

European Economics

Joachim Fels
+44 (0)20 7425 6138
Joachim.Fels@morganstanley.com

Economic Trends

January 22, 2004

Euro Wreckage?

RECENT REPORTS

The Economy in 2004 <i>European Economics Team</i>	January 8, 2004
EuroTower Insights: The ECB's Dilemma <i>Joachim Fels/Elga Bartsch</i>	January 2, 2004
European Economics: The Dis-United States of Europe <i>Joachim Fels</i>	March 24, 2003

- Political union will remain a pipe dream**
 There is no denying the serious cracks in Europe's political compound that opened up during 2003. The rift between 'old' and 'new' Europe, the conflict over the Stability and Growth Pact and the discord over the EU Constitution are all here to stay.
- A disunited Europe might be bullish for growth**
 Disunity breeds diversity, which breeds competition. Rather than striving for harmonisation, governments would compete for mobile capital by slashing taxes, deregulating labour markets and streamlining welfare systems. Dynamic benchmarking would become the norm.
- The return of the country factor in bond and equity markets**
 A disunited Europe with diverging fiscal and economic policies could lead to a significant widening of government bond yield spreads between countries, reflecting divergences in the creditworthiness of individual governments.
- Pressures for higher inflation**
 A growing divergence of budgetary and general economic policies would likely lead to increased political pressures for an easier monetary policy to grease the wheels. In the event of a severe political crisis, the ECB would probably yield to such pressures.
- The risk of E(M)U break-up**
 A disunited Europe could even lead to secession as some countries might decide that the benefits of re-introducing a national money outweigh the costs. The decentralized set-up of EMU implies that the technical and practical hurdles to secession are actually quite low.
- Don't get too bullish on the euro**
 The financial market implications of the Disunited States of Europe include higher bond yields, wider yield spreads between countries and a steeper yield curve. Moreover, a euro that is at risk of falling apart one day is unlikely to rival the US dollar's reserve currency status.

Morgan Stanley does and seeks to do business with companies covered in its research reports. Investors should consider this report as only a single factor in making their investment decision.

Euro Wreckage?

This note pulls together two earlier commentaries published under the titles Disunited We Stand (Morgan Stanley Global Economic Forum, Year-end 2003 edition) and Could the Euro Fall Apart? (Morgan Stanley Weekly International Briefing, January 16, 2004).

At the height of the Iraq war last year, I wrote a note arguing that the idea of an ever-closer political union culminating in the United States of Europe always has been and would always remain a pipe dream (see *The Dis-United States of Europe*, March 24, 2003). At that time, the public debate was dominated by the discord between 'old' and 'new' Europe on the involvement in Iraq. But I argued that this was only one of several political dividing lines within Europe, which would become increasingly apparent over time. However, I had no idea that this issue would come to the fore with a vengeance already in the final two months of 2003, when the *de facto* burial of the Stability and Growth Pact (SGP) caused a major rift between governments, and when the EU Summit on the proposed EU Constitution failed miserably. With hindsight, 2003 was the year when serious cracks in the European political compound became apparent. Looking ahead, I believe 2004 could be the year when markets begin to price in some of dire consequences of the Disunited States of Europe — the return of the country factor in bond markets, a weakened position of the ECB, which might be pressurized into producing higher inflation, and a higher risk of EU secession and EMU break-up.

Conflict over fiscal policy is here to stay

As I see it, the conflict over fiscal policy and the SGP that erupted in 2003 is unlikely to go away anytime soon. Many of the small countries (plus Spain) that have pursued a more virtuous budgetary policy in the past several years are seriously angered by the slippage in budget deficits in large countries such as Germany and France. This is because rising budget deficits in the large countries, due to their sheer size, are seen as raising the borrowing costs for all governments within EMU, irrespective of the consolidation efforts that the smaller countries have made.

