# The Eurozone Crisis and Implications for Gold

## Precious Metals Summit

**Geneva, April 11, 2012**

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## Overview

### *The Eurozone crisis has had an impact on gold!*




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## The Eurozone Crisis

1. ***Fixed Exchange Rates***
   - *SE (South Europe) is uncompetitive – and not able to devalue*
   - *SE has large current account deficits with NE (North Europe)*
   - *SE needs massive internal devaluation*
2. ***Excessive Debt Levels***
   - *Large budget deficits left over from the Great Recession*
   - *Over-borrowing on the back of interest rate convergence*
   - *Rising retirement costs*
   - *Primary budget balance must be a surplus, and even then …?*
3. ***Cross-Border Bank Exposure***
   - *Large positions in foreign government debt*
4. ***Eurozone Scenarios***
   - *An orderly or disorderly breakup?*



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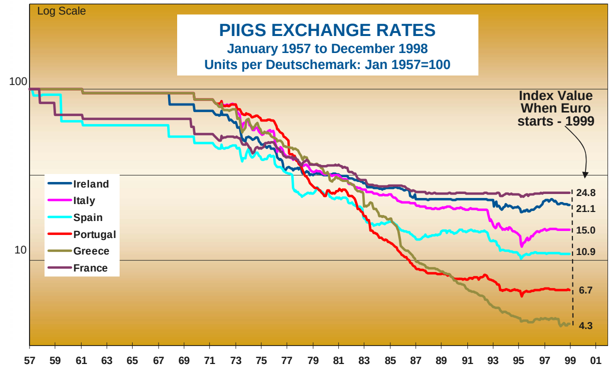
# Eurozone Crisis – (1) Fixed Exchange Rates

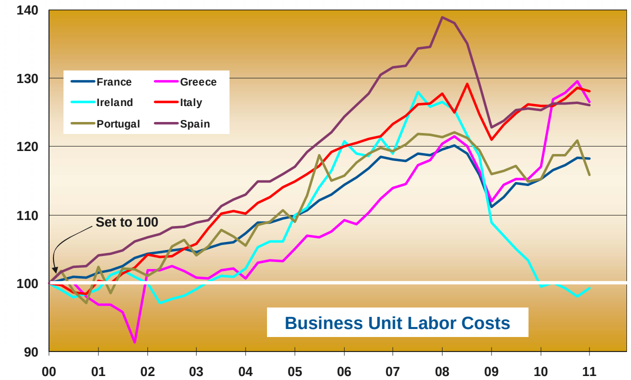
## Before euro: PIIGS regularly devalued






# Eurozone Crisis – (1) Fixed Exchange Rates

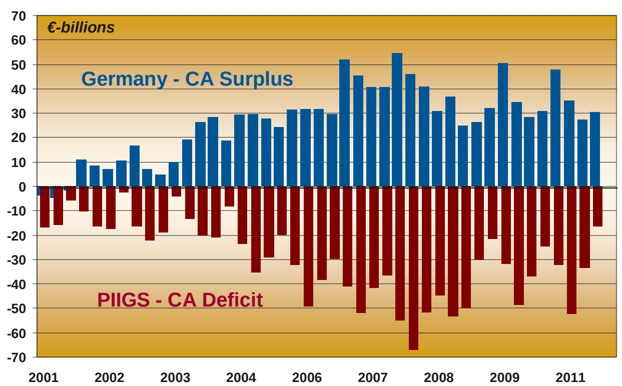
## After euro: labor costs continued to widen






# Eurozone Crisis – (1) Fixed Exchange Rates

## After euro: Germany surpluses/PIIGS deficits






# Eurozone Crisis – (1) Fixed Exchange Rates

## The fundamental problem

***Southern Europe (Club Med) is uncompetitive!***

*Solution in a fixed exchange rate system:*

- ***Germany and Northern Europe should "reflate internally"***
  - *Encourage inflation to rise on the back of significant increases in wage rates and extensive fiscal stimulus*
- ***Greece and Southern Europe should "internally deflate"***
  - *Encourage price deflation on the back of massive fiscal contraction and rising unemployment*
- ***Greece and Southern Europe should overhaul all labor market legislation***
  - *Encourage labor mobility from uncompetitive sectors to more competitive sectors of the economy*

