Only the Beginning

Europe's mess is even bigger than it looks. And the culprit? The euro itself.

BY MILTON EZRATI

Europe seems to have discovered the never-ending crisis. Greece can neither pay its debts nor mount effective budget reform. Another round of rioting has forced a cabinet reshuffle. A contagion of default threatens to engulf the rest of Europe's periphery. Germany thinks and then rethinks its response. Markets suffer waves of intense fear. Yet, bad as things feel now, this is only the beginning. Debt problems will plague the eurozone for the foreseeable future and impose a severe cost on all, whether located in the strong or in the weak economies. Worse, it has become increasingly clear that today's problems are more fundamental than previously thought, go beyond popular accusations of undisciplined profligacy in Europe's periphery, and lie in the basic structure of the euro.

THE SAGA SO FAR

The specific debt problems are so widely reported they hardly need another detailed review. The crisis erupted in spring 2010, when Greece revealed that for years it had hidden huge budget deficits from its own people and from EU authorities. At that time, the public purse ran at close to €40 billion in the red, almost 14 percent of Greece's GDP and far beyond the 3 percent limit preferred by European Union's Growth and Stability Pact. Still more troubling, Greece revealed that the accumulated debt from years of such deficits had brought outstanding Greek government obligations to some 130 percent of GDP, far worse than any other European country.

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THE INTERNATIONAL ECONOMY
THE MAGAZINE OF INTERNATIONAL ECONOMIC POLICY
888 16th Street, N.W., Suite 740
Washington, D.C. 20006
Phone: 202-861-0791 • Fax: 202-861-0790
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Today's problems lie in the basic structure of the euro.

These revelations naturally prompted investors to flee Greek debt. Prior to the upsetting news, the government in Athens could borrow euros at rates only about 1 percentage point above the German rate. But as word got out last spring, that cost of credit rose over 8 percentage points above the German rate. The added borrowing expense so redoubled the pressure on Greece's finances that Athens could no longer sustain the situation. And because Greece's financial failings had already alerted investors to problems elsewhere in the Union—in Ireland, Italy, Portugal, and Spain—the European Union had little choice but to respond. Matters threatened the cohesion of both the common currency and the Union itself.

Even so, governments in Germany and the other, stronger EU economies were reluctant. After an embarrassingly long pause, they managed to cobble together a fund of €750 billion on which Greece and other troubled nations could draw. Members contributed to the fund in proportion to the relative size of their economies, but financing also drew on the International Monetary Fund and the European Central Bank. Any nation that used the fund would become subject to EU oversight to bring its policies back into more prudent lines. As Greece prepared to draw €110 billion, it had to change its retirement rules, the wage schedule of its public employees, and take a number of other painful and unpopular steps to rein in its budget deficit. The arrangement effectively erased Greek sovereignty and made the county theoretically subject to the Union but practically to Germany.

Later in the year, Ireland fell victim to similar financial woes. Irish details differed from Greek, but the outlines of its story were substantively the same. Aggressive policy and overspending had saddled the country with an unmanageable debt load. The Irish, jealous of their sovereignty after years of fighting British control, worried over potential EU policy dictates and resisted help. Eventually, powerful Union members, fearful of the repercussions of Irish failure on Europe's financial markets, and, not incidentally, to their own banks, forced a deal on Dublin. Ireland could draw down some €85 billion from the original fund and had to yield a large measure of policy control, that is sovereignty, to the European Union. By spring 2011, Portugal fell victim to its debt in much the same way as Greece and Ireland. In exchange for access to €78 billion of the fund, it too had to accept EU direction of its finances.

