STRATEGY
ECONOMICS

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The Euro Is Already A Zombie Currency

Summary

- **The euro has already turned into a zombie currency.**
- **It no longer meets many of the key criteria of 'money'.**
- **It is not universally acceptable and it is not a store of value.**
- **The greatest impact of that is not in the future – it is right now.**

Anyone who spends their time analysing the euro debt crisis will know that there is one question you get asked again and again. When will the single currency finally collapse?

You can have fun giving a spuriously precise answer – July 28th, 2014 is my favourite (look it up on Wikipedia if you are wondering why).

But the truth is no one really knows. The euro could stagger on from crisis summit to emergency bail-out for another decade. Then again, it could be gone by the end of the month – if Greece is refused its third bail-out, the country may be kicked out, and the entire currency could unravel over the course of a few chaotic days.

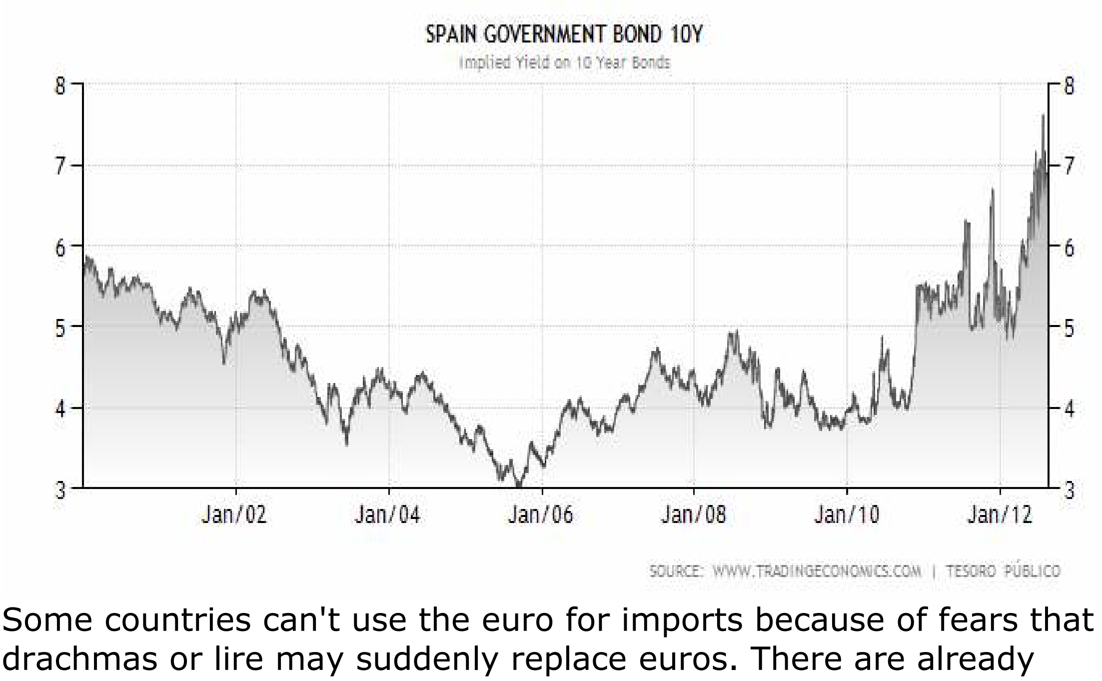
In reality, whether it is a few months or a decade away does not make as much difference as you might suppose. Why not? Because in most of the ways that actually matter, the euro is already dead. It no longer meets most of the criteria of a working form of money. There is an important point in that for investors. It is right now – whilst the currency no longer lives but still staggers on like a zombie - that the euro is wreaking most havoc on the countries of Europe. Once it is finally taken apart, markets in those nations can start to recover – and potentially very rapidly.

One: Is The Euro Still A Currency?

Of course the euro still looks like a currency. There are notes and coins, and you can still go into a shop in Hamburg, or a café in Naples, and get stuff in return, even if there might be a certain amount of grumbling. There is a central bank, although it doesn't appear to have much idea what its job is. And there are payment systems and foreign exchange markets that work as if the euro was a viable part of the global capital markets.

And yet if you think about it a little harder, then the euro is not a currency in every sense of the word. A currency is only partly about notes and coins. It is also about being a universally accepted medium of exchange, a store of value over time, and a way of facilitating trade over long distances. That was why money evolved. And the euro doesn't really meet those criteria any more.

