Trend Macrolytics, LLC
Donald Luskin, Chief Investment Officer
Thomas Demas, Managing Director
Lorcan Roche Kelly, Chief Europe Strategist
John Clinton, Principal

MACROCOSM

Two-Tier Europe is Born

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Lorcan Roche Kelly

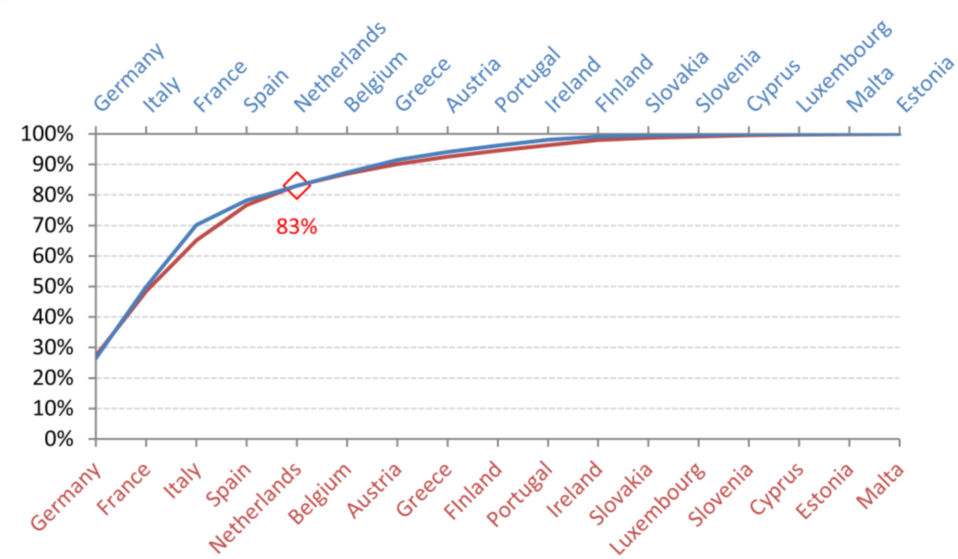
Merkel and Sarkozy have re-imagined the Euro area, and a stable solution to crisis.

The generally negative reaction to yesterday's summit meeting of German Chancellor Angela Merkel and French President Nicolas Sarkozy seems to suggest that the meeting did not produce anything of note. We strongly disagree. We think this meeting marks a potentially very positive turning point in the Euro area's response to its debt crisis. Much more than that: *it is a fundamental re-imagining of the Euro area, led by the two largest Euro area states, Germany and France.*

Never mind that in yesterday's post-summit press conference the idea of Eurobonds was shelved for the time being. All talk coming into the meeting was about hopes for an announcement on their introduction. But we thought this was unlikely (see "New Battle, Old Weapons?" August 12, 2011). We got something much more important -- we got the definition of a new institutional environment which, when put in place, will be a strong framework of integration in which Eurobonds can thrive.

Let's look at what was revealed yesterday. While market participants will

Cumulative, rank-ordered: Euro area government debt — GDP



Source: Eurostat, TrendMacro calculations

Update to strategic view

EUROPE MACRO: Merkel and Sarkozy have proposed far reaching integration of Germany and France -- and invited Italy and Spain to join them -- creating an elite economic zone within an economic zone. This marks a new strategy of strengthening the core through integration, rather than protecting it from contagion by propping up unstable peripheral countries. We think it marks a major turning point -- the discovery of a durable solution to Europe's debt crisis.

[Strategy Dashboard home]

focus on -- and abhor -- the proposed introduction near-term of a financial transactions tax, the longer-term implications of other measures proposed at the summit are much more important and far-reaching.

- France and Germany are stepping up integration on a *bilateral* basis, ahead of the pace set in the wider Euro area.
- Integration includes a common corporate tax base and tax rate in the two countries by 2013.
- There will be closer interaction between French and German finance ministers, working together to produce budgets using shared economic scenarios.
- Sarkozy highlighted France and Germany's leadership role saying, "We want to express our absolute will to defend the euro and assume Germany and France's particular responsibilities in Europe and to have on all of these subjects a complete unity of views."
- All 17 Euro area member states will be encouraged to implement debt brakes within their constitutions, and also commit to balanced budget legislation by 2012.
- An economic government for the Euro area will be created, with heads of state meeting at least twice a year, under a president who will be appointed for a two and a half year term. The summit proposed Herman Van Rompuy as the first president.

