1. Why does the crisis persist?

2. Three main break up scenarios

3. Some open questions
Why is the European situation still fragile?

Status quo reflects an ECB bandage. It allows short term funding, but fails to deal with the two deeper issues:

a) No agreement about how to pay for accumulated past losses

b) No mechanism to enforce compliance for current and future promises

Plus there is grinding austerity that is delivering mixed progress on reforms, especially regarding those that improve growth. **Meanwhile, even medium term growth prospects are poor.**

Until the fundamentals are addressed, problems will remain and if slow growth persists the odds of success are much lower.
Scenario 1: Weak country exit

1. Reform and austerity fatigue continue to grow – how long are youth unemployment rates above 50% sustainable?

2. Debt levels in Greece remain high; Cyprus needs money. Patience in the strong countries is limited.

3. Should the official sector support dry up, a bank run would be likely; a country would need its own currency to reopen the banks. Capital controls would be imposed.

4. I put less weight on a crazy, nationalist political decision to voluntarily exit. (A weak country that leaves will suffer greatly).
Scenario 2: Strong country (Finland?) exit

1. Exiting and having the currency appreciate is very different than with a depreciation – legal uncertainty is still very high.

2. Political pressure to hold a vote on staying in may grow now that the UK has mooted this possibility.

3. Norway and Sweden show that life without the euro is feasible. Business pressure in Finland to stay in might be modest.

4. Trigger likely to be the prospects of a large bailout. (€48 billion in TARGET 2 credit)
Scenario 3: Large Unexpected Bank Failure

1. If there is a need for capital injection on short notice, will a country be able to access debt markets?

2. Ratios of risk weighted to total assets across major banks is surprisingly low. (Liquidity regulation for banks will just make this worse.)

3. Would the ECB be willing to serve as a lender of last resort?

4. View this as a long shot scenario, but include it only for completeness.
Questions

1. Can we assume a) countries will use the OMT and b) once we get past the German elections more money will be available?

2. Will the politicians level with the public about the potential costs of keeping all the current members part of the club?

3. How far apart can France and Germany diverge in competitiveness?

4. If Finland did leave and resolve much of the legal uncertainty, would this be a road map for others?