It is important to note that the SGP was suspended exactly at the point when the EU Commission proposed to make binding recommendations on fiscal policy to Germany and France. This underscores the basic fact that the larger member states are simply unwilling to accept any serious

interference with their sovereignty over national fiscal policy. It is difficult to see how a re-writing of the fiscal rules could overcome this basic fact. In any case, devising and negotiating a new SGP is a matter of years, not months, and even if a new, better Pact could be agreed upon, it would hardly be credible, given the sobering experience with the old Pact. In my view, it might be better to do away with any attempts to coordinate and restrain fiscal policy on a euro-wide basis altogether and rely on national electorates and discriminating bond markets (helped by rating agencies) to punish fiscally profligate national governments.

In this changed environment, I believe markets will have to attach a higher probability to a break-up of EMU and/or the EU at some future date.

Battles about redistribution ahead

Another area of discord, as illustrated by the failed EU Summit last December, is the distribution of voting rights and thus the distribution of power in an enlarged EU of 25 members. The Constitutional summit failed because Spain and Poland were unwilling to give up the disproportionately high number of votes (relative to the size of their population) accorded to them in the Nice treaty several years ago. The deeper issue here is, of course, that the voting influence will be crucial for them in the upcoming battle about the distribution of EU agricultural and structural funds in EU-25. These negotiations about the EU budget for the seven-year period starting in 2007 will kick off later this year. Presently, it looks unlikely that the EU Constitution can be agreed upon before late 2004. The longer this process drags on, the more likely it is that the negotiations on the Constitution will be complicated further by the upcoming re-distributional struggle over EU funds. Thus, the present draft Constitution may turn out to be forever just that — a draft.

Disunited we stand

All these dividing lines in Europe serve to illustrate an important point: Europe is unlikely to move closer towards the EU founding fathers' ideal of a United States of Europe in the foreseeable future. From a political point of view, questions will continue to linger over how effectively the European Union will be able to operate in the future.

Diversity should be bullish for competition and growth

From an economic point of view, however, a diverse union may not be such a bad thing. As I see it, Europe's political, cultural and economic diversity has always been a strength, as it provides for a healthy competition of political and economic systems catering to their local voters and to global companies. Yes, this kind of competition may look messy or even chaotic at times, some countries may run in the wrong direction for a while, and internal disagreements and even institutional crises in the EU will arise. However, as long as the common market for goods, services, capital and people rules, this competition should produce better economic outcomes than a single government for the whole union. Countries that pursue the right tax, welfare and labour market policies in this set-up will be rewarded with capital inflows, stronger growth and lower unemployment, and will serve as a role model for others. Eventually, the process of 'dynamic benchmarking' will lift the tide for all members willing and able to play the game and should result in a less regulated and stronger-growing European economy. Hence my optimism on the long-term growth prospects for Greater Europe.

The return of the country factor

The prospect of a disunited and diverse EU has important consequences for financial markets, however. First, the country factor is likely to become more important in determining bond and, possibly, equity prices. Growing divisions on budgetary policy and the *de facto* burial of the SGP could lead to a significant widening of government bond yield spreads between the more and the less virtuous countries. Partly, this would reflect the actual fiscal policy divergences and partly it would reflect the markets' assessment that a financial bailout for a member state running into serious fiscal difficulties will be less likely in a disunited Europe. In thinking about the potential for a widening of bond yield spreads between national markets it is important to keep two points in mind. First, by joining the euro, national governments have given up the option to resort to the printing press in order to finance deficits. This would only be possible again if a country decided to leave EMU or if the ECB could be pressurized into printing money to bail out a government. Second, the 'no bail out clause' in the Maastricht treaty stipulates that no member state can be forced to step in for the obligations of another member state. Both provisions together imply that, in theory, the credit quality of a fiscally profligate country could deteriorate quite significantly and could lead to a significant widening of government bond yield spreads with more fiscally virtuous member states.

Pressures for higher inflation

Second, a disunited Europe won't make the job for the ECB any easier. While the ECB has no policy instrument to address economic divergence between euro participants, a growing divergence of budgetary and general economic policies would likely lead to increased political pressures for an easier monetary policy to grease the wheels. Whether the independent ECB would cave in to such pressures is uncertain. Yet, history shows that even the most independent central banks are not immune to the political environment in which they operate. Thus, my guess is that a disunited Europe would, over the longer haul, lead to higher inflation in the euro area.

