees underpinning the EFSF to allow on-lending up to the originally envisaged limit of €440bn. Taking into account the above, this would leave just under €340bn for any other vulnerable member states. If these funds were supplemented by the remaining funds from the EFSM and a matching contribution worth 50% of the EFSF/EFSM contribution from the IMF, total liquidity support for other countries would be €525bn (or as much as €550bn if the IMF's original commitment of €250bn were to be made available). This should be sufficient to cover the funding needs of Spain during 2011-13 (€470bn), if our main risk scenario comes to pass and Spain requires external assistance. However, it would not be enough for Spain plus any other potentially vulnerable country, such as Belgium (which has funding needs of around €140bn during 2011-13) and certainly not Italy (€820bn).

The EFSF—running on an empty tank

There are a number of plausible ways in which the euro area's liquidity support facilities might prove to be insufficient. First, there is the potential for a loss of confidence in the complex system of guarantees underpinning EFSF debt. Both the EFSM and EFSF are given a AAA-rating by the three major ratings agencies, Fitch, Moody's and Standard and Poor's. However, the more countries that need to be funded by the EFSF, the more substantial would be the guarantee falling on AAA-rated countries (primarily France, Germany and the Netherlands). Hence, the ratings of these countries would come under greater pressure. Given the leisurely approach adopted by the French government to reducing the country's structural budget deficit, it is conceivable that France could see its ratings downgraded in the coming years. This would result either in a downgrading of the ratings assigned to debt issued by the EFSF, or a reduction in the amount of AAA-rated debt that could be issued. In addition, the ratings agencies have also noted the sensitivity of EFSF debt ratings to any signs of a weakening political commitment to the facility (although a default on EFSF debt remains highly unlikely, given the reputational consequences).

Second, the actual financing needs of a number of states could turn out to be much higher than currently assumed, further undermining the credibility of the promise of guaranteed liquidity support. This could be because the revenue and expenditure assumptions underlying deficit projections are too rosy. The euro area member states most at risk—Greece, Ireland, Portugal and Spain—are

implementing tough fiscal consolidation measures, but the severity of the cuts could lead to a more prolonged contraction or stagnation of domestic demand than we assume, cutting into fiscal revenue and further undermining solvency. Tax evasion and avoidance could increase (it is already a problem in all these countries, except Ireland).

On the spending side, weaker economic growth would cause higher than expected unemployment, pushing up social transfers further in the absence of cuts to benefits, which would be difficult to force through. Debt-servicing costs may also turn out to be much higher than is assumed in national budgets. A relevant consideration concerns the details of how the EFSF's successor, the ESM, will operate. A crucial difference between an EFSF loan and an ESM loan is that the latter will explicitly enjoy preferred creditor status, being junior only to the IMF loan. This implies that private investors will be expected to bear the burden of any debt relief for a country that accesses the ESM. If market participants come to believe that a country may need to access the ESM (Spain for example), risk premiums would shoot up.

External shocks

One of the biggest threats to solvency among the euro area's weaker members is a sharp and unexpected slowdown in economic growth. Here are three risks that could derail efforts to put the euro zone's fiscal house in order.

Soaring oil prices

Turmoil in the Middle East and North Africa pushed global oil prices up by more than 20% in the early part of 2011. If the political disruptions in the region spread in a serious way to the Gulf oil kingdoms, particularly Saudi Arabia, the price of crude could easily climb over US\$150/barrel and stay there for some time. Although Europe uses less oil than the US or China, an energy shock of this magnitude would have a severe impact on the euro area economy.

A sharp slowdown in China

Policymakers in China are desperate to contain rising inflation by slowing the pace of economic growth. They have already made considerable efforts to curb lending, restrain the money supply and prevent a property bubble from forming. Although Chinese officials have a good track record of managing growth, it is by no means certain they will succeed, and their propensity of late to hide the true nature of banks' activities is not encouraging. A hard landing for China's economy would severely damage global growth, dragging the euro zone down as well.

A fiscal crisis in the US

The US benefits from controlling the global reserve currency, which gives it the latitude to run imbalances that would sink other economies. However, the dire state of the US public finances may finally test the patience of global investors. The US fiscal deficit is likely to reach a staggering 10% of GDP this year, and there is no sign in Washington of a comprehensive deficit reduction strategy. If investors lost confidence in the US, the dollar could fall sharply in value. This would be likely to push the euro much higher, damaging Europe's—and Germany's—critical export sector and slowing economic growth.

How long before the public says "no" (or "oxi" or "não")?

Political fatigue with the consolidation process is a clear and present danger. The newfound determination to push through reforms is unlikely to be maintained indefinitely. Many may be hard to sustain if the economies concerned continue to stagnate or contract and/or reforms become associated with noxious side-effects, such as mass unemployment. Greece has already suffered a wave of strikes and protests, some of them turning violent. Growing social resistance to the government's austerity measures could widen divisions between traditionalists and reformers within the ruling Panhellenic Socialist Movement (Pasok), undermining the government's ability to push legislation through parliament without the support of some opposition parties. If this were not to be forthcoming, there is a chance that the government would have to call an election ahead of schedule (a vote is due by 2013). In short, there are good reasons to doubt whether Greece can fully comply with its Memorandum of Understanding with the EU and IMF over the medium term.

In Ireland, the electorate's anger thus far has been directed at the recently ejected Fianna Fail/Green Party government, but the new Fine Gael/Labour coalition will be all but obliged to implement similarly austere policies, and the honeymoon period for the coalition is likely to be short. There is widespread resentment at the erosion of Irish sovereignty by European policymakers and the insistence that Irish banks' senior bondholders should not face haircuts—which in effect leaves Irish taxpayers shouldering the burden of bailing out Irish banks, and indirectly those of Germany, the UK and other countries.

The recent protests in north Africa and the Middle East provide a stark reminder that ultimate political authority resides in the populace—how long could a euro zone government hold firm to its austerity plans if confronted with a mass mobilisation that was sustained over time? Faced with increasing social unrest in the periphery, creditor countries might have little choice but to show greater understanding, which could reduce the political impetus in a larger group of countries to consolidate public finances.

Weak banks could weigh on sovereigns

One of the biggest uncertainties over the scale of the fiscal challenge facing the euro area is the extent of losses in the financial sector that may eventually be brought on to public-sector balance sheets—both in the euro area's periphery and in core states. Ireland has set aside €30bn from its bailout package to assist its banks, but actual capital requirements are likely to be higher. Spain's government has said that Spanish banks' need for additional capital should not exceed €20bn and that this should ideally come from the private sector. Most independent observers consider this too low, with the upper limit of estimates at €120bn (12% of GDP). Portuguese banks may well also need fresh capital to withstand rising loan losses. Such problems are not confined to the periphery. Some German banks are poorly placed to withstand any default on peripheral debt (to which they have large exposures). French banks also have high crossborder exposure to the peripherals (and Spain in particular).

European governments have so far been reluctant to confront such problems—it remains far from certain whether a new round of stress tests in coming months will bring greater clarity over the banks' capital needs when the results are published in mid-2011. The problem confronting the authorities is the

interconnected nature of the sovereign and banking crises. Acknowledging the possibility of a wave of sovereign defaults could put added pressure on banks exposed to these losses, in turn requiring already shaky sovereigns to backstop the banks. It is possible that a euro area government opts to pursue an alternative path, allowing a major bank to fail and unilaterally imposing haircuts on holders of unsecured senior bank debt (or debt-to-equity conversions). This could unleash a region-wide banking crisis, as markets withdrew funding from any bank considered to be at risk of similar treatment, forcing governments that had not put in place bank resolution regimes to step in to save their own banks. Either way, our main risk scenario posits that European policymakers do not have the luxury of assuming that a gradual improvement in public- and private-sector balance sheets over several years will ultimately result in a resolution of these difficulties.

Does the euro area have a Plan B?

All of the above suggests there is some risk that the resources of the EFSF will run out by 2013. So what additional steps might the euro area consider if concerns over the pressure on public finances are not to become self-fulfilling? One option would be to reduce budget deficits in the periphery through the introduction of a permanent mechanism for fiscal transfers between stronger and weaker states, either via the EU or a euro area body with "own resources" (that is, tax-raising or borrowing powers). However, there is little appetite among politicians or electorates for any move in this direction.

Another mooted solution is the development of supranational "euro-bonds". A number of proposals for these have been floated. While they differ in the specifics, they seem to share certain characteristics. The basic notion is that member states could substitute national bonds with euro-bonds, issued by a central agency, either specifically for distressed states or for all member states up to an agreed limit (for example the Maastricht ceiling of 60% of GDP). Euro-bonds could be jointly and severally guaranteed, and senior to any national government bonds issued above the threshold. The assumption made by advocates of such schemes is that the fiscally weak member states would benefit from lower spreads on at least a portion of their public debt, while fiscally stronger countries could gain from a more favourable liquidity premium, given that issuance equivalent to 60% of GDP would amount to a market worth €5.5trn. This might also increase the attractiveness of the euro as a reserve currency.

Such proposals have some high-profile supporters, but remain unappealing to governments in countries with stronger public finances, including Germany, where the suspicion is that weaker countries would merely be free-riding on their stronger credit ratings. Indeed, it is unlikely that the gains from lower liquidity risk for sounder states would outweigh the costs of higher credit risk. It is debatable whether the introduction of "joint and several guarantees" would require a further revision of the EU treaties, but such a development would in any case face significant political opposition in Germany and elsewhere. It seems clear therefore that euro-bonds could not be introduced quickly enough to head off a rapidly escalating crisis in the bond markets.

Thus, if current institutional arrangements cannot sustain the euro area until the ESM comes into being in 2013 and a disorderly default is to be avoided, governments may have to consider increasing the size of the EFSF further, appealing to the IMF, or allowing a significantly expanded role for the ECB. The latter course might in fact be the most plausible: the ECB is the only European institution that could muster the necessary financial firepower quickly enough. Although it would be reluctant to follow the US Federal Reserve and Bank of England (the respective central banks of the US and the UK) down the path of quantitative easing, if the ECB was all that stood in the way of an unplanned sovereign default, it could significantly expand its purchases of government debt. As has been the case with the ECB's liquidity schemes, an expansion of this programme would be presented as a temporary measure, while fuller consideration could be given to developing a more permanent fiscal support mechanism, possibly along the lines of the euro-bond discussed above. In this scenario, the euro zone survives, but the conditions demanded by creditor countries for taking these unpalatable steps would be likely to be so high that the political underpinnings to the monetary union would be drastically weakened.