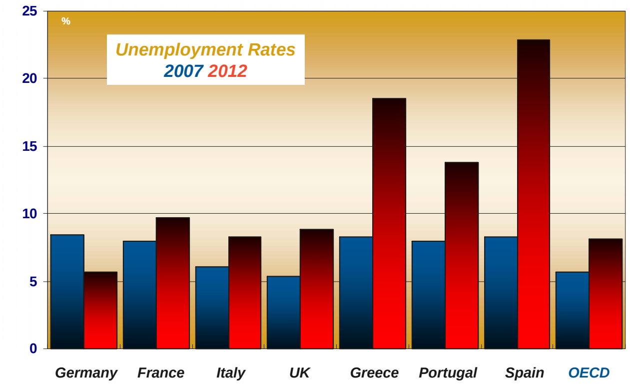
## Eurozone Crisis – (1) Fixed Exchange Rates
### *Euro-system operates like the gold standard*

- *The gold standard was a fixed exchange rate system*
  - *Monetary policy was determined by gold inflows and outflows: Money supply rose/fell as gold came in/went out*
  - *Domestic monetary policy was "non-existent"*
  - *Fiscal policy was "non-existent" as a counter-cyclical policy*
  - *And labor markets – wages - were assumed to be flexible and would adjust as needed to rising/falling money supply*
- *But labor markets did not adjust quickly*
  - *Keynes: "the gold standard died on the backs of the unemployed"*

*Will the Euro die on the backs of the unemployed?*



## Eurozone Crisis – (1) Fixed Exchange Rates
### *Unemployment has risen (notably youth)*




*Source: OECD, IMF*



## Eurozone Crisis – (1) Fixed Exchange Rates
### *IMF-like organizations are invented*

- *The Bretton Woods system of fixed exchange rates needed an IMF*
  - *The IMF's original role was to lend "reserves" to countries experiencing "temporary" disequilibrium (trade/CA deficits/capital outflows)*
    - *But all disequilibrium is first assumed to be temporary*
  - *Speculators jump in and force an eventual devaluation*
    - *There were many devaluations in the Bretton Woods system*
  - *The US dollar left the system in August 1971 because the US was unwilling to "internally deflate" when Germany and Japan refused to "internally reflate"*
- *So the Eurozone needs an ESM*
  - *The ESM becomes the "permanent" EFSF with the job of providing "reserves" for countries in "temporary" disequilibrium*
  - *But will it work?*



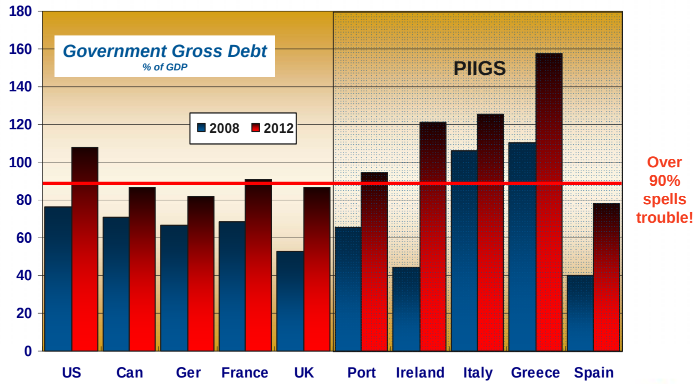
## Eurozone Crisis – (1) Fixed Exchange Rates
### *The fundamental question is:*

*Can any country stay in a fixed exchange rate system with Germany?*

- *Germany likes surpluses*
- *Which means other countries are forced to "like" deficits*
- *Which works fine in a political union (i.e. Cal. and NY)*
- *But in a political union*
  - *There is labor mobility across regions*
  - *There is a system of fiscal transfers*
  - *There is one national bank legislator*
  - *There are national monetary and fiscal policies*

*As it now stands Germany, like Alberta in Canada, is faced with never-ending transfer payments to the less competitive Eurozone regions*

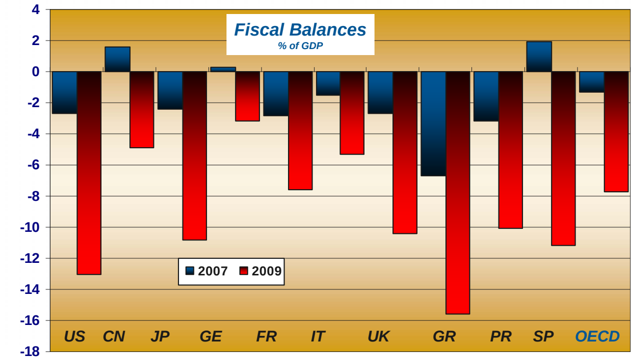
## Eurozone Crisis – (2) Excessive Debt Levels
### The PIIGS debt levels are high and rising




