Future Perspectives

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The future of the eurozone

How the eurozone crisis could end – and the opportunities for business

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The future of the eurozone

Three years ago, the then President of the European Central Bank, Jean-Claude Trichet, gave a lecture to the European Parliament celebrating the first decade of the Euro. The single currency, he argued, "protects incomes and savings and helps bring down borrowing costs, thus promoting investment, job creation and prosperity over the medium and long term." It had, he said, created greater "dynamism within the European economy." That was in 2009. From the perspective of February 2012, it looks very different.

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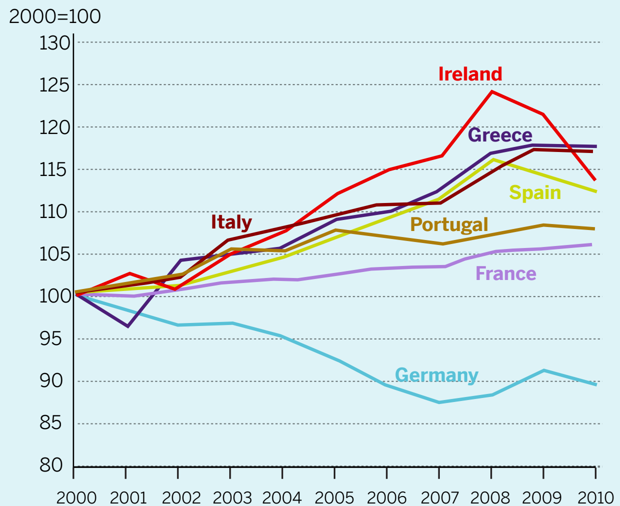
After the eruption of the Greek debt crisis in 2010, 2011 turned into the year of the crisis summit, with European leaders locked in an endless series of late night meetings in Brussels working on plans to save the Euro. Far from being a force for stability, the euro had (by general agreement) become an agent of instability. Far from lowering borrowing costs, it had driven them up in countries such as Greece and Portugal as well as Italy and Spain. And far from encouraging greater dynamism, in 2012 the debt crisis looked as if it was threatening a fresh recession.

Clearly something had gone badly wrong. Whether the euro survives or not, something needs to change. No currency system can stagger along in perpetual crisis.

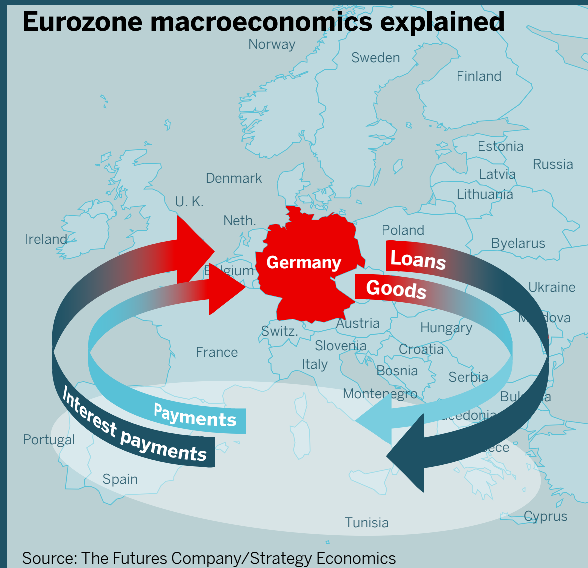
This report won't attempt to review the entire euro crisis in every detail. Nor will it attempt to predict precisely how the latest rescue plans will work out. Instead it aims to give a simple, clear and easy-to-understand account of the structural flaws in the single currency. And it attempts to lift people's sights, to look at how the crisis in the eurozone will reshape the European economy.

By 2020, the eurozone crisis will have resolved itself. Either the currency will have stabilized, or some peripheral members will have peeled away, or, just possibly, it will have split up completely.

But whatever the eventual outcome, the European economy will look very different—for consumers, workers, governments and companies. Some of the changes could be dramatic.



The roots of the eurozone crisis



Source: The Futures Company/Strategy Economics

The roots of the eurozone crisis are not the government deficits that have received so much publicity. These are only a symptom of far wider imbalances that have grown up since the single currency was launched. The real issue is the massive trade deficits that have opened up across the eurozone.

Since the launch of the Euro, the hyper-competitive German economy has racked up big surpluses, while the GIPSIs—Greece, Italy, Portugal, Spain and Ireland—have all racked up huge trade deficits.

The trade deficits are financed by borrowing. In effect, Germany lends the money to the GIPSIs to buy lots of goods from Germany. In some cases, such as Greece, it was the government that borrowed lots of money. In other countries such as Ireland and Spain, it was property developers and banks. In Italy and Portugal, it was a mixture of the state, the private sector and consumers.

Nevertheless, in each country, there was a huge rise in borrowing. In Portugal, for example, the total of household, corporate and government debt rose from 251% of GDP in 2000 to 366% of GDP in 2010.

This debt-to-GDP ratio was unsustainable. In Greece, the bond markets refused to lend to the government any more. In Ireland, the debts in the banking system became so overwhelming that the government had no choice but to take them over. Either way, prolonged trade deficits created debt, and the debt created the crisis.

The euro won't be on a path to long-term stability until those trade deficits start to close. There are some signs of it happening—the Spanish deficit, which at one point was more than 10% of GDP—is narrowing. But it is being achieved through massive austerity programs and recession, which reduce demand. Over the medium term, it needs to happen through the peripheral countries becoming more competitive. Only then will the euro become a more stable currency.