**How far can the euro area
"kick the can" down the road?**

Indeed, the greatest uncertainty with our main risk scenario is whether euro area politicians would in fact be able to muster the collective will to follow through their "no default before 2013" strategy to the logical conclusion. This implies a commitment to protect senior unsecured creditors of Europe's banks from losses until an orderly framework for restructuring can be established. This may not be the end of the story, however. By 2013 governments in the creditor countries may well judge that their banking sectors remain vulnerable and seek to delay sovereign debt restructuring further (under the terms of the ESM, a country can only open restructuring talks with the approval of other euro area states). The €500bn of the ESM may have to be scaled up further. A point would be reached when the only loans left to restructure would be those extended by the "official sector"—namely, taxpayer-backed loans from the ESM. Would the electorates in creditor countries accept this? Would the public in debtor countries be willing to tolerate additional years of externally imposed austerity? It is certainly possible to envisage a more chaotic outcome in which an unco-ordinated default provokes contagion across the periphery, sparking a banking crisis across the region as a whole, leading to angry recriminations within and between the member states. Indeed, it is not inconceivable that a disorderly default could provide the trigger for the break-up of the euro area.

Scenario 3: Heading for the exit

Domestic pressures for countries to leave the euro zone may become irresistible

The ultimate risk scenario (15% probability)

The coming years will see increasingly fraught political wrangling over how to apportion the costs of the adjustment process that is now under way within the euro area. Governments and electorates in deficit countries will grow weary of the difficult demands being placed on them. The creditor countries may lose patience with extending financial support. This scenario posits that sooner or later, the cement that has held European countries together for decades cracks and the progression towards ever-closer union comes to a spectacular halt. One possibility is that the domestic pressures for countries to leave the euro become irresistible, causing weak countries in the periphery to walk away. A second possibility is that Germany could do so, with other "core" members possibly following suit.

Persistent doubts over whether the euro area meets the conditions for an optimum currency area (OCA)—a region in which the benefits of sharing a currency outweigh the costs—have gained strength during the debt crisis. Sceptics contend that the hopes of optimists—that the very creation of the euro would drive the changes needed to make it a success—have proved illusory. A decade after the introduction of the euro, product markets are still not sufficiently integrated, labour markets are too inflexible and workers are too sedentary. Leaving aside the EU budget (which is small and fixed in its priorities), the euro area does not have a central treasury function to transfer fiscal resources to struggling regions. In short, the economic and institutional factors that make the US an OCA are still largely absent from the euro area. These flaws, sceptics believe, condemn the euro area to eventual break-up.

This debate has become more advanced as the damaging effects of recession and the global financial crisis have vividly highlighted the structural weaknesses and macroeconomic imbalances that persist in many euro area economies. There is no doubt that exiting the monetary union would incur huge economic costs for the country (or countries) concerned. If a peripheral country decided to leave, not only would its debt still be denominated in euros, which would worsen the debt-service problem, but the merest hint that the option was being considered would trigger a run on the country's banking system, as local depositors rushed to transfer their euro-denominated savings to banks in other countries. A rational assessment might argue strongly against such a course. However, in an environment of rising public disenchantment and social radicalism, fuelled by a perception that the painful costs of resolution are not being shared out fairly, politicians with a short-term focus on the electoral cycle could embark on a populist course by leaving the euro area. Abandoning monetary union will ultimately always be a political, rather than an economic, decision.

Peripheral departure? In the Economist Intelligence Unit's view, the more likely of the two "exit" scenarios is that of a peripheral departure. This is based on the premise that the economies of one or more of the fiscally weaker and less competitive euro area countries—Greece, Ireland, Portugal and Spain—continue to contract over an extended period, for example between 2011 and 2013-14. This could result from a combination of factors: ongoing capital flight; fragile banking sectors; a persistent lack of competitiveness; resistance to structural change from powerful vested interests; and the deflationary impact of servicing large public and private debt burdens at a time of painful domestic fiscal austerity.

Against this backdrop, by 2013-14 weaker countries would still be running a substantial fiscal deficit well above official "targets" of about 3% of GDP, with public debt burdens rising inexorably higher. In order to secure continued financing (which at this stage may only be available from official EU/IMF channels, with private investors having jumped ship), the government in question would more than likely be faced with implementing further spending cuts and tax rises, possibly for a fifth successive year.

One additional crucial factor would be the official stance adopted by relevant institutions (such as the IMF, EU and ECB) and the creditor nations towards the "debt sustainability" of a country seeking assistance. Whereas many independent observers and investors might have formed the view that the debt path of Greece (to take one example) had become unsustainable and that some form of restructuring was inevitable, official institutions may have reason to hold to a more optimistic view, claiming that any setback in fiscal consolidation was only temporary and could be resolved with a new austerity package. Such a hard-line approach might be adopted in order to avoid having to admit to an earlier error of judgment in backing an inappropriate rescue programme. It could be because of lingering fears that a debt restructuring in the periphery would trigger financial contagion across the region. Or it could be because creditor countries (via the bailout mechanisms) and the ECB may at that point hold such large claims on the debt of a particular country (or countries) that they would have little incentive to support a restructuring, as it would imply a painful and unpopular hit to taxpayers in the core economies. It might be much easier instead to keep pushing the adjustment process on taxpayers in the deficit countries.

In such circumstances, and if significant numbers of voters in the fiscally weak countries perceived this to be the central policy of creditor nations, then governments in the periphery would be faced with ever-increasing public disenchantment and labour unrest. Against this backdrop, politicians from all parties in these countries would be more than likely to question their past assumptions on how best to manage their economies (the less popular and stable a sitting government becomes, the more likely it is to resort to less rational short-term "solutions"). Major shifts in popular political opinion and/or the emergence of a new government could quite quickly spur a populist reaction. This could include a reassessment of the country's membership of the euro and support for free movement of capital, leading to a decision to revert to a national currency in the hope of creating the conditions for future economic growth (and strengthening popular support).

By abandoning the euro, a country would hope to rebalance its economy through a depreciation of its new currency, but it would also be mindful of the many negative effects of exiting monetary union. According to conventional economic theory, variable exchange rates should be sufficient over time to restore the competitiveness of countries that have lost considerable ground since the formation of the euro area because of high wage growth and low productivity increases. There is no guarantee that this adjustment would happen automatically, however. First, there would be an inflationary spiral that could only be broken by the acceptance by unions of nominal wage increases well below inflation. This would be a hard sell in those countries prone to real wage and cost rigidities, such as some in the periphery. Even if wage costs are lowered in relation to the core euro area countries, the extent to which an economy can benefit via higher exports or import substitution will depend on competitive conditions within particular sectors. In many areas, wages are still likely to be higher than in competing countries, such as China or even Turkey or Morocco. If there was no major exports boost from the competitive gains made from leaving the euro area, such gains could only come from import substitution. A weaker currency would facilitate this, but might not in itself make a dramatic difference. There is also a risk that this could lead to increasing protectionist pressures, which could call into question (if leaving monetary union had not already done so) that country's continued EU membership.

The liabilities of banks, including bank deposits, are in euros and could not be changed into the country's new currency—except with the depositor or lender's consent—without undermining the basic contract between depositor and bank. However, bank assets in domestic shares or property would in effect now be in the new currency. Banks would have the right to insist that loans be repaid according to their value in euros, but to do so would probably lead to a large proportion of the loans going bad. In practice, banks might therefore decide to make arrangements that take account of the new currency. Either way, the banks would incur losses that could lead to them requiring further recapitalisation and state support to address solvency concerns. Government debt would remain denominated in euros, unless changed by agreement or by unilateral action. It is possible that the country concerned may already have tried to negotiate a reduction of its sovereign debt. Given the inevitable depreciation of the new currency against the euro and the associated reduced income base on which to service the debt, it would almost certainly be impossible to avoid negotiating such a "haircut" after leaving the euro, and this might well take the form of converting the debt into the domestic currency. However, since the government would have to intervene to help local banks, this would probably not be sufficient to bring sovereign debt under control.

A likely consequence would be that the country's new central bank would be asked to monetise government debt. As a result of the impact of a falling currency on import prices and a highly accommodative monetary policy, inflation would rise sharply during the first few years of the new currency. This would apply particularly to smaller countries such as Greece, Ireland and Portugal, which import a high proportion of their goods and services. To prevent a cycle of currency depreciation and inflation spiralling out of control, it is likely that capital controls would be necessary (as is the case in Iceland).

The decision of one country to leave the euro would not necessarily prompt others to do so. Under a scenario in which Greece chose to leave, but all other members stayed, the economic implications for the euro area as a whole would most likely be relatively modest (the political ramifications would be more far-reaching). However, if a Greek departure was followed in short order by one or two more of the weaker countries, a destabilising period of financial contagion could affect the region, particularly the sovereigns and banking sectors of remaining euro members with comparatively poor fiscal dynamics and/or high financial exposure to the departing countries. As with many issues related to the euro crisis, Spain would be a bellwether. Quite apart from the major economic implications, should Spain decide to leave, then Italy might also think of doing so. That would still leave a core of Germany, France, Austria and the Benelux countries, although it is then possible that France would feel itself locked into an exchange rate that made it uncompetitive. If France ultimately decided to leave, that would mark the effective end of the euro area.

