Global Economic Insight

Now Only Two Possible Outcomes For The Eurozone

John Greenwood, Chief Economist, Invesco Ltd.

22 May 2012

This document is for Professional Clients only in Continental Europe, Dubai, Ireland, Malta, Isle of Man, Jersey, Guernsey and the UK. This document is not for consumer use.

NOW ONLY TWO POSSIBLE OUTCOMES FOR THE EUROZONE

Last September I argued there were only three possible outcomes for the eurozone crisis: (1) unilateral default and exit by Greece and possibly one or more additional economies, (2) prolonged austerity for most of the crisis economies lasting as much as a decade under conditions set by the troika (the EU, the ECB and the IMF), and (3) a rapid shift to full fiscal union.

It has now become clear, as I argued at the time, that the "solution" proposed by the Euro-area authorities – namely (2), maintenance of the existing membership of the monetary union while imposing tough budgetary constraints and recessions on the crisis economies – was unstable and would not succeed because it would not be accepted for long by Euro-area voters. Either austerity fatigue would develop among southern European voters, or bail-out fatigue would be expressed by the voters of the core.

In recent weeks the collapse of the Dutch government, the results of the French Presidential and German state elections, as well as the outcome of the Greek parliamentary elections have all reflected predictable shifts in voter sentiment away from middle-of-the-road parties towards more extreme parties, both on the left and on the right. The Dutch, German and French results demonstrate differing frustrations in the core, while the Greek results are symptomatic of sentiment across most of the peripherals. In effect the voters are saying solution (2) is no longer viable. In the next few weeks, probably soon after the Greek election scheduled for June 17, the eurozone leaders will be compelled to choose between (1) and (3).

Alexis Tsipras, leader of the radical left Syriza party and potentially Greece's next prime minister, thinks a compromise with the troika is still possible. Quoted in an interview with the Wall Street Journal (May 18) he said that since "a financial collapse in Greece would drag down the rest of the euro zone,...Europe must consider a more growth-oriented policy to arrest Greece's spiraling recession and address...the growing "humanitarian crisis" facing the country." In effect, the terms demanded of Greece are unreasonable and the dangers to the euro of Greek exit are so dangerous, that the creditor nations and the troika will be persuaded to back down.

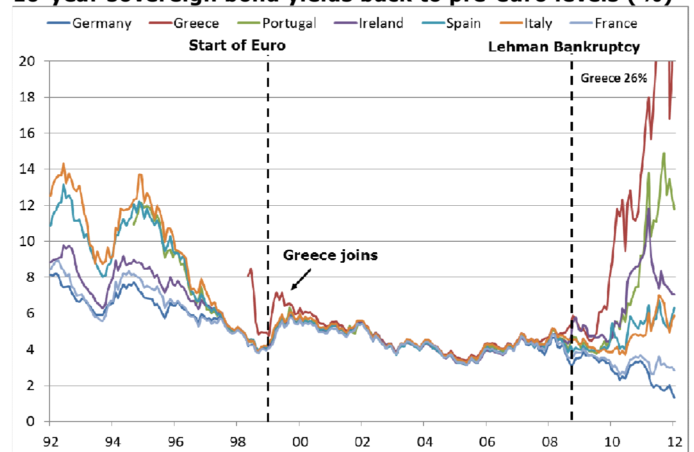
Currently opinion polls show that 75-80% of Greeks wish to remain in the eurozone but they also reject the austerity programme imposed by the troika – a classic case of voters wanting to have their cake and eat it too. But watering down commitments on either side would send a dangerous signal to other member states that such comprehensive agreements between states could never be relied upon. Financial markets would quickly lose confidence, outflows of funds from Greece and other peripheral economies would accelerate, yields on financial instruments would rise even further, and the euro could unravel very quickly.

Effectively that leaves two options: (1) exit and default by Greece, or (3) full fiscal union. We are approaching decision time. Which option will the eurozone take?

HOW TO DEAL WITH THE POSSIBILITY OF EXIT AND DEFAULT BY GREECE

The primary problem with the exit and default option is contagion. If Greece exited the euro, introduced a new drachma and allowed it to depreciate while defaulting on all external debts, the results could be encouraging for Greece, restoring competitiveness and growth in a matter of months. Voters in Portugal and Ireland might then demand to follow, defaulting on their obligations to the troika, with Spain and Italy surely coming under huge pressure to exit also. Strictly speaking these moves would be illegal, but we are dealing with sovereign nations that will act ultimately in what they perceive to be their national interest. If the pain and cost of current commitments are too great, they will pull out, no matter what legal documents have been signed. Ahead of their exits – as we are already seeing in Greece and Spain – there would be runs on the banks in each economy as domestic individual and corporate depositors and foreign institutional lenders sought to protect their funds from any risk of conversion to new drachmas, escudos, punts, pesetas or lire.

10-year sovereign bond yields back to pre-euro levels (%)



Source: Thomson Reuters Datastream as at 18 May 2012.

