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THE
FALL
OF THE
EURO

Reinventing
the Eurozone
and the
Future of
Global Investing

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THE FALL OF THE EURO

*Reinventing the Eurozone
and the Future of
Global Investing*

JENS NORDVIG

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Preface

I wrote this book because I care about Europe. I feel both sad and angry about the situation in the eurozone and how it has been handled.

I feel sad because so many innocent European citizens are now victims of a devastating economic crisis. Young, bright graduates in Madrid, Rome, and Lisbon are having a very hard time getting a decent job—not through any fault of their own, but because of ineffective economic policy. It is unfair. And it is not only about youth unemployment. Many other groups around the eurozone are unfairly feeling the pain from years of economic mismanagement.

I feel angry because of all the misinformation about the euro: what it is doing to the eurozone countries and what can be done about it. For a long time, the “religion” of the common currency has precluded any debate about alternative policies. European policy makers have been schooled to think about the euro in a certain way, and overconfidence and tunnel vision have made it almost impossible for them to think creatively about new solutions. Misinformation leads to bad decisions, and bad decisions lead to bad outcomes. Millions of people are suffering as a result.

I grew up in Denmark. As a child, I traveled with my parents though France, Spain, Italy, Portugal, and Greece on long vacations; as a teenager, I went to summer school in Germany; while I was studying economics in university, I spent time in Spain; and my first real job was as a markets economist based in London, focusing on Central and Eastern Europe. Through these experiences, I saw the European integration firsthand.

I moved to London in 2000. I immediately felt the city’s diversity and energy. The fact that London is such a cultural melting pot is not

solely a function of the European integration process, but free movement of labor within the European single market has given the city's diversity a further boost. When I moved to the United Kingdom, all I had to do to start a career there was to catch the first plane and go to the local council's office in East London to get a national insurance number.

Because of the European Union's single market, I had the right to work anywhere I wanted within the EU. My older siblings had not had the same freedom when they graduated some years before me. It was a new European freedom to cherish and celebrate.

In those years, a lot of things in Europe seemed to be going in the right direction. The single market was working (allowing goods, capital, and people to move freely). The EU had played a key role in securing peace in the former Yugoslavia. The euro had been launched successfully. Finally, 10 Central and Eastern European countries joined the European Union in 2004. Europe was successfully integrating along multiple dimensions.

By 2010, it was all falling apart. How could it come to this? Over the last four years, I have spent hours upon hours thinking about it all. I wrote dozens of papers and strategy notes in my capacity as head of currency strategy for Nomura Securities. In addition, I was the lead author on a large technical paper called "Rethinking the European monetary union," which was a finalist in the Wolfson Economics Prize competition in 2012. This book builds on this background material and on innumerable direct interactions with investors and policy makers.

The more I studied the history, the politics, and the economics, the more I wanted to scream: "Why did they do it?!" Creating the euro was such a reckless gamble. Many of the weaknesses in the euro's foundations were foreseeable, and had indeed been foreseen by many before the currency was launched. But those European leaders who were spearheading the creation of the common currency pushed away all arguments against it. They wanted the euro, regardless of its faults and risks.

The other components of European integration—including the common market within the European Union—had a 60-year track record of success, based as they were on a philosophy of gradualism. But the fast jump to a common currency created serious trouble only 10 years after the euro was born.

This book is about how Europe got into this mess—and what the ways out are.

Introduction

The euro crisis is morphing from a financial crisis to an economic and political crisis. Financial markets have calmed, but many eurozone economies continue to suffer from historically deep recessions. How unprecedented economic weakness will influence politics from north to south in the eurozone is the key to the future of the euro.

To understand the euro and the current crisis in the eurozone, you need to understand history and politics, and a bit of economics too. Politics was the main driving force behind the euro when the idea of a common European currency was conceived more than 20 years ago. Politics remains the key parameter today. The interplay of national politics in the 17 eurozone member countries will determine the specific form the euro will take in the future, including the possibility of it disintegrating.