Take interest rates for example. In Germany, the yields on 10-year government bonds are less than 2%. In Spain they are close to above 6%, and in Italy over 5%. And in Greece? Don't ask. Government bond yields matter – not just in themselves but because they set the benchmark for borrowing costs right across the economy.



Some countries can't use the euro for imports because of fears that drachmas or lire may suddenly replace euros. There are already reports that oil traders don't want to supply clients in Greece. Why not? Because in six months time when payment falls due they may not get paid in the currency the deal was struck in – but one worth much less. Much the same may soon be true of Spain as well. And who can blame them? Oil is commodity that you can sell pretty easily right around the world. Why sell it to a country where there is a risk of not getting paid when there are so many alternative customers.

Meanwhile, money flees to safe havens. London real estate agents report that the phones are ringing non-stop with wealthy euro-zone property buyers looking for somewhere to park their cash – and houses in the British capital look a safe bet. Swiss bankers are flush with cash exiting Italy and Germany. Everybody with any significant wealth wants at least part of it outside the euro-zone – because they are worried the currency might one day implode.

None of those are the kind of things that happen in functioning currency zones.

Two: The Euro-Zone Is De-Monetizing

Take a comparison with the US dollar – which really is a single currency for a whole continent.

Imagine for example that a company in Alabama had to pay three times as much to borrow as one in Maine – even though it was in the same business and had the same credit record but just happened to be unfortunate enough to be in the wrong part of the country. Or that a company in Boston couldn't import auto-mobiles in dollars because the supplier in Detroit wouldn't accept their cash? Or that people in Texas were buying houses in California to protect themselves from the potential break-up of the currency union?

Very soon, the economy of the United States would cease to function. And we would start to wonder whether the dollar was still a currency in any meaningful sense.

But that is precisely the situation in the euro-zone. The euro still has the notes and coins. But in almost every other sense it is no longer really a currency.

This is more than just a semantic point. It is also important for investors to grasp.

When a currency stops working the damage done to the economy is immediate. Trade stops flowing. Investment gets postponed. Capital flees. Very quickly, unemployment starts to rise, and output declines.

That is precisely what is happening in the euro-zone right now.

This part of the crisis – when the monetary system ceases to function in any meaningful way – may well be the worst point. But once countries such as Italy and Spain get their currencies back, there will be a very rapid improvement. Having any kind of functioning currency, even if it is one that has hugely depreciated in value, and doesn't have much respect in the currency markets, is a lot better than having no currency at all.

The bounce back in the economies of the countries that have suffered most from the euro will be very rapid. Most experts predict chaos – without understanding that chaos is what we have now. In fact, those economies will recover strongly as soon as they have a functioning currency again and so will their equity markers. The only real question is when they are cheap enough to start buying.

- Matthew Lynn
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Forecasts

The UK Economy

	2012	2013	2014
Growth:	-0.2%	0.9%	1.5%
Inflation:	3.1%	2.9%	2.7%
Unemployment:	9.2%	10.2%	9.5%

The EuroZone Economy

	2012	2013	2014
Growth:	-0.7%	0.2%	1.2%
Inflation:	2.0%	1.8%	1.8%
Unemployment:	9.4%	9.2%	9.4%

The German Economy:

	2012	2013	2014
Growth:	-0.5%	1.0%	1.4%
Inflation:	2.0%	2.2%	2.4%
Unemployment:	6.6%	6.8%	6.9%

The French Economy:

	2012	2013	2014
Growth:	-0.7%	1.0%	1.0%
Inflation:	1.9%	2.3%	2.6%
Unemployment:	8.9%	8.7%	8.8%

The Italian Economy:

	2012	2013	2014
Growth:	-2.5%	-1.7%	0.1%
Inflation:	2.1%	2.0%	2.1%
Unemployment:	8.9%	10.1%	10.7%

The Spanish Economy

	2012	2013	2014
Growth:	-2.0%	-0.5%	0.6%
Inflation:	1.9%	2.1%	2.3%
Unemployment:	22.3%	24.8%	25.6%

Exchange Rates

	2012	2013	2014
Euro/$1:	1.15	1.10	1.21
Pound/$1	1.60	1.71	1.78

Commodities:	2012	2013	2014
Gold:	1,900	2,500	2,600
Brent Crude:	125	140	150

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