A core exit? It is also possible that Germany decides unilaterally to leave the euro. Again, there are competing arguments for and against such an outcome. With regard to the latter, the strongest argument of all is political. For all their bickering over rules and money, it is easy to forget how much political capital is invested in the euro. German politicians of all colours consider the EU—and also the euro—as providing the conditions for democratic stability and prosperity in the region. They are also aware that Germany's global influence can be greater through the EU than by acting on its own. If Germany decided to leave the currency union, the foundation of Europe's post-second-world-war order would be destroyed. Finally, Germany has benefited enormously in economic terms from having easy access to markets within a single currency area. Domestic demand in Germany has recently shown tentative signs of a revival, but it remains the case that the country's economy depends crucially on strong demand for its exports, the majority of which go to the euro area.

Countering these arguments is the unpopularity of the euro among the German electorate, significant public opposition to "bailing out" weaker states, and the tensions involved in shaping the single currency along the lines initially envisaged by Germany, based on fiscal and monetary discipline. If the currency union appeared to be evolving into something different, the impact might be to weaken Germany's commitment. This could happen in a number of ways. First, simply by the euro depreciating sharply in the foreign-exchange markets and so becoming a fundamentally weak currency. A second factor could be the ongoing failure of many member states to address their fiscal imbalances over a long period. A third trigger could be if the ECB decided to go down the path of quantitative easing on a substantial scale, for example by buying large amounts of sovereign debt of the weaker economies. A fourth factor might be that the treaty change demanded by Germany as a precondition of setting up the ESM is not ratified by any one of the member states and so cannot come into force. This would probably result in the German constitutional court declaring that continuing financial support to weaker member states was unconstitutional. By itself, such a development could hasten the departure of other member states. However, a combination of these developments (and it probably would require

more than one to occur) would weaken German commitment to the single currency, particularly if this coincided with German economic weakness.

Economically, Germany and other countries with close ties would suffer seriously from a German withdrawal or a full break-up of the euro area through other means. The new German currency would rapidly strengthen in the foreign-exchange markets, which would adversely affect the German export machine. Conversely, other countries that decided to retain the euro would benefit from gaining a substantial competitive advantage vis-à-vis Germany in the German market, their domestic markets and third markets. However, with their currency (or currencies) becoming weaker and the Bundesbank (the German central bank) no longer a decisive influence on monetary policy, inflation would increase, possibly sharply.

Scenario 4: The medicine hurts, but works

The euro zone could undergo a resurgence as countries bring their public finances under control

The golden scenario (10% probability)

Against all the odds, confidence in the euro zone's prospects could be restored relatively quickly if investors come to see that the German medicine is working. In this scenario, strong growth in the core assists a rebalancing of demand inside the euro area. Peripheral countries make impressive headway with implementing fiscal and structural reforms, as acquiescent electorates accept there is no other way. Public finances across the region improve rapidly and long-term growth prospects improve. With institutional reforms being implemented to prevent policymakers from repeating past mistakes, the euro area emerges strengthened from the crisis.

The strength of the economic recovery in Germany and other core euro zone countries during 2010 surprised most observers, including the Economist Intelligence Unit. Although the Economist Intelligence Unit's baseline assumption is that real GDP growth will moderate during 2011 and into 2012, it is possible that the slowdown will not materialise and that average real GDP in the core during 2011-15 could be closer to 3% than 2%. In this scenario, the German economy experiences a strong upturn, powered by continuing robust demand in the emerging markets and the US. This supports much stronger growth in employment than was seen over the past decade, as more marginal workers are drawn into the labour force. Wage growth turns out to be much higher than assumed, helping to give a lift to domestic demand. Despite its tough rhetoric on the need for discipline in managing the public finances, the German government actually adopts a relatively relaxed fiscal policy stance, further assisting growth. The same dynamics take effect in other current-account-surplus and export-oriented member states such as the Netherlands, Finland and Austria. There are also positive spill-over effects for France (given its significant trade links with Germany in particular), helping to bring down the high rate of French unemployment and encouraging a fall in the household savings rate.

Stronger demand in the core of the euro area assists the adjustment process in the periphery and leads to rebalancing of activity in the euro zone as a whole. Core countries consume more (which increases demand for exports from the periphery), causing a rapid fall in their current-account surpluses, while peripheral countries consume less (and thus import less from core countries), enabling a further correction in their current-account deficits. Falling unemployment in the periphery also makes it easier for governments to ask sacrifices of workers, helping to ensure that fiscal consolidation targets are met. An improvement of public finances across the euro zone underpins a gradual rise in investor confidence, helping to reduce pressure on bond yields.

Policy developments assist the adjustment process. The ECB continues to extend liquidity support for banks for as long as liquidity and solvency concerns about euro area members persist, but the new European Systemic Risk Board (ESRB) and European Banking Authority (which became operational at the start of 2011) encourage national regulators to get serious about tackling the problem of weak banks. The new governance framework for the EU and euro zone begins to take effect, with the European Commission and Council of economy and finance ministers (Ecofin) showing a convincing determination to enforce policy recommendations. Serious efforts are made to boost the competitiveness of the weaker economies, which improves long-term growth prospects. And for once, fiscal discipline is heeded by all.

Even under the most optimistic assumptions, Greece will not be able to extricate itself from its mountain of debt without a debt restructuring. However, Ireland could manage to avoid a sovereign debt restructuring via incremental bank write-downs. First, the new government could impose losses on senior unsecured debt, which was never promised the protection of state guarantees. This might help to provide an important release valve for public anger and frustration and assist the fiscal consolidation programme. Second, the Irish government could seek approval from the EU/ECB/IMF to impose a haircut on the guaranteed secured senior debt in the country's failed banks. Repealing the bank guarantee slowly and incrementally could provide a way for reducing Ireland's overall debt levels and decoupling public and private debt. Given the comparatively small size of the Greek and Irish economies, these write-downs would prove manageable for the European banking sector, which could turn out to be in a better state than previously assumed.

Euro area resurgent

With internal balances reduced and the governance framework inspiring greater market confidence, the euro area emerges strengthened from the crisis. Fiscal discipline is now a core trait of the euro area. Sovereigns in the periphery are able to borrow at more sustainable interest rates once again. Indeed, euro-denominated assets look increasingly attractive as the fiscal sustainability of the US remains in doubt. A resurgent euro area also boosts the attractiveness of the euro as a reserve currency, and over the longer term brings the added benefit to the ECB of interest earned from seigniorage and the ability of euro area governments to issue debt more cheaply. The flipside of this is that euro area exports would also suffer to some extent from a stronger external exchange rate.

Part II—Debt crisis monitor

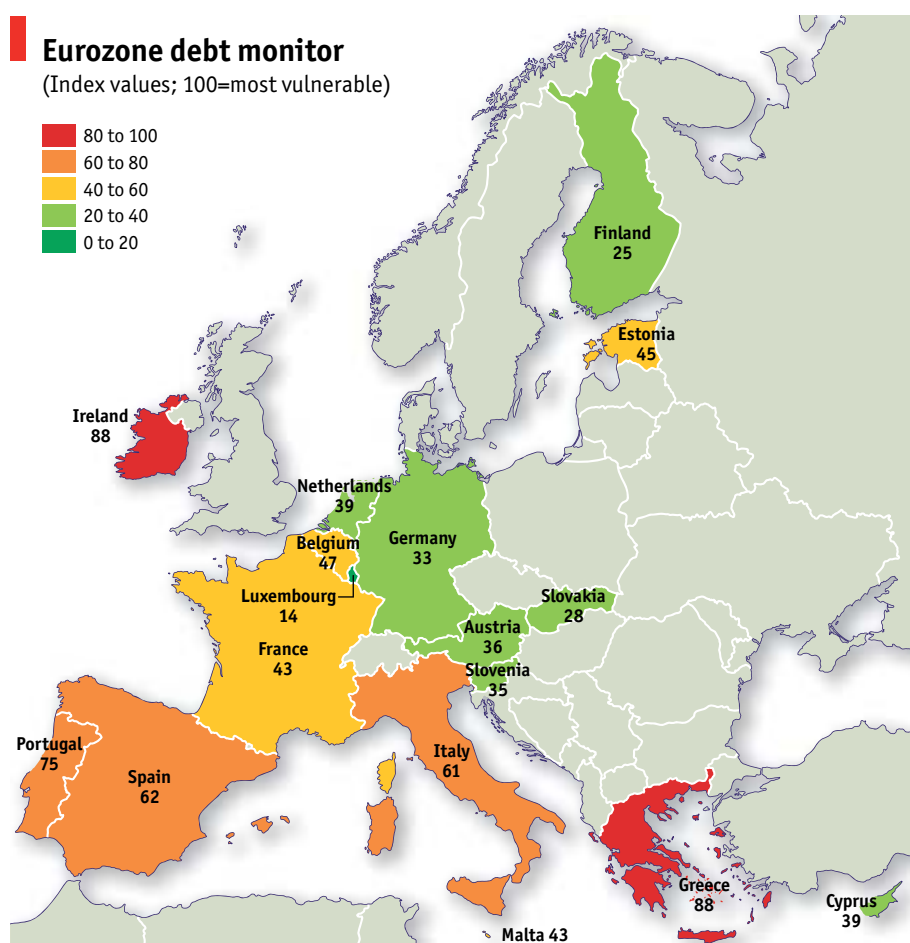
Introduction

Bringing the sovereign-financial feedback loop into focus

The second part of this report quantifies the scale of the challenges facing the euro area. To this end, the Economist Intelligence Unit has developed a "debt monitor", which seeks to measure the vulnerability of countries' sovereign debt to a debt restructuring. The index looks at two connected areas: the public finances and the banking sector (the methodology can be found in the box at the end of this section). Then, in the third part of the report, we discuss the underlying causes of the euro area's current difficulties—namely, the problem of weak competitiveness in the peripheral member states.

The sovereign debt side of our index is broken down into liquidity and solvency components. The more important of the two is sovereign solvency. This considers a country's long-term ability to repay its debt. The sovereign liquidity component analyses the risk that a country might not be able to access financial markets to fund its financing requirements in coming years, as has already occurred to Greece and Ireland. A temporary period of illiquidity can be overcome if bridge financing is available, which buys time to reduce a budget gap and allow public debt to start falling again—at which point the country is able to return to the market. The sovereign solvency issue is more serious, because when a sovereign is no longer solvent, no amount of bridge loans and temporary liquidity facilities will be able to bring the public debt back under control. This discussion is particularly pertinent to the euro area because the policy response seems to consist of treating sovereigns we consider to be insolvent (Greece, Ireland and possibly Portugal) as if they were merely illiquid. The consequence of such a policy is to put off the solvency reckoning until the point where the crisis is more far-reaching and serious than originally.