Policy makers can attempt to circumvent the basic laws of economics, but over time, the core economic truths take their revenge. Uncompetitive countries will eventually experience an economic crisis. Overly indebted countries will eventually have to restructure their debts or default. The longer these imbalances are ignored and allowed to accumulate, the greater the ultimate cost of unwinding them.

The euro crisis has been about letting imbalances accumulate and not recognizing the euro's weaknesses before it was too late. European policy makers have finally woken up to the reality, but they are still playing defense. They are fighting to build new institutions, foster greater cooperation, stabilize markets, reignite economic growth, and maintain political stability.

It is an uphill battle. History suggests that a currency union without a political union is a vulnerable thing, and that some form of breakup is a high risk as long as independent countries are focused on their own interests. The optimal solution would be to create a political union in the eurozone and thereby centralize the decision making (as in the United States). But European policy makers have lost credibility, and euroskeptic sentiment is growing across the continent.

Currently, there is simply no public support for the idea of a United States of Europe—not in Greece, not in Spain, and not in Germany. Meanwhile, the economic reality of an inflexible currency union remains one of severe economic pain. This remains the case in large parts of the eurozone even after a period in which markets have been more stable.

How the eurozone evolves institutionally and how the euro behaves in coming years will affect the livelihood of millions of European citizens. The specific form the euro assumes in the future will have an impact on growth and employment across the eurozone and will also drive global financial markets. In line with how we have already seen the euro crisis drive global markets during the last few years, new shocks from the eurozone have the potential to dominate global asset markets, from equities and bonds to currencies and commodities.

This book is organized in four parts.

Part I, “The Euro: The Early Years,” gives you the historical background for understanding the current crisis in the eurozone. It begins with the early stages of European integration in the 1950s, continues through the birth of the euro in 1999, and ends with the various eurozone-driven financial market crisis waves that rocked global markets during 2010–2012. The four main crisis waves eventually led to the fall of the euro in its original form. The euro as it was created in 1999 was not strong enough to endure a severe crisis. The euro crisis has forced policy makers to rethink the monetary union, giving the European Central Bank more power and pursuing greater economic cooperation. Only a strengthened version of the euro has the potential to survive in the longer term.

Part II, “European Integration: The Difficult Path,” deals with the big choice that Europe is facing. It is a choice between closer integration and cooperation, on the one hand, and a form of breakup, on the other. In 2012, European leaders stared into an uncertain future that included the potential breakup of the currency. To avoid this, policy makers agreed on a new vision for a more mature and closer union.

But there is a difference between vision and reality. The eurozone lacks a political union, and there is no public support for creating one. This is a major obstacle to rapid and radical integration, and it will leave the eurozone in an incomplete and inflexible state for years to come. This is the *realpolitik* of Europe today. The common currency is still missing a mechanism to deal with economic crises in individual countries. There is no eurozone budget to help countries that are in dire straits.

In a manner similar to the way the gold standard operated almost a hundred years ago, the main adjustment mechanism in the eurozone is now deflation. Over the very long run, lower prices will bring about increased competitiveness. But during the adjustment phase, which could take many years, this is a very painful path for countries with high debt. The pain can be readily observed in historically weak growth and unprecedentedly high unemployment rates in several eurozone countries. This, in turn, creates a fragile political situation. The economic pain is increasingly feeding into political instability along various dimensions. This is sowing the seeds of a future crisis, one that is driven by political tension rather than market breakdown.

Part III, “The Mechanics and Implications of Breakup,” confronts the topic of the breakup of the euro, an idea that remains taboo among most European policy makers. This is the scenario that European officials do not want to contemplate, even if the realities of the last few years have forced them to admit that various types of breakup cannot be ruled out entirely.

There are many myths about the implications of breakup, and some of these myths are kept alive for political reasons. This is

an underresearched topic, and you should not believe everything you read. In this part, I try to debunk some of the myths about breakup and to provide a framework for thinking objectively about it—something that European officials have a hard time doing.