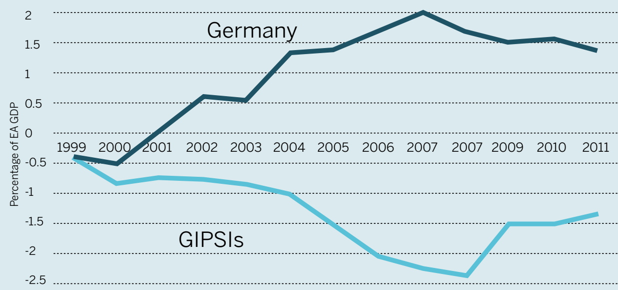
Thinking about scenarios

Sovereign default—when a state defaults on all or part of its debts—is surprisingly common, given how serious it is supposed to be. Since 1900, according to Carmen Reinhart and Kenneth Rogoff in *This Time is Different*, 44 countries have defaulted worldwide, some of them more than once. Of these, 35 have defaulted since 1975. In short, debt defaults by states can be thought of as a normal—if extreme—part of the working of international financial markets. Historically, they note, there have been long periods when a high percentage of countries are in a state of default and/or restructuring.[1]

In developing these scenarios, then, we have tried to strike a balance between the costs and the benefits of default. There are circumstances when default is the best of a bad set of options for a country.

The path of financial crises is well charted by Reinhart and Rogoff. Before: you see spikes in commodity prices, and large asset bubbles develop, inflated by easy credit and strong capital inflows. (This happened in the eurozone as money flowed out of Germany to invest in property and land in the Mediterranean states.) As the asset bubble expands, so debt grows. But inflation in asset values cannot continue forever; there is a moment when the market turns, confidence collapses and crash follows. After: asset markets suffer from a deep and prolonged collapse in value, the value of government debt tends to explode, and there is a prolonged increase in unemployment and a sustained fall in output. Although bailout costs are a factor in shaping the post-crash economy, it is the decline in production which does the most damage to economic performance and therefore to living standards.

European current account imbalances



Source: Paul Krugman, 'Conscience of a Liberal Blog', *New York Times*

Dealing with creditors, then, becomes the critical issue for economic recovery.

For governments and their creditors, this can represent a complex situation best characterized by game theory. Bond markets can increase the interest rates they charge to governments because they see greater risk, but increased interest rates put greater pressure on public finances, forcing tax increases or further cuts in public spending, increasing the levels of austerity and reducing output. (To take a simplified example, if government debt represents 100% of GDP, and interest rates on government bonds increase from 4% to 6%, this represents a 2% cut in output, or the equivalent of a year's

economic growth in more normal times.)

Continued cuts increase the political pressure on governments, and so there comes a point at which it makes both economic and political sense to seek a debt settlement. It also makes sense for bond holders to listen to such proposals; at some point it becomes a choice between getting some money back and getting less. As Keynes once said, if you owe your bank a hundred pounds, you have a problem; but if you owe a million, it has. The numbers are larger now, but the sentiment is the same. In the first instance, such negotiations are about a partial structured default which doesn't exclude the government completely from international capital markets; if that fails, or if there is a sudden failure in confidence, then there may be a full default instead, perhaps leading to years of negotiations between bondholders and government.

> There are penalties to being excluded from capital markets - but there are also heavy domestic costs from paying high interest rates on debt

From the perspective of a government, this amounts to a balance of costs; yes, there are penalties in being partly or fully excluded from the international capital markets, and the period after a default is politically ugly. But there are also heavy domestic political and economic costs from paying high interest rates on debt from an economy which is in a cycle of decline. Beyond this, for countries such as Ireland and Spain, which like the US and the United Kingdom are suffering from a 'balance sheet recession' as described in a recent paper by Richard Koo[2], eurozone membership presents a particular problem. In a balance sheet recession, similar to the one in Japan in the 1990s, debt deleveraging by the household and corporate sector creates a vicious cycle of recession as money is withdrawn from the economy to pay down debt. To break this cycle, governments need to be able to borrow their citizens' savings and then spend them. But within the eurozone, Spanish or Irish savings are as likely to be invested in Euro-denominated bonds invested by other governments, which means taking money out of national economies.

In the context of the European Union and the eurozone, there is a second layer of the game being played out: the point at which the cost of sustaining the eurozone starts to threaten the political integrity of the European Union.

These are high-stakes games. As David Harvey has noted, "One of the basic pragmatic principles that emerged in the 1980s, for example, was that state power should protect financial institutions at all costs." (In particular, he suggests, the IMF became the enforcer of this principle.)[3] At the same time, the aftermath of default is politically explosive. In 2001, Argentina was marked by political instability, factory occupations and takeovers, highway blockades, and the formation of neighborhood collectives. Paul Mason's characterization of a Greek default is also chastening:

> *"Greek politics is polarising at the same time as its professional politicians are running out of answers. It is hard not to predict a social explosion in Greece.*

