

Principal observations from recent discussions about the euro area

1. Political determination to keep the euro area basically intact has, if anything strengthened; and
2. The institutional changes in train are taking the euro in the direction of being more sustainable.

However:

3. Surprising as it might seem, Europe's policymakers apparently have no final design in their minds for the structure of the euro area. They are simply making it up as they go along; and
4. The risks from political radicalism are growing, and extend beyond southern Europe.

Preamble

This paper presents a number of central observations from recent discussions with a range of senior European policymakers and policy advisors, and a handful of seasoned commentators. The observations are interesting partly in their own right, but mainly because of the seniority/authority of those who expressed them.

From our standpoint, the discussions cast further light on what, in *Europe Will Work*, Peter Westaway and I a year ago regarded as two central determinants of Europe's future:

- First, we took the 16 December 2010 declaration by the European heads of state that they were "ready to do whatever is required" to protect the euro as meaning what it said; and
- Second, we recognised the 'role of crisis' in impelling Europe, a collection of individual and individualistic nations, in engaging collectively in the reforms that would be needed if the union was to survive.

Taken together, these two judgements led us to conclude that the euro area would proceed, crisis by crisis, in the direction of a more sustainable ultimate configuration. And so far, this is broadly what has been happening. However, there is still a long way to go. And so, a year further on, and given that markets are currently quiescent, it is an appropriate moment to start to reassess the situation, and look ahead another 6 to 12 months.

The main takeaways from the recent discussions are the following:

Political determination apparently remains strong. A range of people at senior policy level observed that:

- Political determination to keep the euro area intact "has become stronger at every stage".
- One specifically stated that "Mrs Merkel owns the euro project".
- Several observed that EU heads of state are "strongly committed, individually and collectively". In the words of one, "ever since their 16 December meeting the heads of state have owned the euro".

Mrs Merkel is a master of detail, and absolutely refuses to be hurried. Apparently:

- First, she "totally masters" her brief;
 - Only Italy's Monti (and not, interestingly, ECB President Draghi) matches her in this respect.
 - No other European leader "even gets close" to matching her mastery of the detail.
- Then she spends whatever time it takes to get "all her political ducks in a row".
- Only after all that does she act. But "she always delivers".

There is a lack of vision as regards the final structure. Apparently this applies to all the heads of state:

- Neither Mrs Merkel nor the other European leaders have "a clear end-point at which they are aiming":
- There is even "confusion over terminology, including such fundamental words as 'federal', 'economic union', and 'fiscal union'." These words apparently mean quite different things to different European leaders.
- "Policy is being made on the hoof, one step at a time"; said one person.

For these various reasons, policy often proceeds slower than markets would like:

- In the opinion of one (monetary) policymaker, however, "markets are beginning to accept that policy in Europe will inevitably continue to evolve at a measured pace".

The ECB has bought “only so much” time:

While almost everyone believes that it is the liquidity provision by the LTRO that has been largely responsible for the narrowing of spreads, all saw this relief as only temporary, unless or until the fundamental fiscal and structural policies are put in place.

- No one seemed sanguine about how much time had been bought.
- Several suggested “a few months at best.”

Growth is a concern, but no policy action on that front stands to be forthcoming for a while yet:

- Mrs Merkel is central to this (as with so many aspects of the euro project);
- For her, before there can be any consideration of policies to support growth, the full panoply of policies that, in her judgement, are needed to ensure the long-term viability of the union have to be enshrined in law.
- Only thereafter will she, and thereby the European Council as a whole, turn their attention to growth.

There will almost certainly be a bigger firewall, in due course:

- There was a widespread view, including importantly from Berlin that “the Germans will come round to it”.
- However, several thought that “it may not initially be as big as markets will require”.

Political radicalism poses perhaps the greatest risk:

- A number of people spoke about popular discontent in countries ranging from Greece (frequently seen on other countries' television) to the Netherlands and Denmark (less frequently seen on TV abroad).
- Two people – seasoned social observers, rather than policymakers – were “extremely concerned” by the risk of a resurgence of extreme politics, whether of the right or the left.

The European Council arguably does not suffer from a “lack of democratic legitimacy”:

In a vigorous discussion on this subject, the point was made by an insider that, because heads of state are answerable to their parliaments “they agree only to things that they know they can get passed back home”.

The administration in Greece is not competent:

- There was widespread – indeed near universal – doubt about whether the administration in Greece is capable of carrying through the policy changes that have been agreed to.
- This was not (primarily) xenophobia: several contrasted the Greek administration with that of Portugal, whose administration is considered competent, experienced, and likely to deliver on its undertakings.

A final reflection:

The swings in the prices of European assets over the past twelve months or so can be seen as the result of the ebb and flow of two schools of thought:

- **Street analysts**, who judge (almost certainly rightly) that the euro’s design flaws are such that, under present institutional arrangements, economic and market forces would cause it to blow up; but who tend (almost certainly wrongly) to underrate the ability of politicians to change institutional setup sufficiently; and
- **Policy analysts**, who, at least initially, underestimated the seriousness of the euro area’s design flaws, and hence the vulnerability of the euro; but who are better at understanding and monitoring the will and the ability of Europe’s policymakers to fix the system rather than let it disintegrate.

Judging by the tenor of the discussions summarised above, prices of European assets will continue to fluctuate quite widely, driven by continuing shifts in the perceived balance of plausibility between these two quite different intellectual frameworks of thought.

Over the coming months, therefore, the most relevant analysis of the likely future of the euro may therefore come neither from economic/financial analysts, nor from policy analysts: it may well come from sociologists and historians. We intend to shift the balance of our reading, and accordingly our discussions, somewhat in that direction. ■

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