Source: IMF Fiscal Monitor, April 2011 and IMF World Economic Outlook, Sept 2011



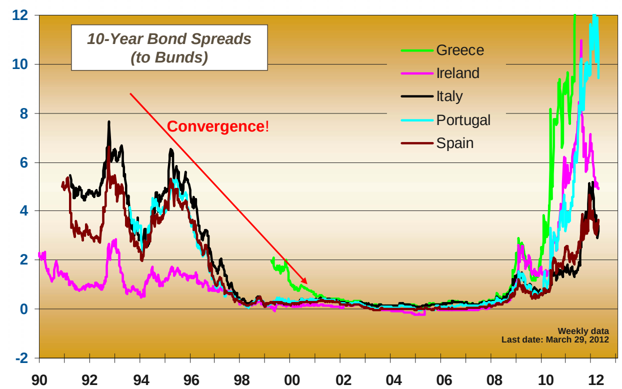
## Eurozone Crisis – (2) Excessive Debt Levels
### The "great recession" blew up deficits




Source: OECD, IMF



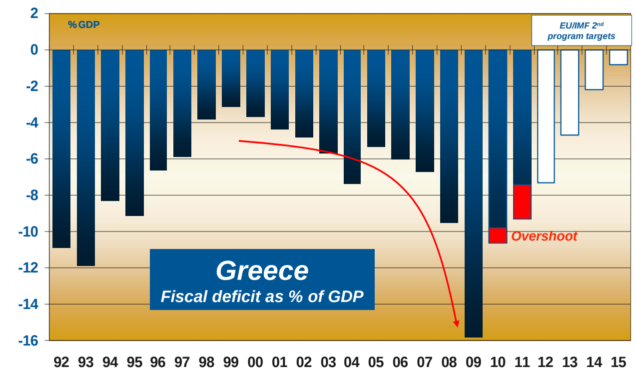
## Eurozone Crisis – (2) Excessive Debt Levels
### Euro convergence encouraged borrowing by PIIGS




Source: Datastream



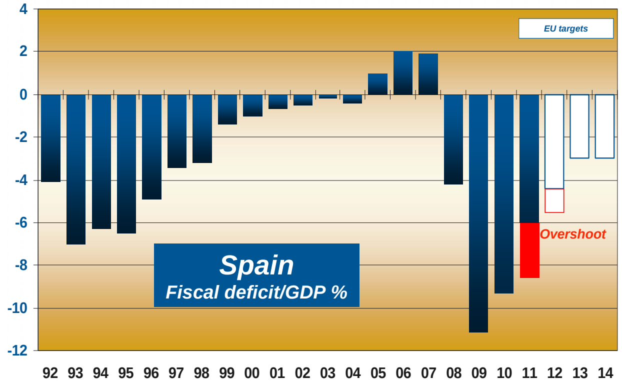
## Eurozone Crisis – (2) Excessive Debt Levels
### Greece seriously over-borrowed …




Source: IMF, EU

## Eurozone Crisis – (2) Excessive Debt Levels

### With 23% unemployment Spain will overshoot




Source: IMF, EU



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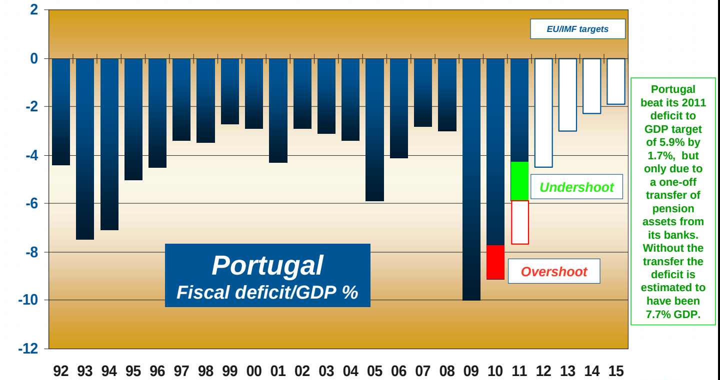
## Eurozone Crisis – (2) Excessive Debt Levels