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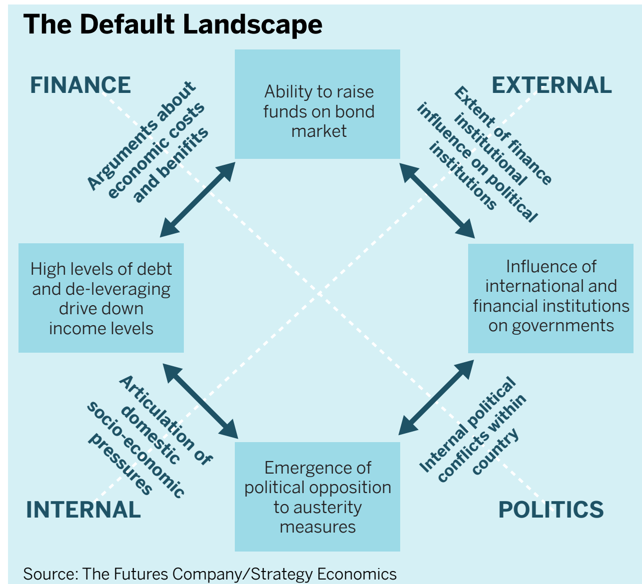
Should it be forced to exit the eurozone, then the exit plans I've seen do not look pretty. The one outlined by SOAS professor Costas Lapavitsas involves bank closures, current account freezes, import and capital controls and probably food rationing."[4]

But the other half of the equation is also important. Greece is already suffering from many of the disadvantages associated with default: it has suffered economic collapse, its debt has increased, and it has been shut out of international capital markets since 2010. And as a result of the eurozone-imposed cuts and tax increases, as Stergios Skaperdas observes, there "has been a fast downward spiral of the economy... The debt-to-GDP ratio went from 115% to 160% in less than two years." The economic desperation that has seen increasing numbers of Greeks put their children into care creates political volatility, heightened by the emergence of parties (either new or previously marginalized) which have not been associated with austerity measures.

Equally, when the Spanish government announces new austerity measures and tax increases,[5] in a country which already has almost a quarter of the workforce (and almost half of all young people) out of work, and whose *indignados* movement was a forerunner of Occupy, it is hard to believe that things will turn out well, either economically or politically.

to reduce its debts to US banks by more than two-thirds.[7]

So, there are a number of tensions which play out in the development of our scenarios for the future of the eurozone, which are set out in the diagram below.



Governments which seek to reduce their debts have more leverage if there is perceived to be a risk of contagion, suggest Reinhart and Rogoff.[6] It should also be noted that there are strategies which governments can use to build agreement to reduce their debts; this does not have to be a unilateral process. Ecuador, for example, audited its debt and identified irregularities and illegalities in some loans; the audit helped

There are economic tensions, on the one hand, between the desire to be able to borrow on the international markets, and the domestic pressures caused by continuing austerity and declining living standards. On the other hand there are political conflicts between the influence of financial and international institutions on governments, and pressures from citizens for a more equitable political settlement

(expressed in American politics as “Wall Street versus Main Street”). Within these, differences over economics may also emerge between the interests of industry and of finance, for industrialists need stable markets, or expanding ones, to prosper. There are also conflicts—which overlap with these—between external diplomatic demands and internal electoral demands. And it is worth repeating that sitting beneath this combustible mix are levels of public debt which are almost certainly unsustainable.

The scenarios in this report, therefore, have looked at the possible pathways from the present unstable situation, based on how these economic and political tensions might play out. These are represented by the decision tree in the diagram on the facing page.

Scenario 1:

The eurozone survives in its present form. This is the scenario that the European Union and the European Central Bank (ECB), backed by Germany and France, would most like to see. But in the face of shrinking economies in the peripheral states, and cycles of austerity measures in response, it seems unlikely to be realized unless the countries with high levels of public debt are able to write off much larger proportions of these than has been permitted by the eurozone so far. To be realized, this scenario would require a fundamental shift in German attitudes to debt and economic management.

Scenario 2:

A ‘dual Euro’ is created, with weaker economies shifting to a ‘southern Euro’: the logic of this scenario is that the countries with weaker economies are able to devalue their currencies, which provides a far more rapid economic boost than the long-term structural adjustment that is otherwise required. So, this scenario enables countries that wish to devalue to stay in the eurozone. This scenario is unlikely even if a blueprint has been drafted in Brussels or by the ECB itself.

Scenario 3:

A smaller eurozone with some peripheral countries returning to national currencies. One of the driving forces of the eurozone—as with the formation of the EEC—has been the alliance between Germany and France which sits at its heart. One of the ways of defending the euro is, in effect, to manage the departure of the weaker peripheral economies while maintaining a core eurozone. This has strategic advantages: a benefit of the euro is that it gives Europe clout as a regional player on the world stage. In this scenario, we see a two-tier Europe, with those inside having more clout than those out of it. But it also requires that Germany and France maintain some kind of parity, which may become harder as France’s economy deteriorates.

Scenario 4:

All countries revert to national currencies, but the euro remains as a trade currency. Even if the eurozone comes unstuck, it seems unlikely that the euro will disappear. The strategic advantages of a shared currency remain valuable, and the EU and ECB continue to make and receive payments in euros, while