The Irish and then the Portuguese needs convinced the stronger members of the European Union to build stronger safeguards into its rescue fund. They decided that after 2012, the managers of the fund would have to determine if a particular country's problems arose from illiquidity—a temporary shortage of cash, or insolvency—a fundamental flaw in its national finances. In the first case, the fund would advance credit with similar policy strictures to those imposed on Greece, Ireland, and Portugal. In the second case, the rescue would insist that bondholders lose some or all their investment. The Germans insisted on this last piece, they said, to make investors more vigilant about each nation's finances and not count on the rest of the European Union to make good on the loans. They argued, not unreasonably, that wary investors would impose fiscal discipline on those nations that strayed from prudent fiscal policy and sound financial management.

THE PAIN UNAVOIDABLY WILL SPREAD

Now the European Union faces a new round of failure in Greece. Athens has fallen short of the demands of the original rescue. Despite all last year's strictures, the government's budget deficit in 2010 still ran 10.5 percent of GDP, well above the 9.6 percent dictated by the terms of the agreement. Greece projects 2011 deficits at a still-high 9 percent of GDP, lifting its outstanding debt to 160 percent of GDP. Official 2012 projections see deficits at around 8 percent of GDP, also far higher than the initial rescue demanded, while longer-term IMF projections of still-severe Greek deficits have drawn criticism as overly optimistic.

Global credit markets understandably began to behave as if Greece would default. Credit default swaps rose to levels approaching 1,300 points for ten years, raising to a two-thirds probability the implicit expectation of a Greek default. Greece had to pay 15.5 percent on its ten-year bonds and 23 percent on its two-year notes. These outrageous if understandable borrowing costs have compounded the pressure on Greece's already difficult financial circumstances, especially since even at lower borrowing rates, Greece's huge debt overhang had already driven debt service costs to some 6 percent of GDP. In response, the European Union, again after a considerable lag, developed yet another rescue plan, this time one that extended some of the pain to lenders.

Though this latest effort has calmed the worst panic for the moment, it is clear now that Greece is only a small part of the problem. Actually, if Greece were all there was, the EU could manage matters easily. Total

Worse for the European Union, Greece is only a small part of the problem.

Greek public debt amounts only to some €350 billion, a small 1.1 percent of the €31.7 trillion in assets held by euro area financial institutions. What is more, the Greek government could relieve the strain by selling off parts of its remarkably attractive real estate portfolio, which many value at near €280 billion. On balance, then, Europe's financial system could absorb even a complete Greek write-off without much difficulty. The real fear is contagion.

A Greek default would certainly bring more intense speculation of additional defaults in Europe's other weak sisters. Italy's recent problems speak loudly to this matter. There certainly is great financial weakness elsewhere. Ireland is running budget deficits even greater than those of Greece, in excess of 10 percent of GDP in fact, and carries an outstanding debt burden of over 100 percent of GDP. Portugal projects deficits at over 6 percent of GDP and also reports an outstanding debt overhang at over 100 percent of GDP. Though Italy has deficits of only about 4 percent of GDP, its outstanding public debt approaches 120 percent of its GDP. Rating agencies have downgraded many of these countries and put others on downgrade watch lists, while markets already have bid up rates on the debt of all these countries, squeezing their finances still more severely.

The prospect of such widespread failure means that however much the stronger nations of Europe would like to push the cost onto the Greeks and others, there is simply no way they can avoid bearing the burden. The German public may complain, loudly and understandably, that they should not have to work for Greek profligacy, but at base Europe has only four basic options. All are painful.

At one extreme, the European Union could back all Greek debt and commit to similar aid for other weak countries, no doubt imposing stringent conditions on all those that seek such support. Even with help from the International Monetary Fund and the European Central Bank, such an approach would burden the taxpayers of Europe heavily, most notably the Germans. As more nations availed themselves of such support, hundreds of billions could shift from taxpayers to debt holders on behalf of Greece and these other, weaker countries.