The banking component of the index considers the vulnerability of the private sector to a debt crisis. Given the role of the sovereign as a backstop for the banking sector, this shows the vulnerability of the sovereign to debt problems in the private sector, which are mediated mainly through the banking sector. Banking instability was a feature of the first round of the global financial crisis, when "toxic" assets were destroying western banks' balance sheets. Now, in the sovereign round of the financial crisis, banks are again highly relevant, as they rely on sovereign guarantees to remain afloat in many countries. In some countries, the vulnerability of the banking sector threatens to outgun the firepower of the sovereign. And when the sovereign becomes unable to support its banking sector, this in turn puts the credibility of the sovereign under pressure. The problem is compounded by euro area states' lack of independent monetary capability. The euro area could face up to this issue by creating a euro-area-wide banking resolution regime that does not make one country liable for the failure of a large pan-European bank.



Country vulnerability: index scores
(index values; 0-100; 100=most vulnerable)

	Sovereign solvency	Sovereign liquidity	Banking sector	Overall index score
Ireland	80	96	98	88
Greece	92	100	60	88
Portugal	72	82	70	75
Spain	62	62	62	62
Italy	66	66	40	61
Belgium	48	62	24	47
Estonia	36	70	32	45
France	54	32	32	43
Malta	30	60	50	43
Cyprus	22	44	76	39
Netherlands	34	34	58	39
Austria	40	20	48	36
Slovenia	36	34	36	35
Germany	36	22	40	33
Slovakia	38	10	28	28
Finland	28	18	28	25
Luxembourg	0	12	50	14

Source: Economist Intelligence Unit.

The debt monitor: overall index results

Tier 1: Ireland (88), Greece (88)

In the top tier of our index are the two hardest-hit euro area member states, **Greece** and **Ireland**. Both have been bailed out by the EU/IME, and their vulnerability to a debt restructuring is extremely high. It is our central forecast that both will be forced to default on their debt, but the extent and timing of this process will depend on both political and economic factors.

Tier 2: Portugal (75), Spain (62), Italy (61)

Portugal is clearly the next most vulnerable of the euro area countries. Its public debt is around the euro area average, but rising fast, and there are strong concerns over its ability to cut its fiscal deficit and then to grow fast enough to achieve a reduction in public debt levels. Financial markets have already decided that Portuguese debt is too risky, and a bailout is expected in 2011. A restructuring of Portuguese public debt remains a risk, but is not our central forecast.

Spain and **Italy** find themselves in our second tier as well, although their respective scores place them towards the bottom of this band, and their debt vulnerability is much less pronounced than for Portugal. Spain faces, above all, a liquidity risk in the next five years, as it tries to reduce its fiscal deficit against a background of extremely high unemployment, a medium-sized property crash and a risky banking system (which is slowly being addressed). Provided Spain can thread the needle on stabilising its still low public debt while maintaining social stability and saving its banking system, it can avoid a bailout and return to reasonable economic growth that will allow it to pay down its external debt. Italy, conversely, is not particularly unstable, with a smaller budget deficit that can be financed comfortably, but it has built up an uncomfortably high level of public debt. The concerns here focus on Italy's ability to grow in the longer term at a rate that will allow it to reduce its sovereign debt—that is, the issue is one of solvency, whereas its banking sector is less of a worry. The euro area would struggle to carry either of these countries if they required a bailout, let alone both.

Tier 3: Belgium (47), Estonia (45) France (43), Malta (43)

Belgium and **France** are the two main countries in the third tier of the index, which contains countries that are only mildly vulnerable to debt restructuring. Belgium's high public debt makes it vulnerable to a bond market panic over sovereign financing, because political disunity means there are fears over its fiscal consolidation capability. France too faces questions about the determination of policymakers to carry out the structural reforms that would return the public finances to a more sustainable footing. The role of the electorate in blocking past reforms also contributes to concerns. Both Belgium and France can consider a sovereign debt crisis to be "over the horizon", but neither can afford to be complacent about the issue. Moreover, both will be creditors to the euro area's bailout facilities, which is likely to further weigh on their debt profiles.

Estonia and **Malta** have reasonably comfortable public debt profiles that could yet deteriorate if action is not taken over the medium term. Neither poses a systemic risk to the euro zone, in the manner that Belgium or France would if they experienced a sovereign funding crisis.

Tier 4: Netherlands (39), Cyprus (39), Austria (36), Slovenia (35), Germany (33), Slovakia (28), Finland (25)

The fourth tier of our index includes **Germany**, the fiscal anchor and guarantor of euro area stability. Germany's large economy gives it the deepest pockets in the euro zone, but also saddles it with the obligation of defending economic and monetary union, something it has done with some reluctance so far. Alongside Germany, the fourth tier covers three other fiscally strong founder members: **Netherlands**, **Austria** and **Finland**. All four countries are considered capable of making fiscal savings, cutting their budget deficits and reducing their public debt to sustainable levels. As a result, they are all net creditors to the bailout funds. They are highly unlikely to experience any risk of debt restructuring, and any threat of this happening to Germany would shatter the euro area. They are joined in this tier by recent euro area entrants: **Slovakia**, **Slovenia** and **Cyprus**.

Tier 5: Luxembourg (14)

Luxembourg inhabits the final tier alone, with a low public debt risk profile, but also a negligible impact in economic terms on the euro area's sovereign debt crisis.

The scale of the fiscal challenge

Several euro zone countries have worrying debt dynamics

The euro area lacked the tools to address its crisis

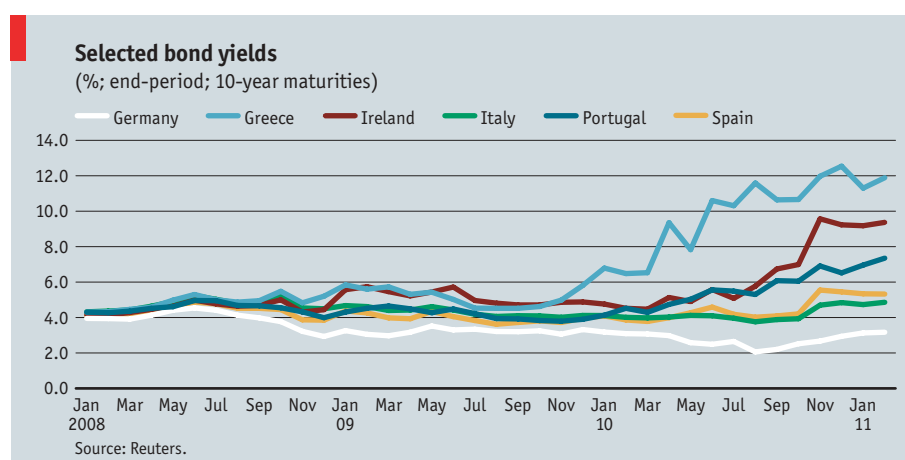
The euro area's sovereign debt problem has been particularly acute for a number of reasons. The economic and monetary union framework has tightly integrated the economies and financial systems of member states, meaning that any sovereign debt defaults, even by small countries, bear large systemic risks. The euro area also lacks the full integration that is common to other currency areas, which would include a unified political leadership, a central bank to act as the liquidity provider and buyer of last resort, and a European-level bank resolution scheme—which would prevent small sovereigns from being saddled with the rescue of large European banks with significant crossborder operations. Lacking these elements (except for a central monetary authority that remains reluctant to rescue struggling sovereigns), the public debt crisis continues to fester. The lack of a unified political leadership has complicated resolution of the crisis. As the best credit in the euro zone and the member with the deepest pockets, Germany underpins the euro area's stability and has led the response to the fiscal emergencies. However, it has done so according to its own understanding of the crisis and its attitude towards monetary union. This has meant that fiscal deficits—even those in Ireland, Portugal and Spain that result from prior private-sector imbalances—have been attributed to reckless government borrowing and spending, and consequently, the German-led solution has been immediate and severe fiscal consolidation in peripheral countries, despite the economic and political strains this has placed on economic and monetary union.

Options for tackling rising public debt

A country struggling with its debt profile has a number of options for stabilising its deteriorating public debt trajectory and returning to a more sustainable public finance situation. The first aim should be to move the fiscal balance towards a primary surplus—that is, a fiscal surplus before the payment of debt interest, which would indicate that the underlying fiscal stance is sustainable, even though public debt is still likely to be growing. Once countries move to a primary surplus, their public debt starts to grow more slowly, and improved market confidence in the underlying fiscal stance should allow for a reduction in borrowing costs, which assists in bringing down debt interest costs in a virtuous cycle. Getting to a primary balance and then surplus is, however, the hardest part. The euro zone is forcing struggling peripheral member states to cut their fiscal deficits at such a rapid pace that these countries' economies are starting to contract again. This undermines the revenue side of fiscal consolidation and deepens the need for further fiscal cuts. The severe speed at which this is being mandated risks undermining the internal political cohesion of the peripheral countries, driving down government popularity and—in a worst-case scenario—demolishing the backing for fiscal consolidation even from political elites, let alone electorates.

A second option for stabilising an unsustainable public debt trajectory (related to the first) is for borrowing countries to secure a reduction in their interest

payments. This not only cuts the interest burden, but also alters the dynamics of the growing public debt. Although sovereign debt is likely to continue to rise as a share of GDP, the rate of increase should slow. The result is that fiscal consolidation becomes more manageable, and market confidence in the public debt dynamics can eventually return. The euro zone has not embraced this option, however. Policymakers, led by Germany, have attached penal rates of interest to their liquidity-providing loans to Greece and Ireland, incorporating the funding costs, but also a moral hazard component, to prevent a bailout from becoming an attractive option. This approach is based on the euro zone's underlying arrangement that countries are responsible for their own debt problems and that there is to be no burden-sharing among member states. The creditor countries could use the prospect of an interest rate cut as a lever to obtain favoured policy outcomes in the bailed-out countries, but this would further exacerbate the tension that this arrangement creates.