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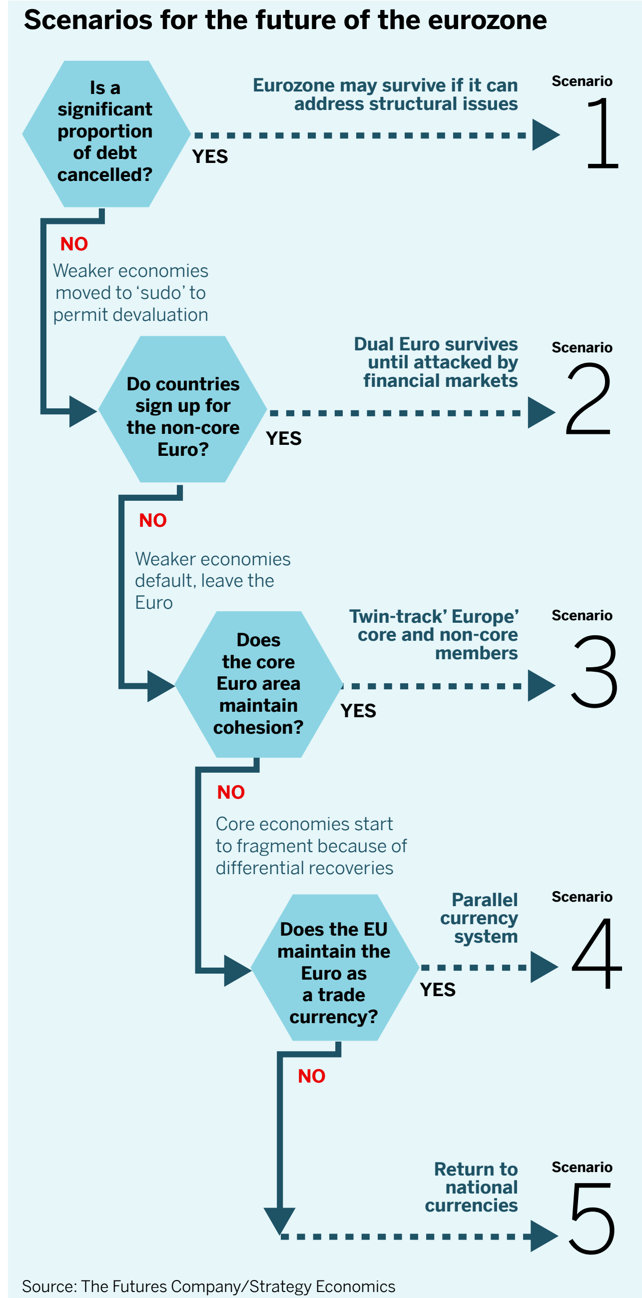
European companies can issue euro-dominated bonds. National governments don't particularly like this, since it creates a second fiat currency, but it is required as a condition of EU membership. This is increasingly straightforward to manage in a digital world. It provides some economic discipline within the EU, and the continuing benefits of EU membership outweigh the disadvantages.

Scenario 5:

All countries revert to national currencies. This is the end of the euro experiment, and something of a nightmare scenario. This scenario represents an economic failure as well as the collapse of much of the idea of the political union of Europe. Such a currency disintegration would be messy and prolonged, and would certainly extend the European recession for several years. On the face of it, it is a return to the EU of the 1970s and 1980s, but it could be worse. It could be a return to the fractious hostile Europe of the 1880s instead.

In the next section, we will focus on the scenarios which involve defaults, and their economic implications.



Source: The Futures Company/Strategy Economics

Exploring the implications for Europe and the eurozone

What are the economic implications of the different scenarios, and how will they shape the commercial environment in which companies doing business in the eurozone will have to operate?

The eurozone cannot continue to stumble from crisis to crisis

Scenario 1:

The eurozone survives in its present form

This is by far the most preferable solution for policymakers, and the one that involves the least change to the economic makeup of Europe. It is a mistake to think that it involves no change, however. The eurozone cannot continue as it is, stumbling from crisis to crisis, and with major countries such as Italy increasingly locked out of the financial markets. If it is still a working currency area of 17 countries in 2020, it will need to be very different from today.

There will be three main changes.

One: A fiscal union—or Die Fiskalunion as it is known in Germany—will have been created, involving major transfers of funds from the core to the periphery. That will be accompanied by far greater control of national budgets by a central authority. Since tax and spending decisions are at the core of what governments do, the fiscal union will be far more politically centralized. Most major economic decisions will be made in Brussels. But there will also be far more persuasive nationalist movements within each country, since not everyone will be happy with the loss of national sovereignty involved.

Two: Peripheral Europe will need to have restructured its economy, and will have become far more competitive. Labor markets will be have been liberalized, and youth unemployment will have been cut. Retirement ages will have been raised. Female participation in the labor market will have been dramatically increased. Protected monopolies in areas such as retailing and transport will have been broken up. State assets will have been privatized. Wages will have been held down for years, and productivity raised. All those measures would allow peripheral Europe to compete with the core—but will imply huge changes in the structure of each economy.

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Three: Core Europe—mainly Germany—will have restructured its economy to become far less reliant on manufacturing and exports, and far more dependent on retailing, leisure and financial services, thereby allowing it to import far more manufactured goods from Southern Europe. The eurozone will survive only if it becomes far more balanced economically—and this means there will be change in the core as well as the periphery.

Scenario 2:

A dual euro is created, with weaker economies shifting to a southern euro

The Southern euro—the 'medi' or 'sudo' as it has been dubbed in the financial markets—has a growing band of supporters, particularly in Germany, which has the dominant voice in this debate. In many ways, it is a neat solution. Many of the advantages of a single currency are preserved, but divided into more natural currency areas. The trouble is with the sudo. The largest economy within it by some way would be Italy. And the Italians have suggested that they would not wish to take on the economic responsibility involved.

But if it did happen, it would create a line down the European economy. In effect, there would be two economic zones, with the sudo constantly depreciating against the 'neuro' (as the northern euro might be known).

It is unlikely that a single market would survive in these circumstances. Rather like the splitting of the Roman Empire in 395 AD, the two zones would gradually drift apart. In reality, companies should prepare for two European economies: a north and south. They would both be single markets. But over time they would acquire different rules and characteristics.