The risk of E(M)U break-up

Third, in this changed environment, I believe markets will have to attach a higher probability to a break-up of EMU and/or the EU at some future date. While I believe that the economic benefits from participating in both are sufficiently large to make such an event unlikely, we simply cannot neglect the possibility of fraction. Clearly, those who devised EMU were convinced that the melting of national currencies into the euro would be irreversible. Consequently, the Maastricht Treaty, which laid down the master plan for EMU, doesn't contain any provisions for the break-up of EMU. But that doesn't mean it cannot happen. Hardly any constitution ever contained a plan for the break up of a country and still, there are many examples of secession in history. Put simply, if a member state of EMU ever decided to leave EMU and to re-introduce a new national currency, it would be impossible for the other members to prevent that from happening. Yes, it would be a complicated process, but a break-up of EMU or the secession of a member state is feasible in principle.

High economic and political costs of leaving EMU

There is no denying that leaving EMU would involve significant political and economic costs for the seceding country. Politically, secession would not go down well with its (former) partners and would imply a serious political crisis in Europe. Economically, the country would forego the benefits of zero conversion costs and of the absence of currency risk in trade and capital transactions with the other members of the single currency. Most importantly, however, while contracts between parties within the seceding country would by law simply be redenominated into whatever the new national currency would be called at whatever the conversion rate would be, re-denomination would not easily apply to cross-border contracts. Foreign creditors could demand that contracts with parties in the

seceding country would be honored in euro ('continuity of contract'), whether these are claims on the private sector or on the public sector (say, in the form of government debt). Thus, if a country wanted to introduce a new currency in order to be able to depreciate it against the euro, it would face rising foreign debt servicing costs.

End of 'stability culture' could lead to secession. Despite these costs of leaving the euro, a country might still conclude that the benefits of re-introducing a national currency outweigh the costs. Suppose, for example, that the 'stability consensus' within Europe would weaken further, perhaps as a consequence of increasing political divisions, and that the ECB would respond by or be pressurized into engineering a higher inflation rate. In that case, a country with a high preference for price stability, say Germany, might conclude that this is not what it bargained for and that it wanted to introduce a New Deutschemark which would be internally more stable than the euro and externally stronger than the euro. In this case, the fact that existing cross-border contracts would have to be honored in euros would even be an advantage as the New Deutschemark would be worth more than the euro in our thought-experiment.

Practical and technical hurdles to break-up are low

Moreover, and this eventually may turn out to be a fatal flaw in the design of the euro, the technical and practical hurdles for re-introducing a national currency are much lower than generally presumed. First, the national central banks still exist and are fully operational. The regular open-market operations to provide liquidity to the banking system (refinancing operations) are conducted in a decentralized fashion by the national central banks on instructions from the ECB. Hence, a national central bank would have everything in place to operate national monetary policy from day one. Second, apart from the relatively small amount of foreign exchange reserves transferred to the ECB,

the bulk of the reserves is still with the national central banks. Third, payment systems in the euro area are still national and are simply linked together, but not replaced by, the Eurosystem's TARGET system.

Check your notes and coins

Fourth, but not least, even the euro notes and coins have been issued by the 12 national central banks, not the ECB, and — importantly — can still be easily traced to their national origin. For the coins, this is obvious: their flipside carries a national design that differs from country to country. For the euro banknotes, which have an identical design on both sides, this is less obvious. However, they can be distinguished by the letter before the serial number, with which they can be traced back to the issuing central bank (for example, an X for notes issued by the Bundesbank). Thus, if a country wanted to re-introduce a national currency, it could simply decide to use the euro notes and coins issued by its national central bank as legal tender until the new national money has been minted and printed.