A third option is to reduce a country's debt burden directly, which cuts interest payments and helps to narrow the fiscal deficit. Yet, the process of reducing the public debt burden is fraught with risk. A debt restructuring (essentially a default) would have severe knock-on effects for the balance sheets of a wide range of financial institutions. The banking sector in the affected country would be likely to need recapitalisation, precisely when regular market funding is unavailable to the sovereign. In addition, peripheral sovereign debt is spread throughout the euro area's banking system, a legacy of the earlier years of economic and monetary union, when all sovereign debt in the zone was seen as equally unrisky. This gives any sovereign default by a peripheral member state a systemic dimension and has so far prevented any official discussion of sovereign debt restructuring. Instead, creditor countries have extended large bridging loans to countries locked out of the funding markets. This short-termist mindset permits German and French policymakers to avoid the costs of recapitalising their banks, but also means that the coming reckoning with the unsustainable peripheral sovereign debt is delayed—and possibly worsened.

The fourth option for dealing with high public debt is both the least painful and the hardest to achieve. It involves securing strong and long-lasting economic growth, while exercising expenditure restraint in the public sector. A sustained burst of strong growth would close the fiscal deficit much more quickly than

expected, while enlarging the economic base that carries the public debt. Fast economic expansion has historically been possible for countries that have become highly indebted following a war, when there is substantial pent-up demand, but it is hard to imagine this being a serious option for solving the euro area's sovereign debt crisis, at least not in the short- to medium term. The highly indebted peripheral countries are far from being able to grow strongly, given their severe fiscal consolidation schedules, varying degrees of high private-sector debt, low consumer and business confidence, lack of credit provision from hamstrung banking sectors, high unemployment and stagnant real wage growth. Of the most-at-risk countries, Ireland and Spain are considered better able to achieve high growth rates after the fiscal crisis has been solved, whereas Portugal and Greece are viewed as more likely to suffer from weaker economic growth.

Strengthening fiscal surveillance

A big part of the euro zone's response to the debt crisis has been the drive to deepen fiscal co-ordination between states through reforms to the Stability and Growth Pact and the excessive-deficit procedure (EDP), the EU's budgetary surveillance and enforcement mechanisms. An "economic governance package" is currently being negotiated, which is hoped to be adopted by the European Council and European Parliament by June 2011.

Changes to the SGP include greater convergence in budgetary frameworks, such as expenditure rules, statistical and accounting standards, and forecasting practices. There will be earlier scrutiny of national budgets at an EU level. Governments also agreed to expand the range of sanctions and change the way they should be applied. In future, sanctions would be applied more quickly and it will be harder for member states to block penalties.

A crucial point in the new framework is that the co-ordination of economic policies should not be limited to the management of the deficits (which as before are meant to be limited to 3% of GDP) but that it should also include the level of public debt (which in theory should not exceed 60% of GDP). Thus member states whose debt exceeds the benchmark 60% of GDP will be required to reduce this overhang, and would be subject to an EDP if the pace was not deemed satisfactory—even if the deficit falls below 3% of GDP.

Some scepticism over the robustness of this new architecture is warranted. The emerging framework addresses some of the shortcomings of the previous regime, but the EU has a poor track record of enforcing budgetary surveillance—owing in part to the lack of political will to do so. Persistent criticism from Jean-Claude Trichet, the president of the European Central Bank (ECB), could stiffen the resolve of legislators in the European Parliament to toughen up the enforcement mechanisms in the coming months.

Debt monitor: sovereign solvency and liquidity

Tier 1: Ireland, Greece

Ireland and **Greece** top our sovereign solvency and sovereign liquidity rankings, and both have been bailed out by the EU/IMF emergency credit facilities. Having entered the crisis with high public debt already, Greece's public borrowing is now worth almost 150% of GDP. We do not believe that the country can avoid a debt default and restructuring. Ireland entered the crisis with low public debt, but the combination of a private debt implosion and a catastrophic sovereign guarantee for Irish bank debt saw it record the largest fiscal deficit in 2010 (an estimated 34% of GDP), and given the further debt taken on as part of the bailout, there is only a small chance of Ireland avoiding a debt restructuring in coming years. Neither country is likely to return to the government debt markets in a sustainable manner by 2015 unless this occurs.

Tier 2: Portugal, Spain, Italy

Portugal is expected to access the EU/IMF bailout facilities in 2011, as it is no longer able to maintain full liquidity in public debt markets. Although Portugal's public debt is not nearly as high as for Greece and Ireland, financial markets have lost confidence in its ability to stabilise its public debt, on account of weak economic growth and a lack of competitiveness.

Italy and **Spain** also find themselves in our second tier, although the risk level of their public debt remains considerably behind that of Portugal. Italy's main issue is its high level of government debt, at an estimated 120% of GDP in 2010. The country can still fund itself well from domestic sources, but we see a risk that investors will eventually balk at the high debt level in combination with weak economic growth prospects. Spain's public debt is considerably lower, at around an estimated 60% of GDP in 2010, having entered the crisis with particularly low public debt. Now, a huge fiscal deficit, high unemployment and worries about federal-regional relations mean that Spain's funding needs could become more difficult to fulfil. Both countries have a good chance of avoiding a full-blown financing crisis—indeed, that is our central forecast—but if they were to need bailing out, the euro area would struggle to muster the fiscal necessary firepower.

Tier 3: Belgium, France, Estonia, Malta

The third tier contains those countries where sovereign liquidity and solvency are beginning to be questioned, but where the financing of deficits is still achieved comfortably. **Belgium** enters this category because public debt is above 100% of GDP and because of concerns over the cohesion of the state, given the strength of separatist tendencies. **France**, too, can be considered in the waiting room in terms of the riskiness of its public debt profile. France's public debt is likely to approach 90% of GDP in the next few years, amid questions over its capability to make the necessary structural reforms to its labour and social welfare systems that will allow medium-term stabilisation and reduction of the debt as a share of GDP. France's contingent liabilities from the euro area bailout also weigh on its debt profile.

Estonia's high external indebtedness and repayments schedule raise concerns, but its deficit-cutting programme means that there is little risk of financing crisis. **Malta** faces some onerous funding requirements, although it has a solid debt profile.

Tier 4: Germany, Netherlands, Austria, Finland, Slovakia, Slovenia, Cyprus

Germany and the **Netherlands** are the two original EU members with the most solid debt profiles, and there is high confidence in the sustainability of their public finances. Germany is the fiscal guarantor of the euro area, but with the largest economy it has to shoulder a significant share of the euro area's bailout facilities. At present, this is manageable, but its contingent liabilities from the bailout will remain a risk feature of German sovereign debt. The Netherlands is also a sizeable creditor to the euro area and will contribute heavily to euro area emergency credit facilities. Its public debt level is moderate, despite having to bail out its banking system in 2008-09.

Finland and **Austria** are the other euro area countries with highly rated fiscal profiles. Along with Germany and the Netherlands, these are the member states pushing hardest for peripheral members to pay their own way out of their debt crises. Recent euro area joiners, **Slovakia**, **Slovenia** and **Cyprus**, are also considered strong sovereign credits, and their public financing needs attract little concern (although Cypriot banks constitute a risk factor to the sovereign). Their contribution to the euro area's bailout facilities will be small in absolute terms.

Tier 5: Luxembourg

Luxembourg sits alone in Tier 5, with extremely low public debt and no sovereign solvency or liquidity concerns.

Tackling the banks

There are unexploded bombs in Europe's banking sector

The fates of banks and sovereigns are intertwined

During the early stages of the financial crisis, a joke made the rounds on European trading floors: "What is the difference between Ireland and Iceland? One letter and six months." At the time, few took the observation seriously. However, as the economic tide turned, the mountain of debt that Irish borrowers had built up turned sour and, as in Iceland, proved too much for domestic lenders to bear. The scale of the problem was also too much for the state to shoulder, as attempts to guarantee liabilities and backstop shaky assets proved an unbearable strain on the public purse. Problems that stemmed largely from the private sector forced the sovereign into a bailout.

Could it happen elsewhere in the euro area? Ireland does not have a monopoly on beleaguered banks, but the extent to which problems in the private sector threaten other sovereigns' solvency vary widely. Outside of Ireland and some other smaller euro members, banking sectors are much more heterogeneous, making country-level generalisations difficult. In these cases, a key differentiator is often size. Europe's largest banks are generally healthier than their smaller rivals, particularly when it comes to earnings power. According to the European Central Bank (ECB), the largest banks in the EU—defined as lenders with assets greater than 0.5% of all EU banking assets—reported an aggregate 8% return on equity at the end of June 2010, the latest data available. Medium-sized banks reported a negative 1% return on equity, while small banks eked out a positive return of only 1%.

Despite fears of financial institutions growing "too big to fail", in the euro area there will be fewer, larger banks in the near future. Consolidation in the name of improving capital adequacy, liquidity and general banking-sector solidity is an explicit goal of restructuring efforts by Spain, with mergers between large private-sector lenders in Greece also under way. The businesses put up for sale by some large banks as a condition of receiving bailouts during the depths of the financial crisis seem destined to end up in the hands of other large banks.

As banks grow larger, they typically expand their range of activities, mixing retail, commercial and wholesale units. To some, this is a prudent diversification of risks and profit drivers. To others, it is a dangerous mixture of "utility" and "casino" businesses, with memories still fresh of disasters stemming from wholesale lending and securities units putting the health of entire financial groups, including the funds of retail depositors, at risk.

Measures are being introduced at the global, regional and national levels to bolster the stability of large financial institutions. Stricter capital and liquidity rules as a result of the so-called Basel III standards will gradually take effect, with large firms deemed of systemic importance facing harsher rules than those imposed on their smaller counterparts. Initiatives such as "living wills" for large, complex institutions are also meant to make it easier to compartmentalise and, if necessary, cleave a stricken unit from a financial group without putting other divisions at risk. These measures will undoubtedly improve the safety of

the euro area's banking system, but the timeline for implementation will be measured in years. As many countries face immediate fiscal and financial strains, this is of marginal comfort.