Scenario 3:

Smaller eurozone with some peripheral countries reverting to national currencies

A smaller eurozone with some nations splitting away is a high-probability outcome. It is politically easier simply to remove some small countries than to restructure the entire bloc.

The most likely route is that membership is temporarily suspended, with no one in a great rush to re-impose it, rather as Sweden appears to have conveniently forgotten about its legal requirement to join the euro. Greece might leave first, followed by Portugal, and perhaps Slovakia. If it was just those three countries, the impact would be fairly minimal.

The big issue would be whether the core remaining eurozone could move forward to stability or not. The trade data would suggest not. Spain, Italy and now France all run massive trade deficits with Germany, suggesting that all three of them are still steadily losing competitiveness within the eurozone.

The overall outcome would be similar to Scenario One—southern and northern Europe will still both need to be transformed to achieve long-term stability. But the removal of the most highly indebted countries would make that process easier, buying some time to create a more unified currency area.

Scenario 4:

Countries revert to national currencies, but the euro remains as a trade currency

It is quite possible that the euro will survive as a parallel currency alongside national currencies. This would have two major consequences.

First: the euro would be the financial/multinational currency. We would expect that equity and bond markets would use the euro. Corporate debt would be accounted for in euros. Equity prices would be denominated in euros, and cross-border transactions would be accounted for in the single currency. A two-tier economy could open up, with the financial markets and multinationals using euros, and small and domestic businesses using national currency. However, and this is important, it should not be assumed that the 'euro' economy would do better. Medium-sized companies are often more dynamic than big ones and can grow faster.

Second: the euro would expand over time. Small countries might not find it worth the expense of maintaining national currencies. The three Benelux countries might switch to the euro as the only currency used in those countries. So might the Baltic States—Estonia (already a member), Latvia and Lithuania. Austria might decide to join. Meanwhile, the 'euro' economy might gradually expand over time, as larger percentages of each national economy switched to it. The euro would expand organically, adopted from the bottom up rather than the top down. By 2040, a large part of Europe might effectively be using the euro as its main currency, and some of the national currencies might start to fade away again.

> The future of the euro could be as a parallel currency alongside national currencies

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Scenario 5:

Countries revert to national currencies

A total reversion to national currencies is the most dramatic outcome for the eurozone. It is not the most likely outcome at this point, but it can no longer be ruled out. The circumstances of the euro's collapse cannot be predicted at this stage; it might happen chaotically or it might happen by agreement.

On the face of it, this scenario is no more than a return to the Europe of the 1980s. But the process of getting there would mean that we ended up in a very different place.

This scenario implies both that the countries with weaker economies have left the Euro relatively quickly, and that the core economies have been unable to maintain their cohesion. In turn this means that a number of the EU's institutions would have failed. It suggests a prolonged period of crisis, and the erosion of trust between countries within Europe. In other words, it involves an extended period of economic, political, and diplomatic pressure - and possibly even the unravelling of the European Union.

Europe's economies after the eurozone crisis

A country like Germany that builds up a big surplus impoverishes its trading partners

As we outlined at the beginning of this report, international economics is a large and complex system. Unlike a household, a country such as Germany that builds up a big surplus merely impoverishes its trading partners, requiring them to run big deficits. It's this imbalance which is at the heart of the current eurozone crisis, and the only way to resolve the crisis is to change the economic balance between Germany and the Mediterranean nations. So it is possible to sketch out how the European economy will be re-shaped as this is corrected.

We see three big trends:

One:
The periphery recovers quickly

Greece, Portugal, Spain and Italy would recover fast. There would be a very traumatic transition period (although because of its geopolitical importance, Greece in particular would be likely to receive US aid, just as it did in the years after World War Two). Within five years of the end of this difficult period, their economies would begin to grow significantly.

Here's why:

We also assume there would be a substantial devaluation of their currencies, which would immediately boost their competitiveness.

We assume as well that, as part of the break-up of euro, the peripheral countries would negotiate a partial default on their debts. This can be highly significant. Italy, for example, spends about 6% of GDP on debt repayment. Freeing itself of that burden would be a huge boost to the rest of the economy; it would be similar to the peace dividend seen after the end of the Cold War when countries were able to significantly reduce their spending on defense.

Finally, we assume that all the peripheral countries will have made significant structural reforms. It may not be enough to stay in the euro. But when combined with devaluation and debt relief, it will provide a platform for dramatic growth.

Remember that Italy was one of the fastest-growing post-war economies. From 1951 to 1973, its growth rate averaged 5% a year, only slightly less than Germany and Japan over the same period. In Italy it was known as 'il miracolo economico'. This can certainly happen again.

Two:
Core Europe will slump

Germany and the rest of the core eurozone have done well out of the single currency. But if it broke up, they would go into a prolonged slump.

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Here's why:

We assume they would see a major upwards revaluation of their currencies. Although Germany exports as much on quality as on price, price is not irrelevant. The export sector would be hit hard.

Worse, the losses from debt renegotiation by the peripheral countries would be borne by the core eurozone banks, mainly in France and Germany. The banking system would have to be bailed out by the government, hugely increasing debt-to-GDP ratios. In effect, the core would pay for the euro's collapse. This would be a drain on the economy in much the same way as reparations were after World War One.