To avoid such a disastrous firestorm of contagion across the southern member states, the eurozone authorities would urgently need to erect effective firewalls. Faced with this magnitude of crisis in the next few weeks the EU authorities would quickly need to escalate their measures in several steps: (a) initially using the enlarged EFSF/ESM funds to support financial instruments in the affected economies, and possibly enlarging them even more, (b) further expanding the balance sheet of the ECB by provision of potentially several trillion euros to banks, (c) increasing the eurozone deposit insurance scheme beyond the current EUR 100,000, (d) guaranteeing other bank liabilities (as was done in the case of Ireland in September 2008), or, more seriously, (e) imposing temporary capital controls.

In my view, intervention with EFSF or ESM funds could not succeed as they amount to only EUR 700 billion at most, insufficient to cope with the potential problems in Spain or Italy. Moreover, rapid escalation of the ECB's balance sheet would face huge opposition from Germany, Holland and Finland. Again, some of these measures – particularly (b), (d) and (e) – will be regarded as contrary to the spirit or letter of the laws currently governing European institutions, but this would be an existential crisis for the eurozone, and extraordinary times would require exceptional measures.

Let there be no misunderstanding: exit and default would carry grave consequences for financial markets and huge costs in terms of losses to the holders of Greek obligations – larger now

This document is for Professional Clients only in Continental Europe, Dubai, Ireland, Malta, Isle of Man, Jersey, Guernsey and the UK. This document is not for consumer use.

than they would have been a year ago, even after the Greek bond exchange in March – but what is the alternative?

BUILDING A FISCAL UNION

The remaining option is a rapid move to full fiscal union. Only then would the dangers of contagion and financial collapse in some of the peripheral nations be avoided. But full fiscal union implies a substantial move towards central or federal control of eurozone government revenues ***and*** expenditures, and in turn the ability of the federal eurozone government to issue bonds on behalf of ***all*** member states collectively – steps the members have steadfastly refused to embark upon since they all jealously guarded their national (budgetary) sovereignty.

Sadly those of us who in the 1990s opposed the creation of a monetary union without a fiscal union were always dismissed by Europe's elite. At this critical stage it is therefore desirable to spell out just three of the fundamental principles governing monetary unions in the hope that this time they will not be ignored, and the next phase of European monetary union will be built on more secure foundations. None of these principles is new, and to reinforce that point I will illustrate each with a historical example.

LESSONS FROM HISTORY

First, there is a key lesson from a forerunner of European monetary union, namely the ERM or Exchange Rate Mechanism of the late 1980s and early 1990s. From early 1987 the UK Treasury under Nigel Lawson began "shadowing the Deutschemark" with the idea of bringing inflation down in conformity with Germany's successful control of inflation. However, almost as soon as the pound started adhering to the ERM, interest rates in Britain needed to fall, causing credit and money growth to accelerate, and generating a housing boom. The housing bubble burst in 1990-92, and when interest rates started declining, Britain's overvalued exchange rate came under downward pressure as funds fled. In response the government tried raising rates, but to no avail, and was forced to abandon the whole sorry ERM experiment in September 1992. Although still sometimes presented as a failure, Britain's decision to leave the ERM was, in retrospect, possibly one of the best macro-economic decisions of the past two decades because it freed Britain to be able to pursue an independent monetary policy.

The lesson for students of monetary unions was that even economies of comparable per capita income such as Britain and Germany may require independent monetary policies. As a corollary, economies of widely differing per capita incomes (such as Germany and Spain or Germany and Ireland) would face huge difficulties on maintaining monetary stability within a monetary union. All this was well known. Academics and politicians recognise these problems as the "Walters critique" after Alan Walters, who, as Margaret Thatcher's adviser, maintained a continuing battle against the Treasury for its foolish adherence to the policy of pegging the pound to the deutschmark. Yet this knowledge was deliberately ignored in constructing ERM II and later the EMU itself.

The second lesson comes from Hong Kong which, since 1983, has maintained a special kind of fixed exchange rate with the US dollar called a Currency Board under which the HK dollar is essentially a different denomination of the US dollar. To maintain Hong Kong's peg intact for the past 30 years, Hong Kong has followed eight fundamental rules to ensure the robustness of its economy, its public finances, and the balance sheets of its banks, companies and households. The lesson for Europe is that the Maastricht criteria and the later Stability and Growth Pact conditions were hopelessly inadequate measures of whether an economy was performing well enough to maintain membership of a fixed exchange rate system.

The third lesson comes from the early monetary history of the United States, and it concerns the relationship between the fiscal position of the constituent states and the fiscal position of the federal government. It answers the question of whether it is better to set up a monetary union first followed by a fiscal union, or the other way around. Briefly the US created a fiscal union before it formed a monetary union, and it did this in two stages. First, following the War of Independence against Britain, the federal government was weak and indebted whereas the states, though indebted, had sources of revenue. Accordingly in 1790 Alexander Hamilton devised a plan (the "First Report on Public Credit") to bail out the states and pay off foreign creditors using the credit of the federal government in exchange for granting the federal government limited powers to raise revenue in future. State debt was essentially nationalised.

