Toolkit for eurozone survival

The eurozone's short-term outlook depends on markets, voters, bureaucrats and politicians. Its longer term future requires radical change. Andrew Smithers considers the conditions that are needed for the eurozone to survive.

Andrew Smithers

Central banks managing a fiat currency must be able to print money. Even under the gold standard, countries had the options of suspension or devaluation. The Bank of Japan, the Bank of England and the Federal Reserve are owned by their governments whose bills and bonds they can buy and sell. They have no credit risk in doing so. They may appear to have a price risk if they buy long-dated bonds, but they are part of the government and, if the activities of government are considered as a whole, no additional risk is being run. Central banks' usual activities are simply part of the overall funding of government debt. Governments can borrow by issuing bonds or printing money, and they can do this directly or via their central banks. The risks being run by the holders of the bonds and the currency are those of devaluation and inflation.

Funding is the usual way in which central banks ensure that short-term interest rates are at the level they desire. They can extend this beyond short-term interest rates by quantitative easing. Depending on which assets they choose to buy, they can flatten the yield curve[1], support the bond or mortgage markets or depress the exchange rate. The result of these activities may improve output or change inflationary expectations and, unlike the usual activities of central banks, they may involve credit and exchange rate risks, but losses can always be financed by printing money.

Need to print money

If there is a European Central Bank (ECB) a decade from now, it will need to be owned by a government that can print and borrow its own currency. In effect, the eurozone will therefore either have to be a country, or a set of currency boards anchored to one country. Hong Kong's pegging of its dollar to the US dollar is an example that could be followed by several countries within the eurozone, with the Deutschemark being the most likely currency to act as the anchor.

There will, of course, be local governments within the eurozone. They will

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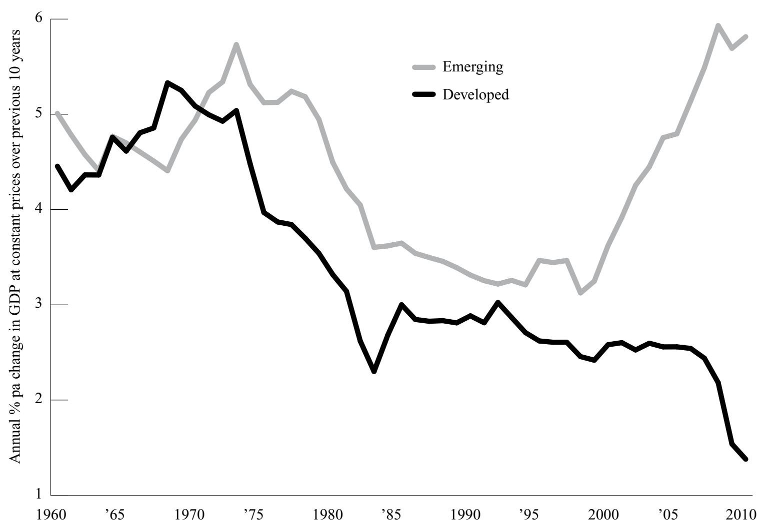
either have their borrowing tightly controlled by the central government, as in the UK today, or will be able to default, as in the US. In the UK's example, the central government has power to step in and run a local authority that fails to control its spending. It is doubtful whether such draconian powers will be wanted by the central government or the member states of any future eurozone. If that is the case, the ability of member states to go bankrupt will, therefore, have to be acknowledged and the pretence that this can be prevented by sanctions will be dropped in practice, even if rules on borrowing remain in place.

With this change will go the pretence that the debts of member states are without credit risk. The ECB must then, for the most part, ignore these debts in its discounting and open market operations. It cannot otherwise avoid putting risks on its balance sheet and thus on its shareholders, who should by then have learnt from experience that this is highly undesirable. They will have grasped the nature of these risks and be unwilling to accept them.