Finally, since before the crisis, the economies of core Europe have been distorted by having an undervalued currency. They have become excessively reliant on exports. So they would need to restructure towards domestic demand, building up sectors such as retail, leisure and financial services that have been lagging in the past decade. This will be a painful period of adjustment, and it will have to be achieved against a backdrop of a contracting economy.

> The economies of core Europe have been distorted by an undervalued currency. They will need to build up domestic demand - in sectors such as retail and leisure

Three:
The single market will go into retreat

The euro was created, in part, to complete the single market. It is hard for goods and services to move freely across borders when prices are fluctuating against each other. Through the 1970s and 1980s—first with the 'snake' and then with the exchange rate mechanism—governments tried to control currency movements.

With the return of national currencies, we would expect to see the single market move backwards, not completely, but partially.

Here's why:

We would expect to see a rise of economic nationalism. EU law will provide some protection against this, but companies should expect and plan for an increase in informal protectionism.

In addition, we expect to see a move back towards local production. In a Europe of different national currencies, the only real way to protect yourself from currency movements is to have factories in each country. The euro saw a centralizing of production to the benefit of the core euro economies, Germany in particular. The post-euro era will see a decentralization of production.

The break-up of the ruble-zone

You don't have to dig very deep into the history books to find an example of a currency union falling apart. There is one from the very recent European past—the creation and dismemberment of the ruble-zone that was created so that the states that emerged from the break-up of the Soviet Union in 1990 and 1991 could share a single currency. It is a story that has very clear lessons for the likely fate of the euro as well.

The arguments for creating the ruble-zone were remarkably similar to those for creating the euro. The former Soviet Union covered what later turned into 15 different countries. The legacy of central planning meant that they were highly integrated; centralizing production and creating national/regional specialization had been one of the main aims of the Soviet planners. It was also a very closed system, because the Soviet Union traded relatively little with the rest of the world.

So rather than have 15 new currencies, it made a lot more sense to have a single currency. Just like the euro area, floating currencies appeared inefficient in such a tightly integrated economic area. Also, it was argued that the smaller counties might find themselves buffeted by the foreign exchange markets, whereas membership of the ruble-zone would ensure stability—again, an argument often heard for the euro. Indeed, the IMF in 1992 was urging the former Soviet republics to stay in the ruble-zone, much as today it is advising the peripheral euro-area counties to stay in the euro.

When it was created, the ruble-zone had 15 members ranged from the Baltic states of Lithuania and Latvia in the west to Tajikistan in the east. It was the largest single currency bloc in the world (the CFA franc created by France to circulate in Africa never got above 14 states). The Russian Central Bank maintained a monopoly on issuing banknotes, rather like the European Central Bank. Each member state, however, had its own central bank, which wasn't permitted to print notes, but could create credits for the government, essentially monetizing their debt.

Again, that is remarkably similar to the eurozone. While it is only the ECB that can issue banknotes, the national central banks remain in existence. They cannot create credits for their governments, but in effect the debts of the peripheral nations are now being monetized because the ECB is buying their bonds in the markets. The comparison isn't perfect, but it also isn't that different.

So what happened?

The ruble-zone was a catastrophe for everyone involved. The scheme incentivized each country to run up vast government deficits, and then transfer most of the costs to their neighbors. Georgia was the worst offender. It went from a budget deficit of 3.5% of GDP in 1991 to 34% in 1993. In the same period, Uzbekistan went from a deficit of 3.5% of GDP to 15.8%. There was an explosion of debt right across the region. The pressures

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on the system were intense. In the summer of 1992, the three Baltic states, Latvia, Lithuania and Estonia, all of which had been fairly fiscally responsible, quit the system and established their own currencies. Soon afterwards, the remaining members introduced their own currencies one after another: the Armenian dram in November 1993, the Uzbekistan som in January 1994, and so on. Russia itself effectively pulled out of the system with the introduction of a new ruble in 1993. Tajikistan staggered on with the ruble until 1995, long after everyone else had given up on it.

So what can the eurozone learn from the ruble-zone?

One: the strong countries leave first. It was the Baltic States that were the first to exit the system. Why? Because they could afford to. They were the relatively strong economies, with manageable fiscal deficits. By leaving the ruble-zone they were swapping a chaotic currency for a relatively stable and strong one (their own). It is not hard to see the same incentives coming into play within the euro area. As the currency staggers through perpetual crisis, there is less and less incentive for the Finns or the Dutch to stay in.

Although all eyes have been on the possibility of Greece being the first country to leave the eurozone, it could also be a country such as Finland, perhaps to preserve its triple-A rating.

Two: when the ruble-zone broke up, it was a small country that left first. It is easier for a small country to leave than a big one because it is doesn't have to take responsibility for destroying the monetary system. If Finland decided to suspend membership—perhaps to preserve its triple-A rating—it could be presented

as a minor adjustment. If Germany leaves, it would be the end of the euro in its present form. Although all eyes have been on the possibility of Greece being the first country to leave the eurozone, it could also be a small country such as Finland or Slovakia.

Finally, an analysis of the ruble-zone shows that the countries with the lowest fiscal deficits made the swiftest recovery. The same may be true if the eurozone does break-up; the lower the debt burden on leaving the currency union, the easier it will be to recover—although the lower debt burden may come in the form of defaults.

The ruble-zone was an interesting experiment in monetary union. In the end, it swiftly fell apart and was just as quickly forgotten.

What does the future of the eurozone mean for my strategic planning?

