Observations on the Latest Euro Zone Crisis

"The bulk of evidence suggests that the establishment of a currency union in Europe is associated with non-negligible regional problems."
Barry Eichengreen, University of California at Berkeley, Working Paper, October 1990.

Greece, the Euro Zone and Further Flight to Safety

There were substantially increased purchases of US, German and UK Treasuries in the last ten days and significant sales of global equities. This occurred even though the US fiscal situation has not been resolved, more German resources may be required to stabilize the euro zone, and the UK is in the midst of a double dip recession. While traders rushed to safe havens for sovereign bonds, they drove down prices of bonds perceived as risky, such as Spain's. On Tuesday of this week, yields on Spanish bonds, touched the 6.5% level for the first time since November, and the price of credit default swaps on Spanish sovereigns hit a record high on Monday. Although a major trading loss at JP Morgan London, evidence of slowing world growth, especially in China, played a role, the main factor reducing confidence in risky assets was the repudiation of austerity evidenced by the French and Greek elections. There is indication that the new socialist President of France, François Hollande, would be unlikely to promote the hard-line socialism of François Mitterand and Lionel Jospin (famous for wealth tax, 35-hour working week and nationalization of banks) and may be able to improve flexibility in the French labor market by getting the unions to sign off on firms being able to lay off employees during recessionary times.[1] Given the euro zone's current cyclical positioning, it seems that policy flexibility and more gradual fiscal tightening are more optimal than rigid austerity. The new French leadership tips the scales more in this direction. However, the Greek elections have led to genuine concern that Greece is likely to leave the euro zone.

Post-Election Turmoil in Greece

Financial markets were especially unnerved by uncertainty over what happens next in Greece. Greece's second bailout is contingent on the Greek government specifying a further package of reforms by the end of June, which are to be carried out in two installments, the first in 2013 and

[1] Bloomberg

the second in 2014. These deadlines will be impossible to meet even if a new government wanted to comply with them and are unlikely to be enforced. If Greece still repudiates its agreement in early 2013 or before, it has no other alternative than to exit the euro. Relations between the country and its creditors seem to have reached a stage where a Greek exit from the euro (commonly called "Grexit") has become almost a foregone conclusion. The more it does, the more it undermines confidence, creating additional risks. There is concern that a Greek exit could change the nature of the monetary union and create very considerable contagion across the periphery. If the euro becomes a reversible currency, a wave of bank runs could ensue in other peripheral countries, which could unravel the entire monetary union.[2] The EU has a big weapon in its arsenal to contain contagion, unlimited action by the ECB, but it is uncertain whether it will be used.

An alternative to a voluntary exit from the euro, which has some political support in Greece, would be to achieve a primary surplus in 2013 in line with the IMF EU plan and then to default on all outstanding debt. Though unpopular outside Greece, this strategy would probably enable Greece to stay in the euro, according to Wolfgang Münchau in the Financial Times. When the dust settles, it will make little difference whether Greece remains in the euro or leaves it, since most of the Greek debt may never be repaid.

Nonetheless, we believe that the adverse effect on other countries of a Grexit, if it occurs, will be contained. While banks are trying to match loans with deposits in vulnerable countries, such as Spain and Portugal, the ECB's long-term financing operations already in place allow them to turn eligible collateral into cash on a large scale. Moreover, bankers have had much time to prepare for the worst since the first Greek bailout in May 2010. There is also a substantial difference in fiscal circumstance between Greece and other peripheral countries. The Greek state was insolvent when it received its first bailout in May 2011, which European leaders fail to acknowledge. Even after a default that reduced more than half the face value of its private bond holdings and reduced their net present value by three quarters, the IMF expects Greece's government debt to be 161% of GDP by 2013. By contrast Ireland and Portugal's debt is projected to peak next year at 111% and 118%, respectively.[3] The argument that Greece is a special case is a strong one.

It is argued that in Greece factors weighing on competitiveness are so deeply rooted that they are unlikely to be fully addressed by exchange rate adjustment. We do not believe that this is the case. In fact there is evidence that Greece, as a result of internal disinflation, has restored 78% of the international competitiveness it has lost since 1999.[4] Hence a sizable initial devaluation would not be necessary to restore Greece's export competitiveness, although the currency will probably overshoot on the downside. If Greece exits the euro, we do not expect a more than 30% sustained deterioration in the terms of trade and a resulting reduction in domestic

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[2] The Economist
[3] The Economist
[4] Professor Paul de Grauwe, 'In Search of Symmetry in the euro zone.' Economic Policy, CEPS, Policy Briefs, May 2012, Table 1

purchasing power of comparable magnitude. However, the main benefit of Greece having exchange rate flexibility could be that it also had control of its money supply, which would mean it could monetize the cost of the public sector wages. Other potential economic effects on Greece are spelled out in the May 13 Financial Times article: 'Euro zone: If Greece goes." In the Argentinian case, a return to a national currency rapidly brought back growth and competitiveness. The Argentinian exit from the dollar in 2001 has shown that bank holidays and capital controls can be used to avoid a post exit implosion of the domestic banking system. In the Greek case, these measures would have to be instituted pre-exit given the current near record deposit withdrawal rate. In addition, Greece would have to unilaterally convert all euro-denominated debt to the new Drachma. This 'drachmatization' is comparable to the pesification of dollar-denominated debt, which occurred in Argentina.