### Portugal too is struggling …




Source: IMF, EU



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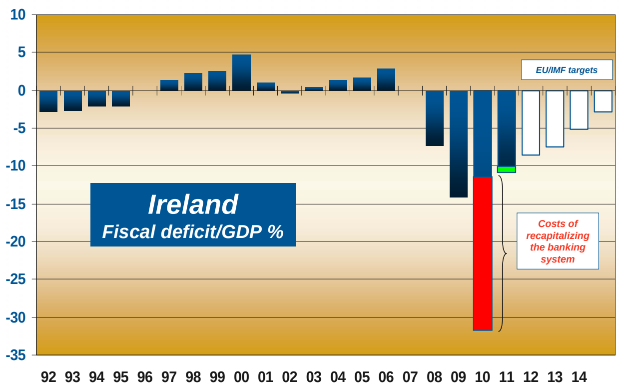
## Eurozone Crisis – (2) Excessive Debt Levels

### Ireland could get it together – successful deflation




Source: IMF, EU



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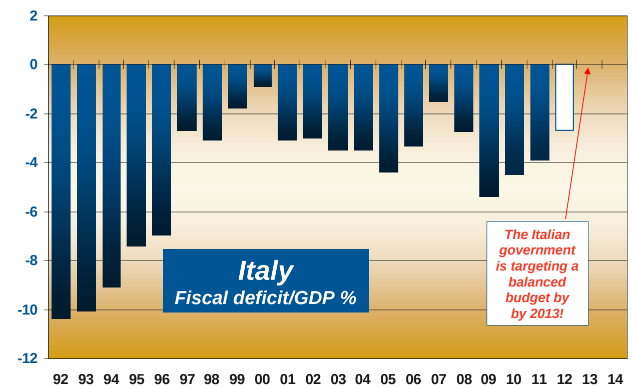
## Eurozone Crisis – (2) Excessive Debt Levels

### Italy has not been given deficit targets…yet!




Source: IMF, EU



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## *Eurozone Crisis – (2) Excessive Debt Levels*
### *To reduce debt countries must run primary surplus*

**For high-debt countries, a balanced primary budget will not reduce debt/GDP ratios**

| | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| SCENARIO 1 | | | | | | | | | | | |
| INTEREST RATE | 5% | | | | | | | | | | |
| NGDP | 4% | | | | | | | | | | |
| PRIMARY DEFICIT | 0% | YEAR | | | | | | | | | |
| | | 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 | 9 | 10 |
| DEBT | 150 | 157.5 | 165.4 | 173.6 | 182.3 | 191.4 | 201.0 | 211.1 | 221.6 | 232.7 | 244.3 |
| NGDP | 100 | 104.0 | 108.2 | 112.5 | 117.0 | 121.7 | 126.5 | 131.6 | 136.9 | 142.3 | 148.0 |
| DEBT/NGDP | 150% | 151% | 153% | 154% | 156% | 157% | 159% | 160% | 162% | 163% | 165% |



## *Eurozone Crisis – (2) Excessive Debt Levels*
### *To reduce debt countries must run primary surplus*

**To stabilize debt/GDP ratios there must be a primary surplus and positive nominal growth**

| | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| SCENARIO 2 | | | | | | | | | | | |
| INTEREST RATE | 5% | | | | | | | | | | |
| NGDP | 4% | | | | | | | | | | |
| PRIMARY SURPLUS | 2% | YEAR | | | | | | | | | |
| | | 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 | 9 | 10 |
| DEBT | 150 | 155.5 | 161.2 | 167.1 | 173.2 | 179.5 | 186.1 | 192.8 | 199.8 | 207.1 | 214.6 |
| NGDP | 100 | 104.0 | 108.2 | 112.5 | 117.0 | 121.7 | 126.5 | 131.6 | 136.9 | 142.3 | 148.0 |
| DEBT/NGDP | 150% | 150% | 149% | 149% | 148% | 148% | 147% | 147% | 146% | 146% | 145% |



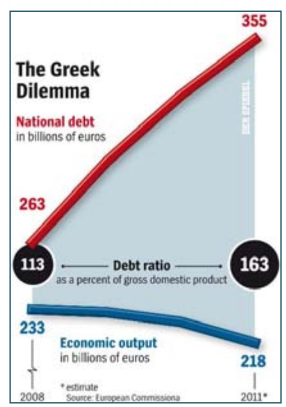
## *Eurozone Crisis – (2) Excessive Debt Levels*
### *To reduce debt countries must run primary surplus*

**The southern European countries have primary deficits and negative nominal growth**

| | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| SCENARIO 4 | | | | | | | | | | | |
| INTEREST RATE | 5% | | | | | | | | | | |
| NGDP | -2% | | | | | | | | | | |
| PRIMARY DEFICIT | -2% | YEAR | | | | | | | | | |
| | | 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 | 9 | 10 |
| DEBT | 150 | 159.5 | 169.4 | 179.8 | 190.7 | 202.1 | 214.0 | 226.5 | 239.5 | 253.2 | 267.5 |
| NGDP | 100 | 98.0 | 96.0 | 94.1 | 92.2 | 90.4 | 88.6 | 86.8 | 85.1 | 83.4 | 81.7 |
| DEBT/NGDP | 150% | 163% | 176% | 191% | 207% | 224% | 242% | 261% | 282% | 304% | 327% |