The reason we use scenarios is to help plan for uncertainty. This helps to ensure that we are less likely to be blindsided by changes in the external environment or even the operating environment, are more likely to identify risks to target operating models, and are better tuned to opportunities for improvements in service and operational effectiveness. Whichever of the scenarios sketched out above turns out to be the most accurate, the eurozone economy will look very different in 2020 from the way it looks today. The striking thing about the future of the eurozone is that the only uncertainty about the consequences described below is their timing.

There are seven big trends that we believe companies should start planning for.

New consumers

One: Italian women go out to work

If the euro is to survive, the peripheral countries will need to undergo massive socio-economic change to close the gap in competitiveness with the core euro members. The huge imbalances in the system are caused by the gap in competitiveness, so it is only by closing this gap that the currency union can become more stable.

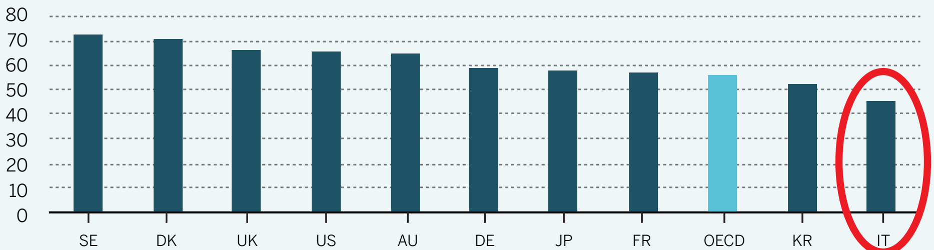
This has huge implications for many sectors of society.

In Italy, for example, female participation in the workforce is only 45%, compared with almost 70% in the UK, and more than 70% in Sweden. It is one of the lowest rates in the OECD.

Female labor participation is one of the major determinants of economic growth for advanced industrial societies. Since GDP is simply average output multiplied by the numbers of workers, and since both productivity and overall populations are not changing significantly, one of the few ways to increase GDP substantially is to increase the numbers of women working.

If Italy is to close its competitiveness gap with the rest of the eurozone, it has to

Italian women are amongst the least likely in the OECD to be in paid work



Source: OECD

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enable more women to work, to be hitting UK levels by 2020. This has major implications for the consumer market. Working women consume very differently from non-working women, and family structures and spending are very different in societies where it is the norm for women to be in work.

This will present huge opportunities for companies that make products and provide services for working women. Again, there is much potential in Italy for foreign companies who have experience in addressing this market.

Two: The young Europeans get jobs

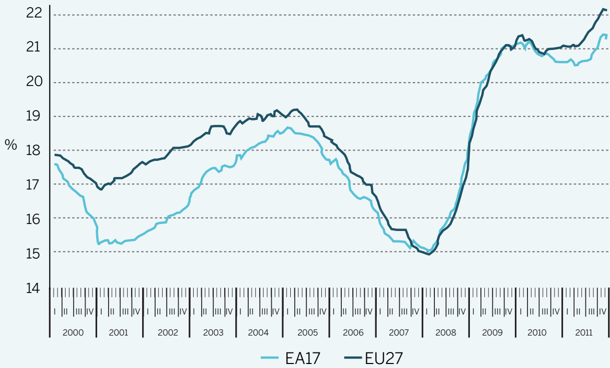
Spain now has a youth unemployment rate of 50%, compared with just over 20% in 2005. In common with all the peripheral eurozone countries, youth unemployment rates are very high, and continue to grow. This is partly because of the severe recessions in the peripheral countries, but also because of restricted labor markets which offer very high levels of social protection to the employed, at the expense of the unemployed.

This will have to change. If the European economy is to become stable again, the competitiveness gap between the core and the periphery will have to be closed, as we have argued above. One of the key ways of doing this will be to deregulate labor markets so that more jobs are created. If the euro is to survive, restructuring of labor markets is an essential condition. If the periphery economies leave the euro, their new currencies will have to be massively devalued, creating new jobs as exports boom.

Either way the present unsustainable rates of youth unemployment will start to fall.

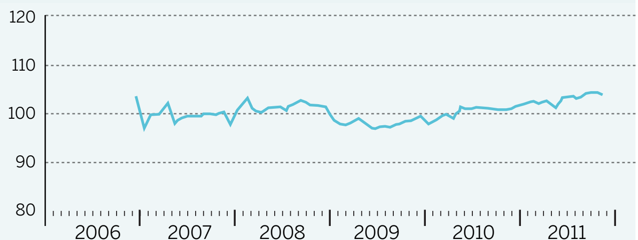
This has major implications for consumer markets. At the risk of stating the obvious, young people with jobs spend very differently from young people without jobs. Apart from anything else, they have more money. Property will boom as they move out of their parents' houses, and so will retail and leisure spending.

EU unemployment rates by gender



Source: European Commission. January 2000-December 2011, seasonally adjusted.

Where's that boom? – German retail sales 2006-2011



Source: Bundesbank.

Changing national economies

Three: Germany becomes a consumer economy

In all scenarios, Germany needs to boost consumption. Despite a booming economy, German retail sales have been flat (see graph on previous page). It can happen because the euro collapses, and the new deutsche mark soars in value, making imports very cheap and exports expensive. Or it can happen because Spain and Italy and the other peripheral countries become far more competitive, and export more to Germany, while reducing their imports from that country. Either way, Germans will have to consume more.

That means Germany will need to grow its leisure, retail, property and financial services sectors hugely. Paradoxically, its economy will have to become a lot more like the UK's (while the UK is trying to become a bit more like Germany).