Chart 1: growth rates of developed and emerging economies

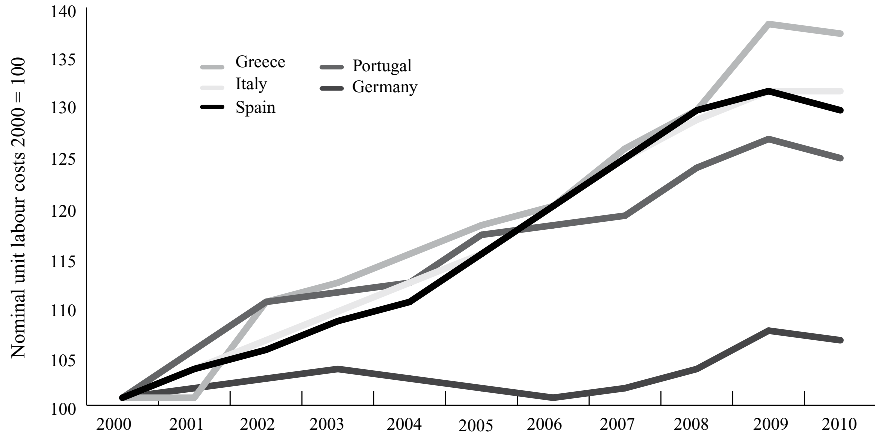


Source: Angus Maddison to 2003 updated from IMF

The rules governing commercial banks will need to change. Only the debts of the eurozone government will qualify as risk-free assets with regard to capital ratios and liquidity. Existing rules will need to be changed. Capital adequacy ratios worldwide are ridiculously low. They expose taxpayers to huge risks and provide massive, unnecessary and foolish subsidies to banks. They will need to be much higher in a decade from now.

Other financial institutions will also need to improve their balance sheets. The external exchange rate of the euro is likely to be left to market forces. It will not necessarily be much different from today relative to dollars, sterling and yen. However, together with these currencies, it needs to fall in real terms to correct the current imbalance between the real exchange rates of the developed and emerging worlds. The former's real exchange rates will also need to keep falling if, as seems overwhelmingly probable, the emerging world continues the recent pattern, shown in Chart 1, of growing much faster than the developing world.[2]

Chart 2: Germany v peripheral belt: relative wage costs

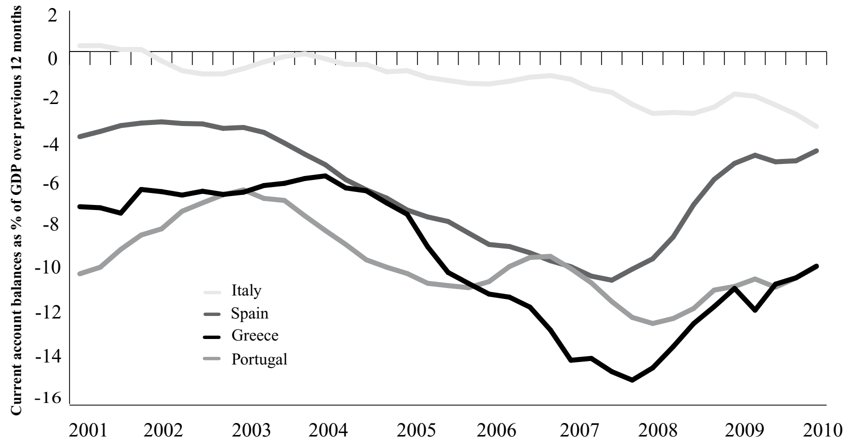


Source: *The Economist*, Novermber 12, 2011

This is a very important constraint on the policies that the developed world, including the eurozone, will be able to follow. The countries of the emerging world are unlikely to countenance either rapid domestic inflation or a rapid rise in their nominal exchange rates. Unless they do so, the necessary downward adjustment of the real exchange rates of the developed countries will require that they have very low inflation rates. As their falling real exchange rates will result in rising prices for internationally traded goods, inflation of domestic services will have to be particularly low.

Very large changes are, however, required in the internal exchange rate of the 'peripheral' vis-à-vis the 'core' belt, since wage costs within the eurozone have, as Chart 2 illustrates, diverged greatly over the past decade. (As shown in Chart 2 the 'peripheral belt' consists of Greece, Italy, Spain and Portugal. The others are referred to as the 'core' countries.) The result has been that these countries have run large and persistent current account deficits despite the recent weakness of domestic demand (see Chart 3).

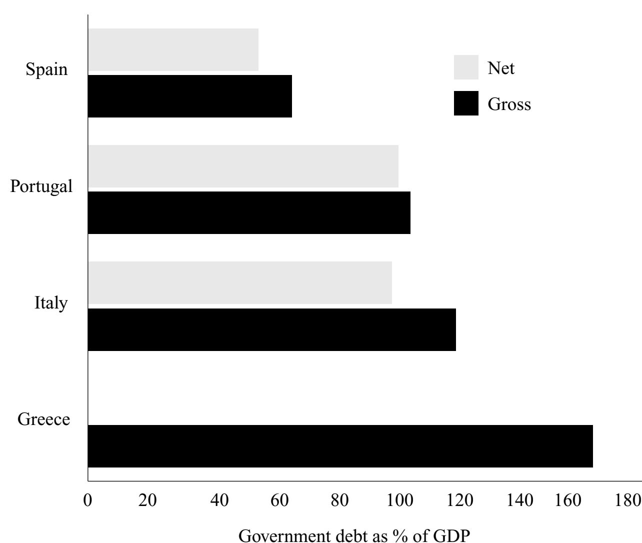
Chart 3: peripheral belt: current accounts