## *Eurozone Crisis – (2) Excessive Debt Levels*
### *This is what has happened to Greece:*

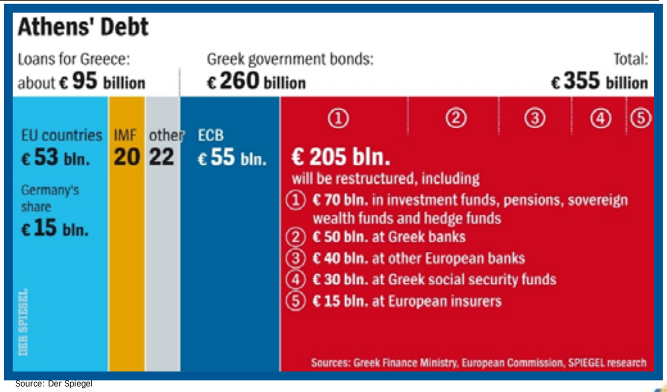



Source: Der Spiegel

**Greek debt has risen dramatically relative to nominal output (NGDP)!**

## Eurozone Crisis – (2) Excessive Debt Levels

### … and €205bn of Greek debt had to be restructured

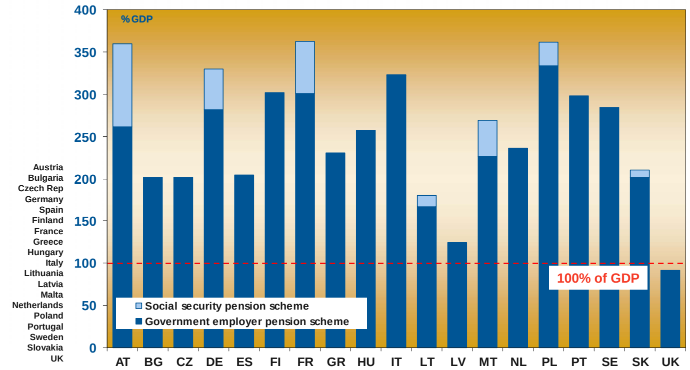



Source: Der Spiegel



## Eurozone Crisis – (2) Excessive Debt Levels

### Then, Europe's pension liabilities are out of sight!




Source: Research Center for Generational Contracts, January 2009
NB – Future contributions are not taken into account



## Eurozone Crisis – (3) Cross-Border Exposure

### European banks are on the hook for $2,051 billion …

**Consolidated foreign claims of reporting banks***

| | Europe | France | Ger. | Italy | Neth. | UK | US | Can. |
|---|---|---|---|---|---|---|---|---|
| Greece | 117 | 43 | 37 | 3 | 4 | 12 | 6 | - |
| Ireland | 430 | 35 | 102 | 17 | 20 | 151 | 61 | 4 |
| Italy | 730 | 369 | 145 | - | 38 | 62 | 33 | 2 |
| Portugal | 178 | 26 | 30 | 3 | 5 | 24 | 5 | - |
| Spain | 597 | 145 | 161 | 29 | 70 | 96 | 47 | 2 |
| Total | 2051 | 617 | 474 | 53 | 137 | 344 | 152 | 8 |
| France | 867 | - | 217 | 46 | 92 | 268 | 189 | 14 |

*Claims allocated to country/region where original risk lies*
*Source: BIS, Sep 2011 – US$bn*



## Eurozone Crisis – (3) Cross-Border Exposure

### The German banks are on the hook for $455.8 bn …

**Exposure of German Banks**

| | to the public sector of | to banks of | to private sector of | Total foreign claims |
|---|---|---|---|---|
| Greece | 11.3 | 1.0 | 6.4 | 18.6 |
| Portugal | 7.9 | 8.7 | 13.4 | 30.0 |
| Ireland | 2.8 | 20.0 | 78.8 | 101.6 |
| Spain | 26.4 | 62.7 | 71.8 | 160.9 |
| Italy | 44.5 | 40.2 | 60.0 | 144.7 |
| **Total** | **92.9** | **132.6** | **230.4** | **455.8** |