Alternatively, the European Union could allow Greece to default outright. Though German citizens might have a greater sense of justice if Greece were driven out of the euro and the European Union, and forced to return to a devalued national currency, they would still not avoid expense. Such a default would undoubtedly lead to contagion that would so threaten the solvency of banks in Germany, France, the Netherlands, and the United Kingdom that these governments would have to mount a rescue of their financial systems much as the United States did during its subprime crisis. Taxpayers would find themselves paying anyway, maybe even more than in a Greek bailout, but in this scenario, directly to their own banks to fill the gap left by the defaulting nations.

Of course, European governments could get tough all round and choose a third way that would refuse support either to the periphery or to their banks. Tax money might not move with such a decision, but the ensuing financial dislocations would still inflict a terrible price on their populations by almost surely precipitating a crippling recession. No doubt, such an ugly prospect, especially the financial destruction involved, explains why the European Central Bank has steadfastly resisted any consideration of Greek default.

There is a fourth alternative, often called a "soft default." The latest plan has elements of this approach.

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Proposals under this heading have multiplied in recent months. Some proposals advocate partial credit support from the European Union, as the United States did with Latin America through the Brady bonds. Others want debt exchanges, some coercive, some voluntary, in which lenders would promise to buy new Greek debt as their current loans mature. Some proposals would relieve immediate cash flow burdens by extending maturities, reducing coupons, maybe giving a payment holiday, or even arranging payments in kind. In one respect, this sort of relief has already begun, since Greece has already extended the maturity of its 2010 EU loans from 3.5 years to 7.5 years. None, of course, end the pain or reduce the cost. They only spread it out over more participants and over a longer time.

Because politics, more than economics and finance, lies behind any decisions, there is no telling how Europe will ultimately move. Germany, despite the anger of its voters, may in the end conclude that a full Greek bailout is the cheapest solution after all. That consideration seems to have motivated Chancellor Merkel's recent more-accommodative stance. But since the status quo is untenable, Europe will have to move, and, as should be clear, the cost, one way or another, will fall on the citizens of Germany and the other rich countries.

IT WAS FOREORDAINED FROM THE BEGINNING

But even if the European Union could devise a best solution on the debt, even if Greece and Ireland or all the nations on Europe's periphery were to swear off their profligate ways, the pressure on Europe and the euro would continue. These were built into the euro's structure from the start. Not only did the rationale for the common currency effectively promote spendthrift behavior in Greece, Ireland, and the rest of Europe's periphery, but its structure put them at a sales and financial disadvantage to Germany.

In today's rush to condemn, people seem to have forgotten how, when gathering nations to join the euro, EU officials actively encouraged borrowing by the smaller, poorer nations. To sell the common currency, they told these nations that the more liquid, stable nature of the euro would enable them to borrow more easily and at lower rates than they could in their own currencies. They pointed out that such reduced borrowing costs would relieve strains on national finances and permit faster development. These arguments recurred as each nation considered joining. In 2007, Iceland's euro advocate, the Kaupthing Bank, made lower credit costs the main selling point. Euro advocates in Britain's Liberal Democratic Party put "lower interest rates" second on its list of twelve reasons for joining the common currency.

Right from the start, then, the common currency gave German producers a sales advantage, and because the low rate of Germany's entry understated German incomes in Europe, it also created a feeling of austerity that encouraged saving.

Remarkably, even Estonia, joining the euro in the midst of the breaking sovereign debt crisis last year, still clung to the argument of cheaper financing costs.

For a while, reality seemed to confirm the claims. Greece, after it joined the euro, could borrow at rates only 0.5–1.0 percentage points above the German rate, a considerable reduction from the spreads of 2.5–3.5 percentage points or more it paid to borrow in its old national currency, the drachma. Ireland, Italy, Portugal, and Spain could make similar comparisons. Though now it is clear that the currency in which debt is denominated affects rates a lot less than the creditworthiness of the borrower, the weaker, poorer countries, while the low-rate fiction lasted, had a powerful inducement to borrow and spend much more than otherwise. Now that the damage is done, the European Union's leadership has suddenly repudiated its old arguments, leaving questions about how many of these smaller, weaker economies would have joined the euro in the first place had they not believed the original false promise.