Some countries, like Spain, have ordered banks to boost their capital faster than agreed under the global Basel III accord. Elsewhere, some banks are racing to bolster their capital ratios to satisfy skittish investors or get ahead of the glut of fundraising that may take place as regulatory minimums are raised in stages along the way to full Basel III implementation in 2019.

Many banks will need to raise new capital

Europe's largest banks typically feature lower capital ratios than their smaller counterparts, as they tend to maintain more aggressive balance sheets and rely more on lower-quality capital. As a result, many large lenders will need to raise funds, as new capital adequacy standards boost their risk-weighted assets and shrink their Tier-1 capital. This brings the sovereign-financial feedback loop into focus, as the financing needs of some debt-heavy sovereigns will lead them to compete with banks in capital-raising exercises. And as investors see the fates of sovereigns and their banks are strongly entwined, banks may find their access to funds limited owing to changes in sentiment towards their home country; banks in the euro area's troubled periphery are already forced to rely heavily on the ECB for funds. Direct exposure to the sovereign debt of these counties is also an issue, with banks across the euro area—particularly in France—exposed to securities that, in the worst case, face a value-destroying restructuring.

Foreign exposure to peripheral euro area government debt

(By bank nationality; US\$ bn; end-September 2010)

	Greece	Ireland	Portugal	Spain
Germany	26.3	3.4	8.4	29.4
France	19.8	6.6	16.1	46.0
Italy	2.6	0.8	0.9	3.3
Other euro area	16.3	4.0	16.6	16.9

Source: BIS consolidated banking statistics (ultimate risk basis).

Sovereign stress also affects banks in more fundamental ways, with the austerity plans introduced to address fiscal shortfalls feeding through to banks in terms of dampened growth, higher non-performing loans and limited earnings potential, particularly in countries where households are already highly leveraged. In this regard, the largest banks are protected by their profitability, diverse business lines and, especially, exposure to more buoyant markets outside of Europe. Small and medium-sized banks with a domestic focus are less flexible, and thus more at risk. To the extent that these smaller lenders (when taken together) comprise a significant share of a member state's financial system, this creates a dangerous liability for sovereigns. This is currently a pressing issue for Spain's savings banks and, to a lesser extent, a clutch of struggling medium-sized lenders in Italy and Germany.

The banking sub-index of our debt monitor measures the size, structure and stability of national banking systems, with a view to gauging the risk that the financial sector poses to the sovereign. For the euro members with scores towards the wrong end of the scale, Ireland's object lesson shows that this is no laughing matter.

Debt monitor: banking

Tier 1: Ireland (98)

Ireland's banks are the riskiest in our rankings by some distance. The outsized banking sector—with assets nearly ten times GDP—fuelled a credit bubble that will take years to deflate. The propensity to finance long-term loans with short-term wholesale funding also pushed Irish banks to the brink when interbank lending markets seized up. Now wards of the state and almost wholly reliant on the ECB for funds, Ireland's banks remain the sovereign's most pressing problem.

Tier 2: Cyprus (76), Portugal (70), Spain (62), Greece (60)

Despite fairly conservative management, banks in **Cyprus** are considered the second-riskiest in the euro area. The size of the banking system, around nine times Cyprus's GDP, limits the state's ability to support its banks if they stumble. Cypriot banks' earnings are under pressure as a result of subdued property-sector activity and large exposure to Greek borrowers.

Portugal's banks are heavily reliant on the ECB for funds, owing to worries about their concentrated exposure to a structurally weak domestic economy and dependence on wholesale funding sources.

The threat that banks in **Spain** represent to the sovereign—and by extension, the euro area—is the subject of intense debate. Spain's banking system consists of a clutch of relatively strong commercial banks balancing a throng of struggling savings banks (*cajas*). By some measures, Spain's largest banks, Santander and BBVA, are among the strongest in Europe, with diversified earnings bases shielding them from Spain's struggling economy. The *cajas*, by contrast, are heavily exposed to a protracted domestic property bust and face a wrenching restructuring process.

Greece's banks are victims of the financial-sovereign feedback loop, with loan portfolios under pressure owing to austerity measures and securities portfolios full of risky sovereign debt. Greek banks are also largely shut out of interbank lending markets and suffering from deposit flight. The sector's woes could complicate the sovereign's fiscal consolidation efforts.

Tier 3: Netherlands (58), Luxembourg (50), Malta (50), Austria (48), Germany (40), Italy (40)

Banks in the **Netherlands** were hit hard by the financial crisis, and ongoing efforts to repair balance sheets make the banking system one of the weakest in the euro area's core. ING and ABN Amro were two of the highest-profile casualties of the credit crunch, representing a lingering liability to the sovereign as the banks restructure their operations.

Banks in **Luxembourg** and **Malta** are ranked as riskier than their balance sheets might suggest, mainly owing to the size of the sectors in relation to their countries' GDP. This is also the case in **Austria**, although its banks are also dealing with some legacy issues related to loan losses from exposure to east European economies in the early stages of the financial crisis.

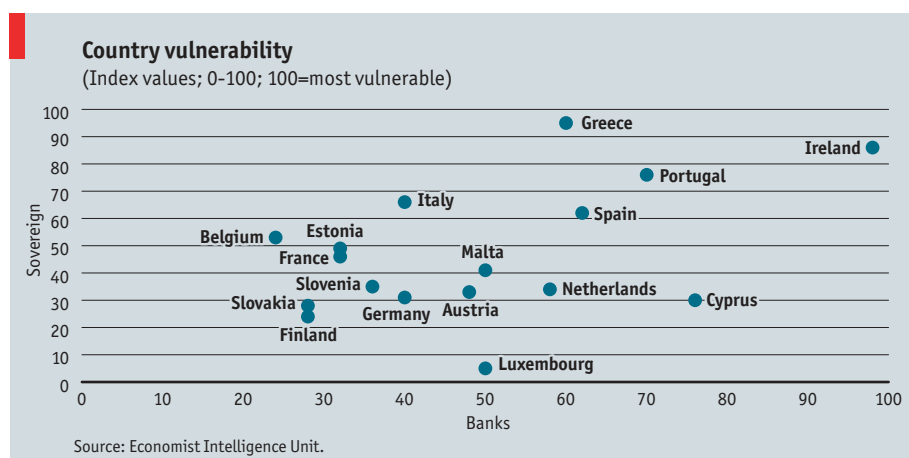
Banks in **Germany** and **Italy** are seen as equally risky, despite the countries' diverging fiscal fortunes. Germany's largest lender, Deutsche Bank, is a world leader, with a balance sheet bolstered by the recent takeover of a deposit-heavy retail lender, Postbank. However, the country's second-largest bank, Commerzbank, and many of the regional state-owned *Landesbanken* required state support to survive the financial crisis and face ongoing restructuring processes. The transition to stricter capital standards will be tough on many German banks, as they rely on instruments likely to be excluded from calculations of core capital. The same applies to Italian banks, which are more thinly capitalised than many other European banks. The country's fragmented banking sector suffers from low profitability, but retail-orientated business models and limited reliance on wholesale funding also makes Italian banks appear safer than many of their racier euro area peers.

Tier 4: Slovenia (36), Estonia (32), France (32), Finland (28), Slovakia (28), Belgium (24)

Banks in the east and far north of the euro area—**Slovenia**, **Estonia**, **Finland** and **Slovakia**—carry similarly low risk rankings. Most of these countries' banks are adequately capitalised and benefit from fairly conservative business models.

Banks in **France** have weathered the financial crisis better than most. They benefit from large retail franchises in a country that avoided a borrowing binge, while investment banking units largely dodged the deep losses that competitors made on sub-prime and other risky securities. Risks loom in some French banks' foreign units, with relatively large (but still manageable) exposure to peripheral euro area economies, as well as countries gripped by popular unrest in North Africa.

Belgium was one of the first countries to step in to support its largest banks—Fortis, KBC and Dexia—during the financial crisis. Thanks in part to restructuring since these bailouts, and the takeover of Fortis by a French banking giant, BNP Paribas, Belgian banks have shed many of their toxic assets and refocused on a domestic market with solid, if unexciting, prospects. The risk that the banking sector poses to sovereign solvency is considered relatively low.



Debt monitor: methodology

The Economist Intelligence Unit's index provides a measure of the vulnerability of euro area member states with respect to the sustainability of public debt. The headline index is on a scale of 0 to 100, with higher scores indicating increased vulnerability to a debt restructuring. The headline index is a weighted sum of three sub-indices for sovereign solvency, sovereign liquidity and the banking sector. These sub-indices, which are also on a scale of 0 to 100, are a weighted sum of scores for a series of indicators, listed below.

Sovereign solvency

- Public debt/GDP (%), end-2010.
- Fiscal balance/GDP (%), average fiscal balance/GDP 2007-10.
- Growth (%), average economic growth 2007-10.
- Net external asset position/GDP (%), mostly end-2009.

The public debt/GDP ratio expresses the stock of public debt as a percent of annual output and is the classic indicator of sovereign solvency. The fiscal balance/GDP ratio and growth performance are both flow measures whose future outcome shapes debt sustainability. We used actual values over the period 2007-10 as a proxy for how these indicators are likely to evolve over the medium term. The net external asset position/GDP ratio is a broad measure of a country's solvency with respect to the rest of the world. A number of euro area countries have large negative net external asset positions, which reflect accumulated claims from current-account deficits. Governments in such countries are typically more dependent on foreign savings and less able to fund themselves domestically.

- Sovereign liquidity
- Short- and medium- and long-term sovereign debt repayments due in 2011/GDP.
- Interest due on public debt/fiscal revenue (%), 2010.
- Spread of ten-year sovereign bonds against benchmark German bunds (basis points), average of four months to January 2010.

