# Plight of the **euro**

## *Insight*

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Since December, the euro has declined over 10% against its main counterpart, the US dollar. The fundamental reasons for the euro's fall from grace are the issues surrounding government debt – in particular the budget deficit in Greece.

Greece has been in turmoil since early elections were called in September 2009 in an attempt to seek a new mandate to deal with the economic slowdown. The new government disclosed that the 2009 budget deficit will be 12.7% of GDP, more than double the figure previously announced.

As a result, credit rating agencies Moody's, Fitch Ratings and Standard and Poor's all downgraded the sovereign rating on Greece with a negative outlook during December. Since then the concern surrounding Greece has continued while the euro has suffered.

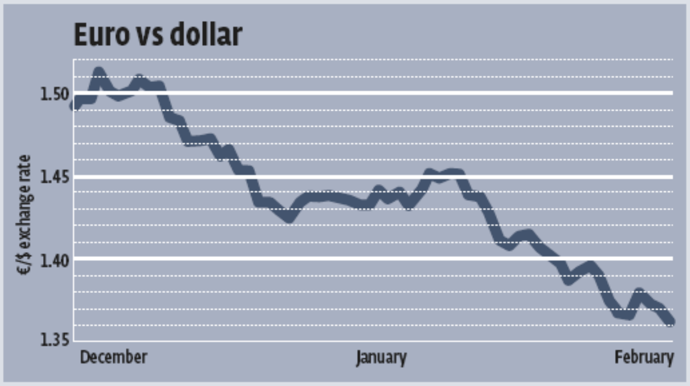
The overall effect on the euro has been negative – it has lost the majority of gains it made since May 2009. The crisis surrounding Greece's debt is starting to engulf other member states and could have longer lasting effects on the eurozone as a whole.

Firstly, investor sentiment within the eurozone has taken a big hit. Due to the size and political ramifications of the debt crisis in Greece, confidence in the whole region is suffering. Where the euro and European assets were previously bought in the belief that the region would have a steady recovery, the opposite is now occurring – euro-denominated assets are being shunned in the short term as investors worry about the stability of the peripheral members of the eurozone.

However, there is still no evidence that this will continue in the longer term, but as the crisis persists it seems more likely that long-term investment will be influenced.

Another concern emerging from the eurozone involves other member states such as Portugal, Spain and Ireland (the fiscal problems of which have been well documented) with reference to their sovereign debt. The main fear is of another Lehman Brothers meltdown caused by the level of exposure to these countries.

According to figures from the Bank of International Settlement, French and Swiss banks had $75.5Bn and $64Bn of exposure to Greece as of 3Q09. UK banks had a total of $193Bn exposure to Ireland, while both German and French banks have $78Bn. In the case of Spain, it is the German banks that have the largest exposure of the major European financial institutions, totalling $240Bn.




The EU has agreed a vague rescue package for Greece. In a statement, they confirmed that they will fully support the efforts of the Greek government and call on it to implement all measures to reduce the budgetary deficit by 4% in 2010. The statement said eurozone member states would take "determined and co-ordinated action, if needed, to safeguard financial stability in the eurozone as a whole." However, the statement was sufficiently lacking in detail that the currency fell shortly after it was issued.

The path ahead for the single currency remains unclear. The current problems for the eurozone represent the first real test of European monetary union, and it seems certain the issue will not be resolved quickly.

An initial promise of support from eurozone members has been made to Greece, although in such vague terms that it looks more like a pledge of solidarity. The main questions the market wants answered are: what happens next, and what form will any co-ordinated action take? If there is an *ad hoc* solution, what happens when the next member state is in trouble?

Until those questions are answered, the persistent uncertainty looks likely only to increase pressure on the beleagured currency.