This is exactly where the eurozone is today. A stronger federal government of Europe is needed to absorb the debts of the member states, and to enable the combined states of the Euro-area to be able to raise revenues and authorise expenditures in future, and to issue bonds in the name of the eurozone as a whole in future. If Brussels were to take over the debts of Greece and other struggling peripherals the immediate credit crisis would recede, and Euro-area credit would establish itself alongside US Treasury debt as one of the foremost debt markets in the world.

Note, however, that when there was a slump following the railroad boom of the 1830s numerous US states again became over-indebted, but on this occasion the federal government did not bail them out. Once the federal government had established its good name in the credit markets the failure of individual states did not undermine the federal government's credit standing, and there was no merit in damaging it by bailing out the states. The monetary issues were not finally settled until after the Civil War, but the principles are clear. The US established a fiscal union before a monetary union, and the subsidiarity of states' debts to federal debt was unequivocal from the 1790s onwards.

The Euro-area is not in a position to re-wind the clock, eliminate the monetary union and start afresh with a fiscal union. However, based on these lessons of history a stronger European monetary union can be built over the next decade.

SUMMARY & CONCLUSION

To summarise, first it is a huge mistake to try to combine economies with widely differing per capita incomes, productivity trends, labour markets and social systems into a single monetary union. Booms and busts in the periphery are inevitable, and will unavoidably result in debt crises, banking crises, and balance sheet recessions when the bubbles burst – problems which will be exacerbated both on the upside and on the downside by wider income differentials. All of this will undermine the integrity of the monetary union, especially if there is no strong federal Treasury to counter the weaknesses of the periphery.

Second, having created a monetary union, the rules to be followed to ensure robustness of the member states' finances need to be far more extensive than the three Maastricht criteria or the two Growth and Stability rules. Hong Kong's experience

This document is for Professional Clients only in Continental Europe, Dubai, Ireland, Malta, Isle of Man, Jersey, Guernsey and the UK. This document is not for consumer use.

over the past 30 years provides a much better template. Pretending otherwise is simply to jeopardise the future of the monetary union – just as is happening now.

Third, as Alexander Hamilton accurately foresaw, there needs to be a fiscal union which is contiguous with the monetary union with the powers to tax, borrow and spend in the name of the union. If the federal entity is secure and soundly financed, then at the level of the member states one can enforce a strict no-bail-out rule – something the eurozone has signally failed to do over the past two years. As a result, eurozone capitulation to the need to bail out Greece, Ireland and Portugal has undermined the monetary union, and the risk of contagion to Spain and Italy now threatens its very existence.

To conclude, we have seen that there are now only two options open to the eurozone. Which path will be followed – break-up or full fiscal union? Either way it looks as though we shall know the answer in a matter of weeks.

By John Greenwood, Chief Economist, Invesco Ltd.
22 May 2012

Important information
Where John Greenwood has expressed opinions, they are based on current market conditions and are subject to change without notice. These opinions may differ from those of other Invesco investment professionals.

Issued in **Austria** by Invesco Asset Management Österreich GmbH, Rotenturmstrasse 16-18, A-1010 Wien.

Issued in **Dubai** by Invesco Asset Management Limited, PO Box 506599, Building 5, Level 6, The Gate Precinct, Dubai, United Arab Emirates. Regulated by the Dubai Financial Services Authority.

Issued in **France** by Invesco Asset Management S.A. 18, rue de Londres, F-75009 Paris. Authorised and regulated by the Autorité des marchés financiers in France.

Issued in **Germany** by Invesco Asset Management Deutschland GmbH, An der Welle 5, 60322 Frankfurt am Main. Authorised and regulated by the Bundesanstalt für Finanzdienstleistungsaufsicht.

Issued in **Ireland** by Invesco Global Asset Management Limited, George's Quay House, 43 Townsend Street, Dublin 2, Ireland. Regulated in Ireland by the Central Bank of Ireland.

Issued in the **Isle of Man** by Invesco Global Asset Management Limited, George's Quay House, 43 Townsend Street, Dublin 2, Ireland. Regulated in Ireland by the Central Bank of Ireland.

Issued in **Jersey** and **Guernsey** by Invesco International Limited, 2nd Floor, Orviss House, 17a Queen Street, St Helier, Jersey, JE2 4WD. Regulated by the Jersey Financial Services Commission.

Issued in **Malta** by Invesco Global Asset Management Limited, George's Quay House, 43 Townsend Street, Dublin 2, Ireland. Regulated in Ireland by the Central Bank of Ireland.

Issued in **Switzerland** by Invesco Asset Management (Schweiz) AG, Stockerstrasse 14, CH-8002 Zürich.

Issued in the **UK** by Invesco Asset Management Ltd. Perpetual Park, Perpetual Park Drive, Henley-on-Thames, Oxfordshire RG9 1HH, UK. Authorised and regulated by the Financial Services Authority.