**Billion US$, September-end 2011*
*BIS: Table 9E, January 2012*

## Eurozone Crisis – (3) Cross-Border Exposure

*And French banks are on the hook for $619.6 bn …*

### Exposure of French Banks

| | to the public sector of | to banks of | to private sector of | Total foreign claims |
|---|---|---|---|---|
| Greece | 7.2 | 0.6 | 40.1 | 47.9 |
| Portugal | 5.4 | 6.3 | 14.1 | 25.8 |
| Ireland | 2.6 | 9.8 | 16.6 | 29.0 |
| Spain | 27.1 | 35.4 | 82.1 | 144.5 |
| Italy | 82.3 | 37.2 | 252.9 | 372.4 |
| **Total** | **124.5** | **89.3** | **405.8** | **619.6** |

**Billion US$, September-end 2011*
*BIS: Table 9E, January 2012*



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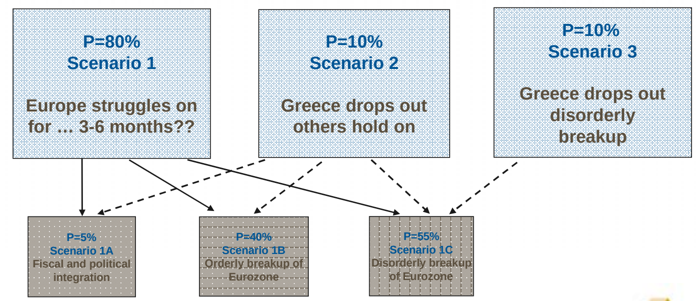
## Eurozone Crisis – (4) Scenarios

*Greece will leave … sooner or later!*

### Eurozone Scenarios



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## Eurozone Crisis – (4) Scenarios

*Scenario 1 will run for some months to come*

1. *The Eurozone struggles on …*
   - *ECB has supported Euro-banks/governments with LTRO – Long Term Refinancing Operation - €1018.5 billion*
   - *The EFSF (European Financial Stability Facility) to run parallel with the ESM (European Stability Mechanism) for a "firewall" of €700 billion (which won't be enough to cover Spain and Italy)*
   - *Economic growth in the Southern Zone (Club Med) to come from "labor market restructuring"*
   - *Eurobonds to remain off the table (the new fiscal stability pact will break down too)*

*Greece leaves with 95% probability - orderly or disorderly …*

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## Eurozone Crisis – (4) Scenarios

*A disorderly breakup is the real danger …*

2. **Orderly Breakup**
   - *Portugal, Spain and Italy are "ring-fenced" against "Greek contagion"*
     - *ECB, EFSF/ESM and IMF collectively pour liquidity into the Eurozone – buy government debt!*
     - *ESM raised to €2000 billion*
3. **Disorderly Breakup**
   - *Greece adopts drachma and devalues - ECB, EFSF/ESM and IMF are unable to "ring-fence"*
     - *Debts: how will Greece honor its euro debts?*
     - *Contagion: which country is next to leave?*
     - *Bank exposure: which are overexposed to PIIGS?*
     - *Bank failure: who recapitalizes failing banks?*
     - *Banks abroad: will contagion spread?*

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## Eurozone Crisis – (4) Scenarios

**Scenarios for the Eurozone:**

### Our Preferred Scenario

- Core "North-Euro" countries leave Eurozone
  - Germany, Netherlands, Finland … will adopt new currency (N-euro) which will rise against euro
  - N-euro banks will lose on euro-denominated loans
  - N-euro central bank ("Bundesbank") will backstop its banks with liquidity as required
- "South-Euro" countries form new Eurozone
  - These countries will keep the euro
  - The new central bank will move to Paris
  - All the region's debts will remain payable in euros
  - Euro will decline against N-euro as new central bank "prints"
- Limited contagion

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## Implications for Gold

**There are mostly positives …**

### Positives:

- Orderly breakup (40%) will require significant liquidity additions
- Disorderly breakup (55%) will require even more liquidity additions because some banks will fail – there will be one or more "Lehman" moments!
- Departing countries will devalue - gold will rise against devalued currencies
- Regardless of breakup, excessive debt levels encourage "printing"



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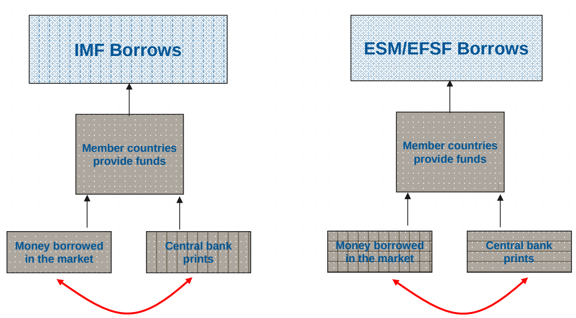
## Implications for Gold