Two lessons are crucial. First, there are many different types of breakup, from the departure of a tiny country such as Cyprus to a full-blown breakup involving dissolution of the eurozone altogether. In addition, the implications of an economically weak country like Greece leaving are fundamentally different from those relating to a strong country such as Germany leaving. Each type of breakup has its own special considerations, and it is nonsensical to make any blanket statements about the consequences of them all.

Second, when thinking about breakup, there are important legal aspects that need to be taken into account. Economists often ignore or forget these factors, but any practical analysis needs to take into account the legal constraints associated with switching to another currency, something that is inherent in a euro breakup. Otherwise, it is just useless theory.

Part IV, “The Future Euro: Investment Implications,” provides a framework for investment strategy in a new world of elevated uncertainty in the eurozone. Over the last few years, we have observed that news from the eurozone now carries unprecedented weight in global financial markets. The challenge for investors and individuals who are trying to protect their savings is that we still don’t know the exact form that the euro will take in the future. It will depend on the interplay between politics in the core and the periphery of the eurozone.

Will the euro be a strong currency? Will it be a weak currency? Or will it break into pieces? How the current deadlock is resolved will shape the future of the euro, have a major impact on the lives of millions of European citizens, and drive the performance of many different financial assets around the world.



The Euro: The Early Years

You cannot understand the euro without understanding its history. The euro was born out of a political desire for European integration. Economics played only a secondary role in the process. This is ironic, since giving up its currency is one of the most important macroeconomic decisions a country can make.

We start in Chapter 1, “The Premature Celebration,” with the euro’s 10-year birthday celebration in 2009. The fathers of the euro were celebrating their own achievements. They did not realize that the shaky foundations of the original euro would soon lead to a period of sustained and homegrown instability.

In Chapter 2, “The Birth of the Euro: A Grand Political Bargain,” I outline the main phases in the history of European integration. The process culminated with the creation of the euro, and it was made possible through a grand political bargain centered on German reunification.

Chapter 3, “The Euro’s Honeymoon Years,” describes the eurozone’s initial 10 years of perceived success. Growth was booming in most of the eurozone periphery, fueled by abundant credit from the core. But under the surface, severe imbalances were building.

In Chapter 4, “The Euro Crisis: Waves of Escalating Tension,” I analyze the extreme instability in European and global financial markets during the euro crisis from 2010 to 2012. Each wave of the crisis had its own epicenter. But all these waves reflected the euro’s fundamental flaws. The common currency would need to be fundamentally reinvented if it were to be viable in the long run.

The Premature Celebration

A great deal of mystery surrounds the concepts of money and currency. What constitutes money? How can a piece of paper be worth anything? What is the value of one currency relative to another?

Money derives its value from the common belief that people can always convert it into goods and services at will. It is the universal acceptance of the idea that money can be exchanged for something else at some time in the future that gives it value. Government actions underpin this acceptance. Certain laws, such as those that allow people to use money to pay taxes, help define the role of money in our society. Meanwhile, government control of the supply of money helps to ensure trust in the value of the currency. As a society, we have entered into this social contract.

Each country has its version of money. In the United States, money is called dollars. In the eurozone, it is euros. In Japan, it is yen. In each case, the currency has value because it can be used to facilitate transactions (buying and selling of goods) and to store wealth for the future.

THE PURPOSE OF A CURRENCY

But currencies serve a purpose beyond providing the ability to buy a carton of milk, sell a house, and accumulate savings conveniently. Governments that have control of their own currency have a powerful tool at their disposal. Having an independent currency allows a country to tailor its monetary and exchange rate policy to meet

the specific needs of the economy. For this reason, currencies are often symbols of national power. During the nineteenth century, for example, at the peak of the British Empire, the pound sterling was the dominant international currency.

The relative values of currencies are determined in foreign exchange markets. For most major currencies today, market forces are allowed to determine exchange rates. The supply of and demand for a currency will dictate its price in accordance with economic and political developments at home and abroad. But the success of a currency cannot be judged from its nominal strength or weakness alone.