The three indicators relate to liquidity and funding. Debt repayments, together with the fiscal balance, constitute a government's borrowing needs. Bond spreads are a measure of borrowing costs and access to capital markets. Interest due/fiscal revenue is a measure of a government's capacity to service its debt from taxation and other fiscal revenue.

Banking

- Total bank assets/GDP (%), end-June 2010.
- Bank claims on private sector/GDP (percentage points), change between most recent quarter for which data are available (mostly third quarter of 2010) compared with three years earlier.
- ECB liquidity support/total bank liabilities (%), most recent liquidity support data and liability data (mostly January 2011). Note: data includes emergency liquidity assistance (ELA) provided by the Irish central bank.
- Loan/deposit ratio (%), end-December 2010

The total bank assets/GDP ratio is a measure of the size of the banking system relative to output. In countries with outsized banking systems, the sovereign may not have the capacity to support the banking system and guarantee its liabilities. Bank claims on private sector/GDP indicates whether credit has been growing faster than the economy over a three-year period. Large increases in this ratio are indicative of credit booms. ECB liquidity support/total bank liabilities is a measure of the dependence of a country's banking system on ECB funding. Heavy dependence is indicative of restricted access to market funding and as such a reflection of the market's view of the banking system's creditworthiness. The loan/deposit ratio indicates how much of the banking system's loan book is financed by retail deposits, which tend to be a stable form of funding. A high ratio is indicative of reliance on wholesale funding, which is more risky and volatile.

Scoring

The scores for each indicator are on a scale of 0 to 5, in which higher numbers indicate increased vulnerability. The scores are determined by sorting the data into groups through a series of thresholds. For example, in the sovereign solvency category, a country with a public debt/GDP ratio below 25% scores zero, while a country with a public debt/GDP above 125% scores a 5.

A number of considerations informed the selection of indicators. We tried to keep the number of indicators to a minimum and to avoid duplication. For the banking indicator, we did not include some obvious choices such as capitalisation ratios and non-performing loans (NPL), owing to inconsistencies in classification across countries.

Weighting

The indicators are weighted to reflect their importance. For example, in the sovereign solvency category, public debt/GDP is the dominant indicator, with a weighting of 50%. Likewise, in the sovereign liquidity category, bond spreads are the dominant indicator, with a weighting of 50%.

In the overall index, a 50% weighting is assigned to sovereign solvency, 30% to sovereign liquidity and 20% to banking. As the financial crisis has shown, there are feedback loops between the sovereign and banking sector ratings. The liabilities of the banking system are contingent liabilities of the sovereign, and the banks are heavily exposed to sovereigns (domestic, but also other euro zone sovereigns) through their large holdings of sovereign debt.

Data sources

The data is taken from a number of sources, including the Economist Intelligence Unit's *CountryData* and *Country Risk Service*; Haver Analytics; the IMF; the European Central Bank (ECB); finance ministries, public debt management offices and central banks of the euro area member states.

Part III—Reducing imbalances within EMU

A monetary union without fiscal transfers may be unstable

Theories of optimum currency areas are back in vogue

The euro area crisis has revived interest in the question of whether the single currency bloc satisfies the criteria defining an optimum currency area (OCA). At the heart of the original work on OCAs by Robert Mundell in the 1960s was the suggestion that countries in a monetary union could benefit from a reduction of exchange-rate volatility and lower transaction costs, albeit at the cost of an independent monetary policy and the ability to revalue exchange rates as a means of facilitating price and wage adjustments. Thus, weighing up the trade-off between these costs and benefits would require knowledge of how different economies are affected by economic shocks. If economies are exposed to asymmetric shocks and are unable to adjust quickly, then the potential costs of joining a currency union could be quite high (although several studies have suggested that these early OCA theorists overestimated the stabilising effect of floating exchange rates and underestimated other benefits of a currency union).

Other economists have stressed the importance of product diversification as a criterion for delineating an OCA—the more specialised a region, the more vulnerable it would be to asymmetric shocks. There are two schools of thought on whether the creation of a single currency area, in which there is also free movement of capital and labour, would actually promote specialisation or reduce it. The "convergence" view posits that differences in wage rates or returns on investment between two regions will eventually be diminished by trade and/or by capital flows and labour migration. The "divergence" school of thought predicts that regional specialisation could increase following the creation of a single currency area, as a result of positive economies of scale (such as a concentration of suppliers or skilled labour). Proponents of the latter view predict a paradox: satisfying one condition for an OCA (factor mobility) will make it harder to satisfy another condition (diversity).

Convergence, then divergence

The recent experience of the euro area will provide further grounds for debate in the years ahead. During much of its first decade, the economies of the euro area displayed a high degree of convergence, but it is now clear that this was partly illusory, raising anew the question of whether some current members might be better served by having their own currencies and the ability to set their own interest rates.

From the launch of economic and monetary union (EMU) at the start of 1999 up to the middle of 2007, the euro area seemed to be performing relatively well. Real GDP averaged around 2.3% per year. As was to be expected, the less well-off countries in the euro area's periphery experienced a period of catch-up growth, with higher average growth rates than in the "core" countries. Over time, the dispersion of real GDP growth rates between individual member states gradually diminished. Annual inflation averaged 2% during this period and on this measure too, the differences between member states narrowed. Intra-euro-area trade and investment increased. Business cycles, as measured by changes in output gaps, were reasonably well synchronised. Employment

growth was not spectacular, but at 1.3% per year on average, was still higher than in the US (1.2%).

However, the onset of the global financial crisis in the second half of 2007 brought this period of convergence to an abrupt end, exposing large internal imbalances. The impact of the crisis was felt across the euro area, but differences in the structure of individual countries meant these effects became apparent in different ways. The economies of Spain and Ireland contracted sharply, as credit flows that had financed construction booms halted. German economic growth collapsed as global demand for its exports plummeted. In France—where domestic demand accounts for a much higher share of total GDP and where household and corporate sector balance sheets were less stretched—the downturn was considerably shallower. As the global financial storm passed, it revealed a euro area divided roughly into two groups: one where economic fundamentals remain strong (comprising the core euro area member such as Austria, Germany, the Netherlands, Belgium and Finland) and one where they are weak (Spain, France, Italy, Greece, Portugal and Ireland).

In explaining the divergence within the euro area it is useful to consider a range of indicators linked to the underlying productive capacities of the two groups (see the charts at the end of this section). For example, the recovery in the "strong group" in the core of the euro area since the second quarter of 2009 has been helped by the higher share of total exports being shipped to countries enjoying rapid growth, such as the emerging markets and major oil producers. In turn, this reflects the higher weight of manufacturing in these countries. Companies operating in countries in the strong group tend to enjoy higher after-tax profits. This enables them to invest more in new capacity and in research and development, which in turn feeds through to higher productivity and greater potential growth over the medium term. These divergences in part reflect past comparative advantages, but they also stem from institutional factors and the choices made since the launch of EMU on a range of economic policies—such as wages, taxation or innovation—which in turn can have an important bearing on where companies choose to locate their activities.

Businesses in euro area core are more cost-competitive

Crucially, businesses located in the core group have on the whole been able to maintain better cost competitiveness than those in the periphery. Unit labour costs have diverged sharply, rising well above the euro area average in the periphery, while falling well below the average in Germany. France more or less represents the average. Underlying these trends is the development of nominal wages, which grew by more than was justified by productivity performance in the periphery. The reverse was true in Germany. In Ireland, the rise in unit labour costs between 1999 and 2007 took place predominantly in services and construction, whereas unit labour costs actually fell in the manufacturing sector. Spain and Portugal both saw steep rises in the unit labour costs in non-traded sectors, but also some modest rises in manufacturing. Greece experienced sharp rises in both sectors. Since 2008, only Ireland has made visible progress in reducing unit labour costs.

Current-account balances within the euro area largely developed in line with trends in competitiveness, with rising surpluses in the core group and widening

deficits in the periphery. Of course, the emergence of deficits is not necessarily indicative of long-term problems: during a period of catch-up growth, relatively poorer countries can increase their growth potential via productivity-enhancing investments, financed by external capital (as investors seek higher yields). Yet this does not appear to have been the case in the euro area. With real interest rates falling following the creation of EMU, capital inflows to the periphery fuelled strong increases in consumption and unproductive investment in property. In the cases of Portugal and Greece, rapid growth in domestic demand was exacerbated by loose fiscal policy. Against a backdrop of relatively inflexible labour and product markets, the resulting wage and price inflation caused the real effective exchange rates of the peripheral member states to appreciate, leading to a rise in current-account deficits.

Before the financial crisis, relatively little attention was paid to the growing indebtedness of the weaker part of the euro area. With credit flows ensuring that growth of employment and output was in many cases above rates in the core, the increased structural divergence of the two parts of the euro area were masked. Having failed to reform their economies in the years immediately following their entry to EMU, the challenge for the peripheral countries now is to outgrow their debts against a backdrop of a relatively small industrial base, weak investment capacity, low exports to fast-growing markets and overvalued real exchange rates. Moreover, this will have to be achieved in the face of strong headwinds—a tight fiscal stance across the region and a single monetary policy that sets interest rates at a level appropriate to the bloc as a whole.

Commission sets its sights on "excessive imbalances"

European policymakers have acknowledged that previous EU instruments did not cater sufficiently for macroeconomic imbalances. As part of the new "governance package", they plan to introduce a new system of surveillance for detecting anomalies in growth models. A "scoreboard" of economic indicators will be developed, denoting risk thresholds for variables such as current-account balances, net foreign assets, unit labour costs, credit growth and house price growth. On the basis of an annual monitoring report, the Commission could issue "early warnings" urging corrective action. Ultimately, member states that fail to abide by these could be subject to an "excessive imbalance procedure" (EIP), including the possibility of sanctions (although as with an excessive-deficit procedure (the EU's fiscal surveillance mechanism), only euro area states would be subject to any financial penalties).

In addition to these changes, Germany has pushed for—and to some extent secured—an agreement for a voluntary "pact for the euro" between euro area states. This foresees greater co-ordination on a range of policies that remain national prerogatives at present, including on pension and retirement systems, wage formation procedures and the tax base. The pact, which was agreed in early March 2011, currently represents little more than a series of aspirational targets, with no obvious enforcement mechanism in place. It was effectively Germany's asking price for agreeing to changes to the bloc's emergency liquidity scheme, the European Financial Stability Facility (EFSF).