By France and Germany taking explicit leadership in the Euro area through integration on a *bilateral* basis, it now seems that it is up to the rest of Europe to try to keep up. *This is the start of a two-tier Europe.*

- Sarkozy invited Spain and Italy into the top tier -- an elite economic zone within an economic zone. He was careful to include them in his comments yesterday, saying that "Our Spanish and Italian friends are making decisions that will bolster the Eurozone."
- By identifying Spain and Italy as members of the newly defined top tier, and by setting clear rules and a timetable for integration, France and Germany have thrown down the gauntlet to the other peripheral nations. For the past 18 months, the PIG tail has wagged the Euro area dog. Those days are ending: there was no mention of the troublesome peripheral nations in Sarkozy's remarks.

Today we learn that there will be a serious enforcement mechanism for countries unwilling to toe the Franco-German line on budget reform. In a letter sent to Herman Van Rompuy, Sarkozy and Merkel recommend that payments of European Union aid to Euro area members with excessive budget deficits be suspended. This does *not* refer to payments committed under bailout agreements, but rather to payments under the Common Agricultural Policy and Fisheries Policy of the EU. Further, countries in receipt of bailout funds will no longer have direct access to money from EU structural and cohesive funds -- this money will instead be diverted to a fund to improve competitiveness on a Euro area-wide basis. Combined, these payments form a large part of the benefit of Euro area membership

Contact TrendMacro

On the web at
trendmacro.com

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Donald Luskin
Menlo Park CA
650 429 2112
don@trendmacro.com

Thomas Demas
Charlotte NC
704 552 3625
tdemas@trendmacro.com

Lorcan Roche Kelly
Sixmilebridge Ireland
212 537 9067
lorcan@trendmacro.com

John Clinton
Charlotte NC
704 552 3629
jclinton@trendmacro.com

[About us]

for some of the smaller nations -- withdrawal of them would leave one less incentive for that membership to continue.

This all basically amounts to Euro area members giving up fiscal sovereignty -- to the Franco-German axis -- and this will require constitutional changes in member states. These changes will require referenda in some countries. In Ireland, the proposals were met with a lukewarm response from the Irish minister for finance, and the Finnish finance minister said she was "not too excited" about playing with her country's constitution. The Austrian finance minister has expressed doubts whether the Franco-German proposals are achievable.

However, is not essential that the peripheral nations are included. They are being given a choice -- either include themselves by changing their constitutions and balancing their budgets, or fail to do this and lose access to EU funding. What is essential for this integration to work is that both Spain and Italy join up. Add the Netherlands, and we have a five-member top tier that represents precisely 83% of *both* Euro area GDP *and* Euro area debt (please see the chart on the first page).

The new strategy is to *strengthen* the core rather than to *protect* it -- specifically, to *strengthen* the largest nations through integration -- rather than *protect* the core by propping up the periphery. The hope is that by the time a peripheral nation -- Greece is the obvious candidate -- realizes it cannot live within the Euro area anymore, the other Euro area nations will have become so integrated that their union will be robust enough to survive the split relatively undamaged.

- Remember -- propping up failing peripheral nations was never an end in itself.
- On one level it catered to European elites' dreams of empire. But in a world of growing distrust of even the most solid sovereign credits, such dreams are becoming an expensive luxury.
- More fundamentally, the purpose was to protect Spain and Italy -- countries arguably too big to prop up, whose failure would have destroyed the French and German banking systems -- from contagion emanating from the smaller peripherals.
- That purpose is now to be achieved by integration of Spain and Italy into a new core -- a top tier -- led by France and Germany.

To be sure, the result of yesterday's summit was only proposals. French and German finance ministers plan to meet "very soon" to discuss actual implementation. But the path is clear -- the rest is details.

For investors worried about the ultimate stability of the Euro area, we think this should all be seen as a large positive. This marks the end of the "extend and pretend" strategy of limping from crisis to crisis in the periphery. For the first time, we have a vision of a stable outcome. And coming just after a near-death experience in which contagion nearly overtook Spain and Italy -- and in which France's AAA rating was at risk -- this doubling down on French and German commitment to the Euro is all the more powerful and durable. Now, as the new top tier defines itself by pushing ahead with closer integration, it is up to the rest of the Euro area -- especially the peripheral nations -- to decide whether they can live with the pace.

Bottom line

Merkel and Sarkozy have proposed far reaching integration of Germany and France -- and invited Italy and Spain to join them -- creating an elite economic zone within an economic zone. This marks a new strategy of strengthening the core through integration, rather than protecting it from contagion by propping up unstable peripheral countries. We think it marks a major turning point -- the discovery of a durable solution to Europe's debt crisis.