A currency's success should ultimately be evaluated based on its ability to deliver on the core objectives of the country's citizens. In many countries, this isn't limited to economic prosperity, but also includes basic values such as democracy, equal opportunity, and political stability.

The euro was created with such fundamental values in mind. Therefore, it should follow naturally that judgment on the euro's success should not be based solely on its value against the dollar, or against any other currency. Rather, the euro's success should be based on the currency's ability to deliver prosperity for all European citizens and its ability to reinforce the most treasured European values.

PREMATURE EURO CELEBRATIONS

The euro turned 10 years old on January 1, 2009. European officials used the occasion to celebrate their achievements. Past and present leaders—the people who had created the idea of the euro and watched it come into being—gathered at a high-profile conference in Brussels, Belgium. The European Union even launched a public website to celebrate the euro. The 10-year birthday website showcased the euro's success through a series of easy-to-understand (albeit fictional) stories from the various countries using the currency. A family from Greece was happy because of low interest rates

on its mortgage. A line manager from Finland was happy because of strong growth and new business opportunities.

On the front page of the website, the top economic official of the European Union, Joaquín Almunia, captured the positive spirit of the moment in relation to the euro:

Ten years on, it is a historic achievement of which all Europeans can be proud. Not only is such a currency union unprecedented in history; we can declare it a resounding success. Within the space of a decade it has clearly become the second most important currency in the world; it has brought economic stability; it has promoted economic and financial integration, and generated trade and growth among its members; and its framework for sound and sustainable public finances helps ensure that future generations can continue to benefit from the social systems that Europe is justly famous for.

At the time, the European currency was still viewed as a pillar of strength, a strong common anchor during a time of global financial turmoil. In previous crises, individual European currencies had fluctuated wildly, buffeted by global shocks or homegrown tensions. This time, the euro had been strong and relatively stable. The initial catalysts for the global financial crisis were concentrated in the United States, and the euro had actually gained versus the U.S. dollar in the early part of the crisis.

BACK TO REALITY

Just four years later, the reality is very different. Some eurozone countries are chugging along just fine; Germany is the best example. But others, like Greece, Spain, and Italy, have plummeted into unprecedentedly long and deep recessions.

In Greece, teachers are seeing their students doubled over with hunger pains during class. Like scenes straight out of Dickens, some

children are even pawing through trash cans to try to find food or begging their classmates for scraps. In a story in the *New York Times* highlighting this issue, one of the teachers said, “Not in my wildest dreams would I ever expect to see the situation we are in. We have reached a point where children in Greece are coming to school hungry. Today, families have difficulties not only of employment, but of survival.”

In Spain, more than 26 percent of the labor force is unemployed, up from less than 10 percent before the crisis. Meanwhile, youth unemployment has skyrocketed to more than 50 percent. People cannot pay their mortgages, are losing their homes, and have nowhere to turn. In February 2013, four people in one week committed suicide after being evicted from their properties throughout Spain.

In Italy, small businesses—in aggregate the biggest employer in the country—are struggling to pay their bills and are closing. According to the Italian business association Confindustria, the number of bankruptcies has doubled since 2007, and with credit conditions still worsening, there is no relief in sight. In May 2013, even the pope chimed in on Twitter: “My thoughts turn to all who are unemployed, often as a result of a self-centered mindset bent on profit at any cost.” You know that the economic hardship is significant when the pope enters the debate.

Meanwhile, Europeans elsewhere, especially the more prosperous ones in the north, are getting tired of the woes of the poorer countries. They are growing weary of funding bailouts for struggling banks and sovereigns in the south. They have turned the screws on places like Spain and Greece by demanding severe government spending cuts and structural reform with the aim of bringing budgets into balance. But this is affecting funding for basic social services, including public hospitals in Greece. This exacerbates the situation for people in poorer countries at the worst possible time.