Of still greater fundamental significance in creating today's mess are the imbalances built into the euro at its creation. When Greece and much of the rest of Europe's periphery joined the euro, they exchanged their national currencies at higher rates than their economic fundamentals of productivity and profitability could justify. In contrast, when Germany joined, it made the exchange at

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a much lower rate than its economic fundamentals demanded. Right from the start, the common currency gave German producers a sales advantage, and because the low rate of Germany's entry understated German incomes in Europe, it also created a feeling of austerity that encouraged saving. The periphery's initial rich exchanges had the opposite effect, imposed a pricing disadvantage on their producers, and by inflating their population's buying power in euros, gave these countries a false sense of wealth that encouraged borrowing, spending, and an easy attitude toward public benefits.

Unless the euro dissolves, Europe's only solution involves a long painful adjustment in the relative economic fundamentals of its periphery.

Precision in measuring such differences is always problematic. The International Monetary Fund does, however, offer a crude gauge in its regular calculation of the difference between existing exchange rates and the rate that would equalize the costs of tradable goods in different countries, what economists call purchasing power parity. When an exchange rate rises above PPP, the country's consumers command an artificially high buying power and the economy's tradable goods become more expensive. When the exchange rate falls below PPP, the opposite is true. These IMF data show that Greece, Spain, and Ireland made their conversion to the euro some 6 percent higher than Germany did, a significant difference right from the start.

Matters only got worse over time. Because the situation encouraged German exports and savings, Germany tended to improve its competitiveness over the years, rendering the original rate at which Germany joined still more advantageous to German exports. In contrast, the lack of savings in the nations of Europe's periphery and their dependence on imports caused them to neglect their productive sides, inducing further deterioration in their competitive abilities and making the original high rate at which they joined the euro even less realistic. By 2009, IMF figures show that Greece's pricing relative to PPP had deteriorated to 12 percent above Germany's, Spain's to more than 20 percent, and Ireland's to fully 32 percent.

To be sure, other factors influenced competitive improvements. Germany faced much more direct pressure from Eastern and Central Europe than did other countries, and that imposed an economic discipline beyond those implicit in exchange considerations. No doubt, preexisting industrial infrastructures or the lack thereof factored into the equation as well. Cultural differences are undeniable, though much popular commentary has shamelessly exaggerated these into crass national stereotypes of hardworking, thrifty northerners, indulgent Mediterraneans, and feckless Irishmen. Such claims not only smack of analytical laziness, they distract discussion from underlying economic and financial issues and resemble little more than dressed up versions of the child's parable of the grasshopper and the ants.

THE WAY FORWARD

If these countries had separate currencies, they would have a reasonably straightforward way out of today's problems. Market pressures would push the Greek drachma down into line with that country's economic fundamentals, lowering the prices of Greek exports and raising those of the German competition, at least to Greeks. Germans at the margin would buy less at home and more from Greece. Greeks would buy more at home and less from Germany. The implied upward valuation of the German deutschemark would raise the buying power of German incomes, raising German inclinations to borrow and spend, while the devalued drachma would have the opposite effect on Greeks. The patterns that have created the crisis would go in reverse and restore a better, if not a perfect balance.

But a single currency renders such adjustments impossible. Unless the euro dissolves, Europe's only solution involves a long painful adjustment in the relative economic fundamentals of its periphery. Greeks, Irish, Italians, Portuguese, and Spaniards have to restrain their economies long enough to create outright deflation, as Ireland is already suffering, or at least to hold inflation rates below those in Germany and other stronger economies in the Union. In time, and sadly with a great deal of unemployment and wealth destruction, relative changes in pricing and incomes would achieve the same result as revaluations and devaluations. It is an ugly prospect for these weaker economies. Stronger countries, too, will suffer extending credit to bridge needs while the adjustments slowly unfold. But it is the bed Europe has made for itself. ◆