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Who will pull out of the Euro first?

Ireland, Spain or Italy? It might sound a bit far fetched to some people but actions speak louder than words. In Germany savers are drawing money out of the bank and demanding that the Euro notes are German Euro notes. Is this a sign that some Europeans are starting to worry about the validity of their currency?

Each member of the Eurozone prints its own banknotes, according to its economic weight, and they are numbered in such a way as to make their country of origin identifiable. According to Ambrose Evans-Pritchard in the UK's Telegraph newspaper, Germans are avoiding notes with serial numbers from Italy, Spain, Portugal and Ireland, instead demanding notes with the German numbers that start with an 'X'.

It may seem unusual to still think of the Euro as a combination of different currencies but the same approach is applied to the government bonds that are issued by each country in the Eurozone. For instance, 10 year bonds issued by the Italian government are yielding 5.034% compared to 4.422% for German 10 year bonds. French bonds are offering just 4.636% compared to 5.089% for Greek bonds. It is the financial strength of these countries that effectively combine to underpin the stability of the Euro currency but there are clearly some variations in the governments doing the underpinning. However, a default on interest payments on government bonds would have a devastating effect on the currency and it is unlikely it would be allowed to happen in the Eurozone, the ECB would most likely step in.

But in the same way that investors are applying different ratings to government bonds from different issuers, German consumers are now applying the same approach to bank notes from different issues. In a world where currencies are no longer backed by hard assets such as gold, and rely completely on public confidence, it is not inconceivable that one country's people might panic and stop accepting notes that are issued by another country. It might be wrong to do this, purely as a result of a lack of understanding of how the Euro is supported by the combined strength of the Eurozone members, but crowd mentality is a powerful force and if people think they are at risk of losing all their money, they will react to save their skins. A run on the notes of a specific country is not totally inconceivable.

The most likely trigger for a run on a currency formed through monetary union is if the chances one country dropping out were to increase significantly. There have been some weak rumours already about Italy dropping out of the Euro but nothing that has caused a tangible effect. However, the economic problems that some countries are experiencing are only going to get worse and investors need to be looking ahead. We could be on the verge of the greatest stress test the Euro currency has ever undergone during its short life.

Over the past few years there has been massive expansion of the financial system in Spain, Ireland and Greece. Low interest rates, combined with a big increase in the number of available financial products on offer such as mortgages and personal loans, has propelled a huge and unprecedented take up in credit in these countries. Borrowing has been available on a scale never seen before. Effectively the interest rate set by the ECB was too low for

these high growth countries, having been kept down to support the much larger economy of struggling Germany, and this fuelled a boom in construction, housing and consumer spending.

However, higher inflation and higher lending rates brought about by the credit crunch have turned off the tap of cheap and easy credit and this is causing the economies of the PIGS countries (Portugal, Italy, Greece and Spain), along with Ireland, a great deal of pain. These countries could now do with lower interest rates to help their rapidly-slowing economies but the ECB has to focus on the bigger picture and is compelled to fight high inflation and to take into account much better growth in Germany.

An economic recovery in Germany couldn't have come at a worse time. There has been a two-speed Europe for some time now but the players have recently changed places and it is the former growth stars that are now in dire need of lower interest rates. In the past, at times of severe economic weakness, a country always had the option of lowering interest rates, just as the US has done. However, even though Spanish GDP growth is expected to more than halve this year and Spain will struggle to avoid recession in 2009, it has no option but to accept the interest rates set by the ECB. The Italian economy is also being crippled by a strong Euro and in pre-Euro days it would almost certainly be considering either lowering interest rates significantly or devaluing the currency.

The real question is, how bad will things get for these countries that are suffering from a huge property crash, a sharp drop in consumer spending and declining demand for their exports? Will political pressure to do the right thing for the country be stronger than the desire to remain as part of the single currency? Many people already blame the Euro for the price rises they have experienced over the last few years, rightly or wrongly, and would probably be keen to see it broken up. If property prices keep falling in Spain and unemployment keeps rising, it will be very difficult to stomach more interest rate rises that are designed to keep external inflation under control, especially as 90% of Spain's financial borrowing is on variable rates.

If the economy in Ireland or Italy is struggling under the weight of a strong currency and high interest rates, how long will it be before a politician latches onto the idea of proposing a swift exit from the Euro to boost jobs and production, to revitalise the home economy? This might seem like a narrow-minded and short term policy to pursue but you can see how it might be very popular with an electorate who are feeling betrayed by Europe and who blame the people in Brussels for their hardship.

In reality, it might not even need to go that far before the Euro is put under pressure and starts to weaken of its own accord. A serious threat to its stability, with the risk of one departure being followed by others in quick succession, would be enough to undermine confidence in the currency and to see a sharp move in its value against other currencies. Whilst this would ultimately be damaging for those invested heavily in Euros, it could also present a very interesting opportunity for those Euro-based investors who were ready and waiting for such a move. George Soros made over $1billion when the Pound was forced out of the Exchange Rate Mechanism in 1992. Some people will also do very well if a currency pulls out of the Euro today, it's simply a case of watching and waiting for the signs and

ultimately being open to the possibility that this could happen. Even though several European countries could go into recession in the next couple of years there is always money to be made by investors if they think ahead and prepare for possible opportunities.