Recently, demonstrators took over a square in Madrid, shouting, “To fight is the only way!,” according to a report on CNN. During demonstrations this year in Greece, Cyprus, and Spain, depictions of Angela Merkel dressed in a Nazi uniform have been shown. Both

sides are fuming. The Germans are paying the bills, but they are getting blamed for the hardship. The common currency was supposed to bring Europe together. But in reality it is a source of disturbing political tension.

THE EURO'S CONGENITAL FLAWS

To the creators of the euro, their achievement looked strong and successful just a few years ago. But the euro's underlying flaws have now been exposed. Since the euro's 10-year birthday, the global financial crisis has morphed into a euro-specific crisis. The euro's flaws have been made evident through repeated waves of financial market turbulence and a trend of underlying economic deterioration.

The euro crisis started in Greece. The country was vulnerable after years of excessive government spending, and it underwent its own credit crunch when investors pulled back in late 2009. Then housing markets collapsed in areas that were previously booming, and Ireland and Spain descended into severe recessions. The largest eurozone banks teetered, not only in Ireland and Spain, but also in France and Italy. Individual European financial markets started to drift apart, reversing the trend of financial market integration that had existed for the previous 10 years. Finally, for the first time since World War II, a developed European country defaulted on its debt. Greece restructured its government bonds in March 2012.

Now, public finances in places such as Portugal and Spain look close to unsustainable. The anchor provided by the common currency has become dislodged, and confidence in European institutions and policy making has eroded. Today, few would agree with the statement that the euro has been a resounding success.

The euro was born out of a political desire for European integration. It was a noble idea, but it lacked a sound and resilient underlying structure. Countries that adopted the euro would be united through the common currency and a common monetary policy set by the European Central Bank (ECB). Each individual country that

was part of the eurozone surrendered its ability to make its own monetary decisions, even in a time of crisis. Unified monetary policy implied that tools that could help save an individual economy during periods of severe stress were no longer available to the individual countries. Meanwhile, there was no centralized fiscal policy to provide an offset. Unlike the United States, the European currency union had no backing from a common federal government that was able to transfer funds between weak and strong regions. What's more, no European institution had any real ability to control an individual country's budget or spending habits. The monetary union was handcuffed in the event of a catastrophe.

These fundamental flaws have caused severe economic and financial stress in the eurozone since 2010. Over the last four years, major swings in global asset markets—across currencies, fixed income securities, and equities—have been driven by European events, a clear departure from patterns in recent history. In the past, Europe was one of the most stable parts of the global economy, and its typically minor economic fluctuations would have little bearing on U.S. equity markets, for example.

TRYING TO REINVENT THE EURO

Recognizing the incompleteness of the infrastructure supporting the euro, senior European officials eventually put forward a blueprint for a so-called genuine economic and monetary union of the eurozone countries. This change in thinking came about in the summer of 2012. The new vision for the euro involves closer coordination of public-sector budgets and common supervision of the region's banks. Some officials also hope to eventually put in place a common financing instrument, so-called eurobonds. This is a long-term vision.

But there are serious obstacles to moving toward a more mature monetary union.

First, short-term problems need immediate responses that a long-term vision won't provide. Large eurozone countries such as

Spain and Italy are currently facing high public-sector borrowing costs and negative growth, which threaten to make their debt burdens unsustainable.

Second, although the eurozone now has more ECB support, European treaties were written to categorically preclude central bank financing of public-sector deficits. While, astoundingly, many deals have been able to circumvent this seemingly clear legal directive, the ECB has been forced to attach at least some conditions and caveats to its interventions. For example, in order to get access to ECB support in the future, the Spanish government would have to submit to unpopular budget restrictions and supervision from the ECB. The lack of unconditional backstop from the ECB leaves public finance in an uneasy vacuum of uncertainty while policy makers struggle to make progress on the longer-term integration process.

Third, the political reality is that voters across the eurozone have lost their appetite for further European integration. Even if European leaders are willing to sign up, European citizens are skeptical that they can make good on their promises. Future elections and referenda may present significant and decisive setbacks to the integration process, and this uncertainty may feed into a growing sense of pessimism in the shorter term.