Don't get too bullish on the euro

Taken together, while under the current circumstances EMU break-up is unlikely due to the high political and economic costs associated with it, the legal, practical and technical hurdles to a break-up are much lower than generally presumed. And the political and economic circumstances could change, especially if, as I suggested earlier, the political divisions in Europe deepen and, as a consequence, the 'stability culture' should unravel. Thus, those investors who make decisions for the long term should allow for the risk of the euro falling apart. Against this backdrop, I wouldn't be surprised if the euro traded significantly lower and euro area bond yields significantly higher than presently in 6–12 months' time.

Important US Regulatory Disclosures on Subject Companies

The information and opinions in this report were prepared by Morgan Stanley & Co. International Limited and its affiliates (collectively, "Morgan Stanley").

The research analysts, strategists, or research associates principally responsible for the preparation of this research report have received compensation based upon various factors, including quality of research, investor client feedback, stock picking, competitive factors, firm revenues and overall investment banking revenues.

Global Stock Ratings Distribution

(as of December 31, 2003)

Stock Rating Category	Coverage Universe		Investment Banking Clients (IBC)		
	Count	% of Total	Count	% of Total IBC	% of Rating Category
Overweight	592	32%	241	38%	41%
Equal-weight	856	46%	287	46%	34%
Underweight	402	22%	98	16%	24%
Total	1,850		626		

Data include common stock and ADRs currently assigned ratings. For disclosure purposes (in accordance with NASD and NYSE requirements), we note that Overweight, our most positive stock rating, most closely corresponds to a buy recommendation; Equal-weight and Underweight most closely correspond to neutral and sell recommendations, respectively. However, Overweight, Equal-weight, and Underweight are not the equivalent of buy, neutral, and sell but represent recommended relative weightings (see definitions below). An investor's decision to buy or sell a stock should depend on individual circumstances (such as the investor's existing holdings) and other considerations. Investment Banking Clients are companies from whom Morgan Stanley or an affiliate received investment banking compensation in the last 12 months.

Analyst Stock Ratings

Overweight (O). The stock's total return is expected to exceed the average total return of the analyst's industry (or industry team's) coverage universe, on a risk-adjusted basis, over the next 12-18 months.

Equal-weight (E). The stock's total return is expected to be in line with the average total return of the analyst's industry (or industry team's) coverage universe, on a risk-adjusted basis, over the next 12-18 months.

Underweight (U). The stock's total return is expected to be below the average total return of the analyst's industry (or industry team's) coverage universe, on a risk-adjusted basis, over the next 12-18 months.

More volatile (V). We estimate that this stock has more than a 25% chance of a price move (up or down) of more than 25% in a month, based on a quantitative assessment of historical data, or in the analyst's view, it is likely to become materially more volatile over the next 1-12 months compared with the past three years. Stocks with less than one year of trading history are automatically rated as more volatile (unless otherwise noted). We note that securities that we do not currently consider "more volatile" can still perform in that manner.

Unless otherwise specified, the time frame for price targets included in this report is 12 to 18 months. Ratings prior to March 18, 2002: SB=Strong Buy; OP=Outperform; N=Neutral; UP=Underperform. For definitions, please go to www.morganstanley.com/companycharts.

Analyst Industry Views

Attractive (A). The analyst expects the performance of his or her industry coverage universe over the next 12-18 months to be attractive vs. the relevant broad market benchmark named on the cover of this report.

In-Line (I). The analyst expects the performance of his or her industry coverage universe over the next 12-18 months to be in line with the relevant broad market benchmark named on the cover of this report.

Cautious (C). The analyst views the performance of his or her industry coverage universe over the next 12-18 months with caution vs. the relevant broad market benchmark named on the cover of this report.

Stock price charts and rating histories for companies discussed in this report are also available at www.morganstanley.com/companycharts. You may also request this information by writing to Morgan Stanley at 1585 Broadway, 14th Floor (Attention: Research Disclosures), New York, NY, 10036 USA.

Other Important Disclosures

For a discussion, if applicable, of the valuation methods used to determine the price targets included in this summary and the risks related to achieving these targets, please refer to the latest relevant published research on these stocks. Research is available through your sales representative or on Client Link at www.morganstanley.com and other electronic systems.