**Liquidity has to come from somewhere**

### Liquidity can be borrowed or printed …



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## Implications for Gold

**Government choices to reduce debt limited**

### Government Choices:

Renege on promises

Cut other services

Raise taxes

Print more money



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## Implications for Gold

### *Governments invariably "print/devalue"*

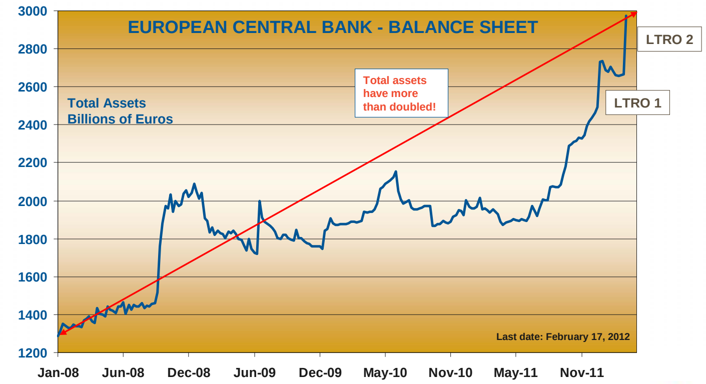
***"Throughout history, feckless governments have dodged their fiscal responsibility by turning to their monetary authority to devalue the currency, monetize debt and inflate their way out of structural deficits"***

***Richard Fisher:***
*President and CEO of the FRB of Dallas*
*March 10, 2011*



## Implications for Gold

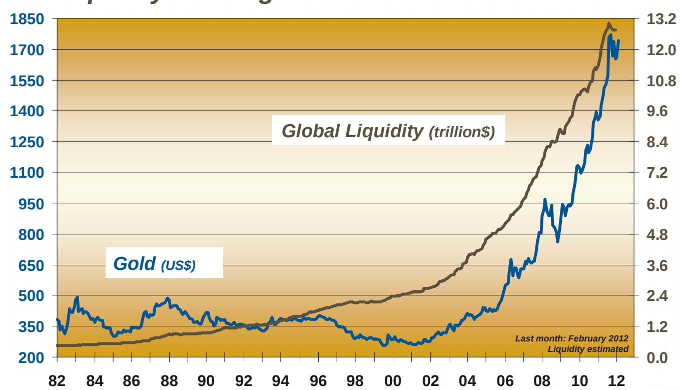
### *The ECB has "printed" …*






## Implications for Gold

### *Liquidity drives gold …*




*Global Liquidity: FX Reserves + US MBase*
*Source: IMF, Federal Reserve*



## Implications for Gold

### *Some currencies will be devalued significantly*

**ESTIMATES OF CURRENCY REALIGNMENT**

| | Against Euro* | Against DM* | Against US$** | Murenbeeld Against US$ |
|---|---|---|---|---|
| Germany | 1.3% | 100.0 | 5.0% | 10.0% |
| Finland | -6.7% | 92.0 | | 0.0% |
| Austria | -6.8% | 91.9 | | 0.0% |
| Netherlands | -7.1% | 91.6 | 5.0% | 5.0% |
| France | -9.4% | 89.3 | -7.0% | -10.0% |
| Belgium | -23.9% | 74.8 | | -15.0% |
| Italy | -27.3% | 71.4 | -12.0% | -25.0% |
| Ireland | -28.6% | 70.1 | 7.0% | -5.0% |
| Spain | -35.5% | 63.2 | -20.0% | -30.0% |
| Portugal | -47.2% | 51.5 | -15.0% | -45.0% |
| Greece | -57.6% | 41.1 | | 50.0% |

* Source: Nomura
** Source: Bank of America

**There is little doubt that some of the euro-currencies will undergo significant devaluation in the likely event the Eurozone breaks up!**

## Implications for Gold
*… But there are a few negatives too*

### Negatives:

**Euro survives: fiscal and political union (5%)**

- *Deflation and recession in Club Med*
- *Transfer payments/Eurobonds*
- *Euro likely rises against dollar (relief)*

1. **Euro does not survive: breakdown (95%)**
   - *New DM will be well bid, and rise against gold while other currencies will decline against gold*
2. **Euro does not survive: depression**
   - *Banks fail, governments default, unemployment rises further, policy paralysis*