This will present huge opportunities for companies in those sectors, both domestic and foreign. German companies are not traditionally strong in retail, property and leisure; those sectors, along with financial services, will see potentially strong growth.

Four: The periphery will grow faster

The eurozone has been getting steadily more and more unbalanced. The core grows faster, while the periphery declines. As we have argued above, this is unsustainable. One way or another it will have to change. Whether this is via the break up of the single currency and revaluations of the new national currencies, or by the periphery making massive strides in competitiveness remains to be seen. But the gap will get closer.

The consequence will be that 2010-2020 will be a mirror image of 2000-2010. It will be Spain, Italy, Portugal and Greece that are among the fastest growing eurozone economies. The core—Germany, the Netherlands, Finland, and Austria—will grow more slowly.

The boom in the peripheral countries will be concentrated in manufacturing and exports because it is the export sector that has to grow to claw back lost competitiveness. This means there will also be strong growth in property and leisure as youth unemployment declines, and in consumer goods targeted at working women as female participation in the economy rises.

Five: Poland will be Europe's financial powerhouse

Imagine in 2020 you are looking for Europe's financial powerhouse. A country with low debt, a growing economy, a thriving private banking system, and a large population. There will only be one country that meets all those criteria: Poland.

Poland's government deficit was 5.9% of GDP in 2011 and will drop below 2.9% in 2012. Government debt as a percentage of GDP will fall to 52% next year. GDP is forecast to grow by 2.5% in 2012 even as the eurozone slips into recession. And with 38 million people, it has a substantial and skilled population. As countries such as France lose their triple-A rating, and nations such as Britain drift away from the core of the EU, there will be space for Poland to develop an increasingly assertive voice.

By 2020, Germany will be struggling with restructuring its economy, and coping with a bankrupt banking system (see point six, below). Poland will be the EU's powerhouse economy—and the one market no major company can afford to ignore.

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Sectoral impacts

Six: Banking systems will become publicly controlled

The French and German banks have massive exposure to peripheral country debts. For example, France has $548 billion of exposure to Italian debt, according to data from the Bank for International Settlements. Germany has an exposure of $212 billion. French banks have $140 billion and $160 billion of exposure to Spanish and German banks respectively.

Our view is that some form of default on peripheral country debt is inevitable. It may happen within the euro, through negotiated haircuts. Or it might happen by countries leaving the single currency. But one way or another it will happen. Unsustainable debt is precisely that—unsustainable. Therefore it will be reduced.

When it happens, there will be huge losses in the banking system. The scale of the bail-outs required will lead to nationalization – just as it did with the Royal Bank of Scotland in the UK. Nationalized banks will be conservative, risk-averse and reluctant to pay bonuses. They will operate far more like highly-regulated utilities.

Seven: National production makes a comeback

The euro has become an engine of de-industrialization across many of the peripheral nations. When Europe had national currencies, the only way to protect your business in the long-term from currency fluctuations was to build factories in all the main nations—in Spain for the Spanish market, in Germany for the German market, and so on. Once currency fluctuations were abolished forever with the introduction of the euro, no one had to worry about currency movements anymore. It made more sense to build one huge factory to serve the whole of Europe.

> Debt defaults within Europe are inevitable - and when it happens there will be huge losses in Europe's banking system

If the euro area fragments, or some countries peel away, companies will feel compelled to start producing more locally again. It will be the only way to insure themselves against currency movements.

Indeed, even the risk of a return to national currencies will encourage companies to re-think production strategies. A company selling to the Greek market, for example, can no longer count on Greece being in the euro in 2020. Moreover, if, as we predict, a total or partial break-up of the eurozone is accompanied by a retreat of the single market, then companies will also need to build local production hubs to insure themselves against a rise in protectionism.

For all those reasons, the industrial map of Europe will gradually become more decentralized, and production will move back to being closer to the point of consumption.

Seven trends which will shape Europe after the euro-zone crisis – at a glance

1. **Italian women go out to work - making the Italian economy more productive**
2. **Young Europeans get jobs - and start spending money**
3. **Germany becomes a consumer economy - more spent on leisure and retail**
4. **The European periphery states will grow faster than the middle - either because of restructuring or devaluation**
5. **Poland will become Europe's financial powerhouse - gaining the rewards of prudence**
6. **Banking systems will end up in public ownership - overloaded with debt**
7. **National production makes a comeback - to help manage currency risks**

Conclusion

Sometimes, when you use futures methods to look further ahead, the work turns around and surprises you. So it is in the research and analysis done for this report.

There is so much focus by politicians and public officials in managing the crisis, with media coverage of the day to day drama of the politics and much emphasis in the commentary on the dangers of default, that there has been little consideration of what might lie on the other side of the crisis.

It is worth underlining, then, that the sometimes startling findings in this research start from only two uncontentious assumptions. Both are uncontentious. The first is that economic crises do not go on forever. The second is that because of the systemic nature of macroeconomics, crises are resolved only by rebalancing the system: nations with large surpluses need to reduce them to enable those with large deficits to bring them down.

Of course, such changes take time, and they unfold unpredictably. Although scenarios are usually about helping to plan for uncertainty, unless the European Union unravels (as in Scenario 5) the outcomes described in this report are likely rather than unlikely. They present significant opportunities for businesses, as well as some risks. Corporate strategists would be foolish not to start planning for them.

> These changes will take time, and when they do occur, they will unfold unpredictably

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Endnotes

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