THE EVOLVING EURO CRISIS

The complexity of the euro crisis is derived from several main elements. The euro is an incomplete monetary union, incapable of dealing with shocks in specific eurozone countries. It has a conservative central bank that is unwilling to provide unconditional support for individual countries. And, perhaps most important now, European countries have diverging political views and cultural backgrounds, and European policies are rapidly losing credibility. A severe decline in public trust in European institutions across the entire eurozone makes significant further integration extremely challenging.

To put it bluntly, *the eurozone cannot survive without further fundamental reform, and if further integration is not feasible, some form of breakup is inevitable.*

In the early part of the euro crisis, any mention of a breakup of the eurozone was regarded as speculative paranoia in European policy circles. But new political realities in Greece and Cyprus have opened up a space for such conversations. European policy makers have finally admitted that some types of exit from the eurozone are a possibility. You could even argue that a form of breakup has already taken place when severe capital controls were imposed on Cyprus in 2013, limiting the movement of money into and out of the country. President Nicos Anastasiades of Cyprus admitted the same in an interview with the New York Times on July 9, 2013. “Actually, we are already out of the eurozone“, he said.

At the same time, policy makers are still trying to pretend that other forms of breakup—such as those involving the departure of Spain, Italy, or even Germany from the euro—remain inconceivable. But this position may change over time too.

THE POLITICS OF THE FUTURE EURO

Still, European policy makers have invested immense amounts of time and energy, not to mention political capital, in the euro project, and they are not about to give up easily. They are pursuing gradual further integration to save the common currency, and they may even have gained confidence from a degree of financial market stabilization since the last intense crisis wave in the summer of 2012.

To be viable in the long run, Europe’s currency union needs to be underpinned by more closely integrated economies. Member countries need to move toward fiscal and political union; and the ECB needs to assume direct responsibility for protecting the currency by assuming an explicit role as the lender of last resort.

Just a few years ago, European policy makers were celebrating the euro as a “resounding success,” and markets were assuming minimal

government default risk across the entire eurozone. But the euro is failing to deliver on the core objectives of European citizens. Markets are no longer collapsing, but confidence in European institutions is. Weak growth and years of broken policy promises are combining to create unprecedented euroskepticism, both in peripheral countries and in the very core of the eurozone.

EUROPE'S NEXT CRISIS IS POLITICAL

This book will provide a new framework through which readers can understand the key indicators that are of longer-term importance for the future of Europe and global financial markets. Investors should learn the danger of premature celebrations and position themselves for a new investment environment in which *political risk* in Europe plays a potentially dominant role.

About the Author

Jens Jakob Nordvig began his finance career at Goldman Sachs in London in 2001. He eventually went on to lead the global currency strategy group before joining the hedge fund Bridgewater Associates. Currently, Nordvig is the head of currency strategy and fixed-income research for Nomura Securities. Over the past two years, throughout the worst of the European financial crisis, Nordvig was ranked as the number one currency strategist by *Institutional Investor*.*

In 2012, he received international recognition as a finalist in the Wolfson Economics Prize competition for his lead authorship of “Rethinking the European monetary union,” an essay on the future of the eurozone.

Nordvig’s work has been published in the *Financial Times*. He is frequently quoted in the *Wall Street Journal*, the *New York Times*, *Bloomberg Businessweek*, and the *Economist* and is a regular contributor to CNBC, Bloomberg TV, and other international news channels.

Nordvig studied economics at the University of Aarhus. At the age of 28, he was the coauthor of a book called *Matematik og økonomi (Mathematics and Economics)*.

Nordvig grew up in Denmark in a town with the nickname City of Smiles. He enjoys yoga and is a surprisingly good golfer. He currently resides on New York City’s Upper West Side with his wife, who is studying to be a neurologist.

* All-America Fixed-Income Research Team Ranking, 2011 and 2012.

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