Euro Zone Instability

Large imbalances and divergences within the euro area have built up over the past decade. These have been the result of reduced competitiveness of the GIIPs countries mostly in the South, mainly the result of increased relative unit labor costs. According to the Bank Credit Analyst, the sum of absolute current account positions rose from 1% of GDP in 1999 to 5% in 2007-2008. Many European countries were not able to keep up with the massive reforms in the German business sector, which resulted in large gaps in relative unit labor costs. The peripheral countries saw their unit labor cost rise by 30% relative to Germany from 1999 to 2008.[5] Labor mobility between countries in the euro zone is hampered by language and cultural differences. In the absence of a common currency, labor mobility and fiscal union, adjustment would have taken place via floating exchange rates which would have allowed these unit labor cost differences to be offset by currency movements and competitiveness to be maintained. In the presence of effective fiscal and monetary unions and movable agents of production, adjustment would have occurred via labor and capital mobility and fiscal transfers from the surplus countries to the deficit countries. In a situation like the current one, there is a common currency and a monetary union, but not a fiscal union, and there is extremely limited factor mobility across regions. This limits adjustment options.

Professor Paul de Grauwe provides evidence[6] that adjustment to external imbalances in the euro zone has occurred through internal disinflation in the deficit countries but no inflation in the surplus countries and through unfair bailout packages for distressed debtor countries. The latter are forced to accept such packages by creditor countries in an extremely strong bargaining position.

Such asymmetric adjustment is unjustifiable. It will result in the breakup of the currency union unless the peripheral countries are willing to accept long-term economic depression. Realigning costs and prices requires symmetric adjustment: not only comprehensive structural reforms and

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[5] Bank Credit Analyst
[6] Professor Paul de Grauwe, ibid. Tables 1, 2 and Figure 3.

wage restraints in countries with external deficits that have fallen behind since 1999, but also stronger domestic demand growth combined with wage and price increases in those countries that are super competitive and have large external surpluses.[7]

More Complete and Symmetric Adjustment

There is evidence that Germany at least is willing to move toward more symmetric adjustment. The German Finance Minister, Wolfgang Schäuble, is calling for higher German wages. He has said that, "It is fine if wages in Germany currently rise faster than in other EU countries. These wage increases also serve to reduce the imbalances within Europe." Financial Times, May 6, 2012. Bundesbank officials have subsequently indicated that an inflation rate above 2% would also be acceptable. This would strongly suggest that the ECB should become less hawkish, especially in the periphery. We expect the ECB to adopt a more benign and targeted policy stance. Financial conditions are becoming easier for the core and tighter for the periphery.

According to Goldman Sachs,[8] not only will the core countries allow their wages to increase more rapidly, but they will also not fully sterilize the large monetary inflows from the GIIPs countries that are presently occurring. The resulting monetary expansion will stimulate the core economies and allow them to purchase more exports from the GIIPs. This should help reduce not only external deficits in peripheral countries, but also fiscal deficits by raising output and government revenues. The core countries have a large incentive to promote a more symmetric adjustment to economic imbalances. According to JP Morgan Private Bank, a large portion of their exports, over 30% in the case of Germany, are to peripheral countries.

The financial markets will continue to challenge sovereign bonds in the periphery and euro zone governments must persevere in balancing their books, reducing the debt overhang and implementing supply side reforms. For example, Spain has a weak banking system which is expected to have shortfalls in excess of 10% of GDP this year. Because its federal government will have to fund these shortfalls, it risks being shut out of financial markets. Thus, euro zone governments will need to encourage the ECB to maintain monetary easing, to provide funding to the banking system and to stabilize the bond markets in times of crisis. By itself, The ESM (European Stability Mechanism)-IMF backstop (which exceeds €500 million) is not enough to ring fence Spain and Italy.

Our Base Case Outlook

The lack of real integration in the EMU, especially the lack of interregional labor mobility and the asymmetry of economic shocks across regions, has long been cited as a reason why the euro zone was not an optimal currency region and the EMU should not have been created. It has also been used as a justification for fiscal federalism, institutionalizing a system of significant fiscal

[7] Morgan Stanley Research, 'What Future for Europe,' transcription of conference call, May 2012
[8] Jim O'Neill, Goldman Sachs, 'Observations,' week ending May 11, 2012

transfers to deficit states. These would compensate for large national differences in economic activity. Nonetheless, we still believe that despite the failure to move toward fiscal integration and to satisfy the other optimal currency area requirements established by Nobel Prize winning economist, Robert Mundell in 1961, the euro area will for the most part continue intact with a lot of help from the ECB. JP Morgan estimates[9] that the ECB holds 14% of the periphery's bank and sovereign debt and that these holdings are likely to double over the next 18 months.

We recognize that the need to preserve national fiscal sovereignty and the unwillingness to accept joint and several liability for euro area debt are among the nearly insurmountable political obstacles to establishing a euro wide fiscal union and transfer mechanism. Germany is highly committed to the continuation of the euro zone and is likely to promote more fiscal union; this is how the founders originally got some countries to join the euro zone, with subsidies. However, it is unlikely that the other members will agree. The Fiscal Pact requiring a full employment balance, along with economic reforms, will take a long time to ratify or enact fully, let alone implement. Still, fiscal restraint, more symmetric adjustment and moves toward greater labor market flexibility and reduced barriers to entry for start-up businesses, such as those instituted by Monti in Italy, should ultimately be rewarded and the euro area economy should gradually rebalance. However, uncertainty over whether this is in fact occurring will likely persist for long time to come. The problems discussed and their protracted resolution are not yet fully reflected in European stock prices. For these reasons, we are still underweighting Europe.

James L. McCabe
May 16, 2012

[9] JP Morgan, 'Eye on the Market,' May 14, 2012

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