

EUROPEAN ECONOMICS UPDATE

6th Jul. 2010



Euro-zone break-up now more likely than not

- **We have come to the conclusion that the balance of probabilities has swung against the euro-zone surviving in its present form.** We have been brought to this point by our analysis of the problems of indebtedness, competitiveness and structural economic weakness in the euro-zone, combined with recent market anxiety about sovereign debt and the continued fragility of the world economy.
- A substantial change to the euro may take the form of a single country, most likely Greece, choosing to leave, or being asked to leave, or a series of countries leaving, Germany leaving, or of a split between a northern euro and a southern euro.
- It seems to us that the chances that one of these changes will happen at some point over the next five years have increased to above fifty percent.
- The timing remains highly uncertain. There are good reasons why such a drastic change will not come soon, not least the continued political commitment to the euro pretty much across the whole euro-zone. **The pressure seems most likely to rise to breaking point in about two or three years time – but we cannot rule out the denouement coming sooner.**
- Accordingly, over coming months we will be pursuing a work programme to explore various aspects of this issue. This will be a continuation of the work that we have been pursuing for some time now. On 7th January we published a piece entitled 'How much will fiscal tightening hurt Europe'. On 23rd April we published a *Focus* on the links between the options of leaving the euro and defaulting. And on 28th April, we published a *Focus* entitled "Will the euro-zone survive?". Although it concluded that the euro-zone should probably hold together for a few years at least, it highlighted the increasing risks of some sort of break-up.
- More recently, we have published studies of the financial situation facing Greece, Ireland and Italy, which have highlighted those countries' loss of competitiveness, as well as examining the fragility of their debt position. Even before these pieces, we published a *Focus* asking whether Germany could save the euro-zone by expanding domestic demand. It concluded that although in principle it could, in practice this was highly unlikely to happen. **So the current change of view has not been a damascene conversion but rather the result of a steady build-up of arguments amidst rapidly changing events.**
- And the process does not stop here. We plan to take our work forward by continuing to ask difficult and important questions. It is widely believed that a euro-zone break-up would be an economic catastrophe. But would it? As part of our continuing work programme, we will publish a piece asking the question of whether a break-up of the euro could be a good thing.
- Subsequent pieces will look at the financial plight of Portugal and Spain. We also aim to look at the barriers to exit, whether a fall in its value could save the euro, and to monitor how changing economic, financial and political forces are shaping the probability of continued euro-zone survival. And we will publish pieces looking at the consequences of various forms of euro break-up, both for the individual countries concerned, for Europe as a whole and for the world economy and financial markets.

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