This report does not provide individually tailored investment advice. It has been prepared without regard to the individual financial circumstances and objectives of persons who receive it. The securities discussed in this report may not be suitable for all investors. Morgan Stanley recommends that investors independently evaluate particular investments and strategies, and encourages investors to seek the advice of a financial adviser. The appropriateness of a particular investment or strategy will depend on an investor's individual circumstances and objectives.

This report is not an offer to buy or sell any security or to participate in any trading strategy. In addition to any holdings disclosed in the section entitled "Important US Regulatory Disclosures on Subject Companies", Morgan Stanley and/or its employees not involved in the preparation of this report may have investments in securities or derivatives of securities of companies mentioned in this report, and may trade them in ways different from those discussed in this report. Derivatives may be issued by Morgan Stanley or associated persons.

Morgan Stanley is involved in many businesses that may relate to companies mentioned in this report. These businesses include specialized trading, risk arbitrage and other proprietary trading, fund management, investment services and investment banking.

Morgan Stanley makes every effort to use reliable, comprehensive information, but we make no representation that it is accurate or complete. We have no obligation to tell you when opinions or information in this report change apart from when we intend to discontinue research coverage of a subject company.

With the exception of information regarding Morgan Stanley, reports prepared by Morgan Stanley research personnel are based on public information. Facts and views presented in this report have not been reviewed by, and may not reflect information known to, professionals in other Morgan Stanley business areas, including investment banking personnel.

The value of and income from your investments may vary because of changes in interest rates or foreign exchange rates, securities prices or market indexes, operational or financial conditions of companies or other factors. There may be time limitations on the exercise of options or other rights in your securities transactions. Past performance is not necessarily a guide to future performance. Estimates of future performance are based on assumptions that may not be realized.

This publication is disseminated in Japan by Morgan Stanley Japan Limited; in Hong Kong by Morgan Stanley Dean Witter Asia Limited; in Singapore by Morgan Stanley Dean Witter Asia (Singapore) Pte., regulated by the Monetary Authority of Singapore; in Australia by Morgan Stanley Dean Witter Australia Limited A.B.N. 67 003 734 576, a licensed dealer, which accepts responsibility for its contents; in certain provinces of Canada by Morgan Stanley Canada Limited, which has approved of, and has agreed to take responsibility for, the contents of this publication in Canada; in Spain by Morgan Stanley, S.V., S.A., a Morgan Stanley group company, which is supervised by the Spanish Securities Markets Commission (CNMV) and states that this document has been written and distributed in accordance with the rules of conduct applicable to financial research as established under Spanish regulations; in the United States by Morgan Stanley & Co. Incorporated and Morgan Stanley DW Inc., which accept responsibility for its contents. Private U.K. investors should obtain the advice of their Morgan Stanley & Co. International Limited representative about the investments concerned. In Australia, this report, and any access to it, is intended only for "wholesale clients" within the meaning of the Australian Corporations Act.

The trademarks and service marks contained herein are the property of their respective owners. Third-party data providers make no warranties or representations of any kind relating to the accuracy, completeness, or timeliness of the data they provide and shall not have liability for any damages of any kind relating to such data. The Global Industry Classification Standard ("GICS") was developed by and is the exclusive property of MSCI and S&P.

This report or any portion hereof may not be reprinted, sold or redistributed without the written consent of Morgan Stanley.

Additional information on recommended securities is available on request.

L14872

The Americas

1585 Broadway
New York, NY 10036-8293
United States
Tel: +1 (1)212 761 4000

Europe

25 Cabot Square, Canary Wharf
London E14 4QA
United Kingdom
Tel: +44 (0)20 7425 8000

Japan

20-3, Ebisu 4-chome
Shibuya-ku,
Tokyo 150-6008, Japan
Tel: +81 (0)3 5424 5000

Asia/Pacific

Three Exchange Square
Central
Hong Kong
Tel: +852 2848 5200