This new focus on macroeconomic imbalances recognises the important role that the accumulation of private debts has had in driving budgetary crises in a

number of countries, both directly, through guarantees and bailouts of financial institutions, and indirectly, through the collapse of revenue derived from unsustainable credit-driven activity (whether investment or household consumption). In theory, this is an important innovation, but in practice it will be far from straightforward to implement.

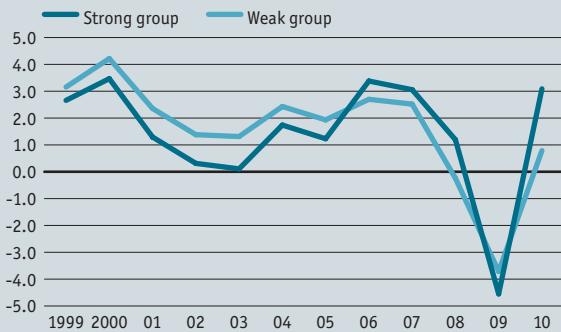
Some euro area countries, notably Greece and Spain, have accepted the need to restore wage competitiveness and are introducing labour market reforms. It seems plausible that the crises in Ireland and Spain could have been prevented, if policymakers had sounded the alarm over developments in credit and housing markets. That notwithstanding, is it really possible to detect imbalances at an early stage and take action before the damage is done? It is important to bear in mind that macroeconomic imbalances are the result of decisions by private actors, not just governments, and tinkering with microeconomic regulations could prove to be a ham-fisted way of seeking to change behaviour. Even if it is theoretically possible for timely intervention to prevent imbalances emerging, reversing developments that are already under way could require confidence in the Commission's judgment that may simply be lacking.

Who should bear the burden of adjustment?

An added difficulty is that deficits in some countries are necessarily mirrored by surpluses in others. Should all the burden of adjustment fall on deficit countries, or will surplus countries be forced to act too? The stability of Germany's unit labour costs owes much to the severe pay restraint shown by German workers in recent years. In turn, rising trade and current-account surpluses are partly a consequence of high household savings and weak investment at home by German firms. Would the Commission press Germany to consider ways to boost its domestic demand, for example by advocating reforms to the country's internationally sheltered (and less productive) services sector, or opening up public procurement markets to foreign competition, or taking tough action on remaining non-tariff barriers to trade? If past experience is anything to go by, the Commission will lack the clout to force a large member state such as Germany to take undertake reforms in the teeth of strong domestic resistance. If Germany's domestic reform remains a taboo subject, resentment among politicians in the peripheral states at interference in their internal affairs is likely to grow, and adherence to the bloc's new rules will be weak.

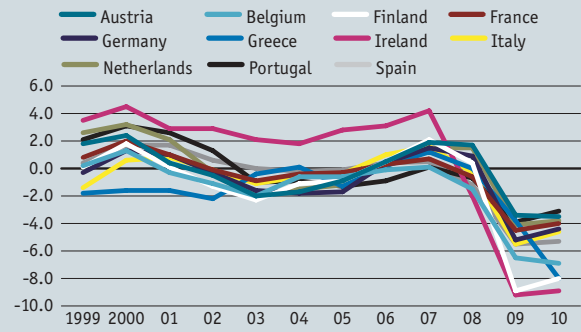
Convergence and divergence

Real GDP growth
(% change, year on year)



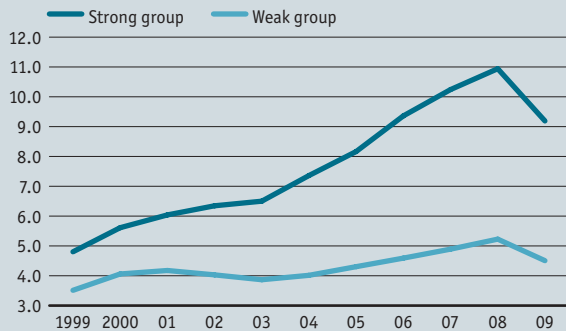
Sources: Eurostat; OECD; EIU; IMF.

Output gaps
(Difference between actual and potential output; %)



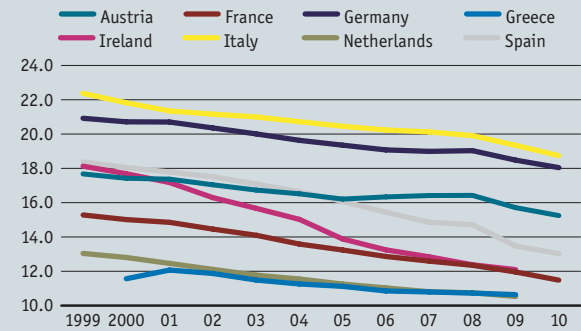
Sources: Eurostat; OECD; EIU; IMF.

Exports to emerging markets and oil producers
(% of GDP)



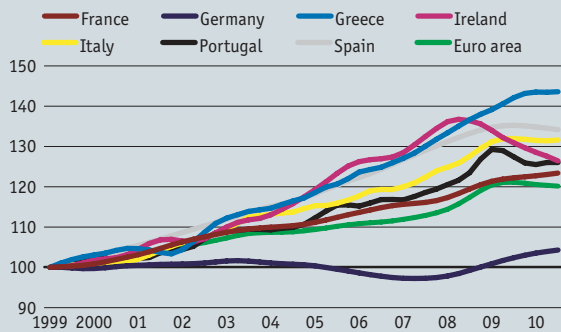
Sources: Eurostat; OECD; EIU; IMF.

Manufacturing employment
(% of total)



Sources: Eurostat; OECD; EIU; IMF.

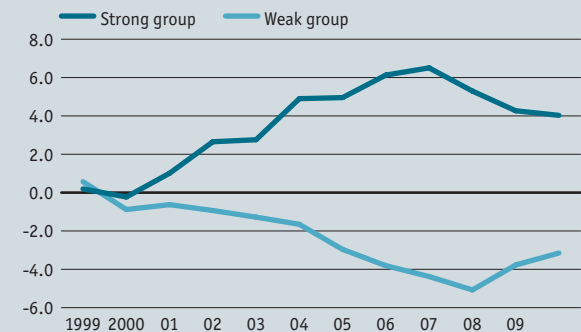
Unit labour costs
(Q1 1999=100)



Sources: Eurostat; OECD; EIU; IMF.

Note. Strong group refers to Austria, Belgium, Finland, Germany and the Netherlands. Weak group refers to France, Greece, Ireland, Italy, Portugal, Spain.

Current-account balances
(% of GDP)



Sources: Eurostat; OECD; EIU; IMF.

Conclusion

The euro zone should pull through, but this cannot be taken for granted

Politics will become more confrontational

The next five years will be unusually challenging for Europe, even in a best-case scenario. The global financial crisis is having wide-ranging and long-lasting effects. Among the most serious of these is a threat to the existence of the euro, the most ambitious project in the process of European integration. Policymakers have come to terms with the fact that the survival of the euro area cannot simply be taken for granted, but will depend on careful management of stresses in the bond markets and weak banking systems, reforms to fiscal governance and determination to tackle structural problems.

The political environment will be strained like never before. There is no doubt that, especially for countries in the euro area with high debts and deficits, there will have to be much more non-national influence over budgeting and other areas of economic policy. It remains to be seen whether the government and electorates in some highly indebted countries will be able to tolerate years of austerity, or whether the benefits of leaving the euro area could begin to be seen as outweighing the costs. The ECB, by purchasing government bonds, has stepped into politically controversial territory and may find it hard to step back. In short, the limits of European solidarity will be tested in the coming years and it is possible (although not the Economist Intelligence Unit's central forecast) that the decades-long process of integration could go into reverse.

Choosing a "one-size-fits-all" interest rate will be difficult

Divergence in the economic performance of euro zone countries is likely to increase in the near term. The conduct of euro area monetary policy under such circumstances will be a challenge for the ECB, not only in terms of maintaining price stability—its core mandate—but in relation to financial stability. The ECB appears poised to begin gradually raising its interest rates in the coming months. With growth and inflation rates differing widely across the euro area, monetary policy is likely to remain too loose in some euro area countries (Germany), while remaining restrictive in others (Spain, Portugal and Ireland). Unless the struggling peripheral countries take bold action to improve their external competitiveness, it will become even harder to conduct a single monetary policy without creating further imbalances. Currency devaluations are not an option to restore external competitiveness, so if labour markets remain inflexible, a high level of unemployment risks being the primary means of adjustment to drive down wages and prices.

Yet, efforts to boost competitiveness might prove to be insufficient to guarantee the survival of EMU over the longer term. If, as some economists believe, the creation of the monetary union is driving increased specialisation of economies, then the constituent member states will remain vulnerable to asymmetric economic shocks. With a variable monetary response no longer possible, the euro area may yet have to consider the possibility of greater fiscal transfers to depressed regions to ensure a viable monetary union.

While every effort has been taken to verify the accuracy of this information, The Economist Intelligence Unit Ltd. cannot accept any responsibility or liability for reliance by any person on this report or any of the information, opinions or conclusions set out within it.

LONDON

26 Red Lion Square
London
WC1R 4HQ
United Kingdom
Tel: (44.20) 7576 8000
Fax: (44.20) 7576 8500
E-mail: london@eiu.com

NEW YORK

750 Third Avenue
5th Floor
New York, NY 10017
United States
Tel: (1.212) 554 0600
Fax: (1.212) 586 1181/2
E-mail: newyork@eiu.com

HONG KONG

6001, Central Plaza
18 Harbour Road
Wanchai
Hong Kong
Tel: (852) 2585 3888
Fax: (852) 2802 7638
E-mail: hongkong@eiu.com

GENEVA

Boulevard des Tranchées 16
1206 Geneva
Switzerland
Tel: (41) 22 566 2470
Fax: (41) 22 346 93 47
E-mail: geneva@eiu.com