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## Indirect Implications for Gold
*These may be more important for gold yet*

### Positives:

1. **Euro a suspect reserve currency**
   - *Will bias large reserve countries against euro specifically and against fiat currencies generally*
   - *At the margin it enhances the appeal of gold as a reserve asset*
   - *EM Central banks will continue to buy gold*
2. **CBGA signatories will not sell gold**
   - *Greece et al understand that gold is a true asset of last resort (if it doesn't want to sell Greek islands!)*
   - *When domestic currency is unacceptable and lines of credit have dried up gold is only acceptable asset*
   - *Gold will be swapped instead*



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## Indirect Implications for Gold
*Will China/Japan finally decide to buy much more gold?*

**SELECTED CENTRAL BANK GOLD RESERVES**
*(gold valued at $1700)*

| Central Bank | Date | (a) Gold Reserves (tonnes) | (a) Gold Reserves (mil. oz.) | (b) FX reserves (bn$) | Gold as Percent of (a)+(b) | Gold required for 15% reserve ratio (tonnes) | Gold required for 15% reserve ratio (mill. oz) | Excess Gold at 15% (tonnes) | Excess Gold at 15% (mill. oz) |
|---|---|---|---|---|---|---|---|---|---|
| ECB | Dec-11 | 502 | 16.14 | 49.91 | **33.98** | 172 | 5.53 | 330 | 10.6 |
| Japan | Jan-12 | 765 | 24.60 | 1237.03 | **3.33** | 3916 | 125.91 | -3151 | -101.3 |
| US | Jan-12 | 8133 | 261.50 | 53.19 | **89.50** | 168 | 5.41 | 7965 | 256.1 |
| China | Dec-11 | 1054 | 33.89 | 3228.63 | **1.79** | 10234 | 329.05 | -9180 | -295.2 |
| Russia | Jan-12 | 883 | 28.39 | 454.35 | **9.77** | 1438 | 46.25 | -555 | -17.9 |
| India | Jan-12 | 558 | 17.93 | 275.39 | **10.14** | 872 | 28.03 | -314 | -10.1 |
| ***Sub Total*** | | ***11896*** | ***382.45*** | ***5298.49*** | **11.11** | ***16801*** | ***540.18*** | ***-4906*** | ***-157.7*** |
| ***Sub Total (ex US)*** | | ***3762*** | ***120.95*** | ***5245.30*** | **3.84** | ***16633*** | ***534.77*** | ***-12871*** | ***-413.8*** |



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## Indirect Implications for Gold
*PIIGS more likely to swap gold*

- ***The PIIGS hold over 3000 tonnes of gold***
- ***We have been concerned about Italy for years***
- ***But PIIGS more likely to swap/sell – were it to come to that***
- ***No country anxious to get rid of its gold***

**GOLD RESERVES**

| | tonnes | | tonnes |
|---|---|---|---|
| Germany | 3396.3 | Greece | 111.6 |
| Italy | 2451.8 | Denmark | 66.6 |
| France | 2435.4 | Finland | 49.1 |
| Netherlands | 612.5 | Cyprus | 13.9 |
| ECB | 502.0 | Ireland | 6.0 |
| Portugal | 382.5 | Slovenia | 3.2 |
| UK | 310.3 | Luxembourg | 2.2 |
| Spain | 281.6 | Iceland | 2.0 |
| Austria | 280.0 | Malta | 0.2 |
| Belgium | 227.5 | Norway | 0.0 |
| Sweden | 125.7 | | |
| | | Total | 11260.3 |
| Addendum | | Switzerland | 1040.1 |



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## Conclusion

*There are more positives than negatives*

1. ***No government wants to accept depression***
   - *Governments would rather devalue and print than accept depression*
2. ***The ECB has shown its hand***
   - *It put out over €1000 billion under LTRO1-2 (of which just over half was net new liquidity)*
3. ***History shows countries will devalue when uncompetitive***
   - *Internal deflation is politically unacceptable*





## The Latest Forecast

*The scenarios make no allowance for geopolitics!!*

### Gold Price Scenarios

| | 2012-avg | 2012-end | 2013-avg |
|---|---|---|---|
| Scenario A: p = 10% | $1534 | $1400 | $1340 |
| Scenario B: p = 50% | $1729 | $1770 | $1854 |
| Scenario C: p = 40% | $1855 | $2010 | $2227 |
| *Weighted:* | $1760 | $1833 | $1952 |

*•Based on March 30, 2012 projections*
*•Next update June-end*





*Thank you for your attention!*

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