Source: National accounts via Ecowin

The peripheral belt must regain its competitive position against the core belt either by the break-up of the eurozone, or by marked and prolonged relative deflation. As explained above, the eurozone as a whole will need to have very low inflation as part of the fall in the real exchange rate of all developed economies. In the absence of significant inflation in the core belt, adjusting the real exchange rate within the eurozone will require large falls in prices, incomes and nominal GDP in the peripheral belt, which will increase the debt-to-GDP ratios in both the government and private sectors.

Chart 4: peripheral belt: government debt



Source: IMF *Global Stability Review*, September 2011

With the exception of Spain, the peripheral countries have debt-to-GDP ratios of more than 100% (Chart 3). This is – correctly – seen as a problem for those countries that borrow in someone else's currency. Once debt reaches 100% of GDP the interest cost – even for countries trusted by investors – is generally around their growth rates. Debt will then tend to escalate as a proportion of GDP if these countries have a 'primary deficit', that is, a deficit that is calculated before the cost of financing the deficit, which for countries with a debt-to-GDP ratio of 100% means that the government's annual borrowing needs to be less than 2% of GDP, which is less than the current level for all the peripheral belt countries (see Chart 4).

Vulnerable to markets

At this point countries become very vulnerable to market distrust. If, as has recently been the case, the market requires a premium over the perceived risk-free rate, then even at levels of fiscal deficits that would otherwise have been controllable, the debt ratio will escalate.

Government debt is not the only problem. The recent experience of Ireland shows that excessive debt levels in the private sector will rapidly spill over into the public sector. Countries offset the impact of massive bankruptcies by running large budget deficits and taking much of the private sector debt onto their own balance sheets, particularly where this debt is intermediated through the banks. In 2007, Ireland had a government debt of 29% of GDP and a surplus of government

revenue over expenditure. Nonetheless, its debt ratio has risen to 120% of GDP, not because of a profligate public sector, but because it was perceived, perhaps correctly, to be necessary to prevent a collapse of the economy, given the debt level of the private sector.

Private sector debts are particularly high in Spain, as Table 1 illustrates. As a result Spain may be just as vulnerable as Italy, even though its national debt is much lower (Chart 4). Should Italy seek to restore its competitive position by deflation rather than denomination, it will raise its ratio of government debt-to-GDP, which is already dangerously high. In the case of Spain, the key problem would be that corporate debt, both financial and non-financial, together with household debt, would rise relative to the nominal value of incomes and output and these ratios are already dangerously high.

Table 1: debt ratios of peripheral belt as % of GDP

	Households	Non-financial Corporations	Financial Institutions	External Liabilities
Greece	71	74	22	202
Italy	50	110	96	140
Portugal	106	149	61	284
Spain	87	192	111	212

Source: *IMF Global Stability Review,* September, 2011

Deflation is currently needed in peripheral countries to adjust real exchange rates within the eurozone. This is already causing pain and, with further deflation and its accompanying reduction in incomes, output and employment, may become unacceptable. Meanwhile, the central banks of the eurozone are accepting the credit risk that comes from deposits shifting from peripheral to core countries. The contingent losses will crystallise should deflation be rejected in favour of default and redenomination.

As Chart 5 shows, unemployment in Spain is already above 21% and the rising risks of default and redenomination that fall on the banks and central banks are causing concern in financial markets. They are seen to be increasing the risks even for core belt countries, such as France.

Mistakes in execution

The changes that will be involved in default and redenomination will provide great scope for mistakes in their execution. For example, governments will have to declare that the debts of private sector entities have been redenominated at the same time as wages, prices and other contracts. They will need to do so overnight. It is also better that they should do so quickly as delay is aggravating the problem. Those who have deposits in peripheral zone banks are shifting them to banks in other countries. When governments declare that debts have been redenominated this will have to extend to both sides of the balance sheets of financial institutions, so depositors with Greek banks will lose money, just as the debtors of Greek banks will have the value of their debts fall.[3]

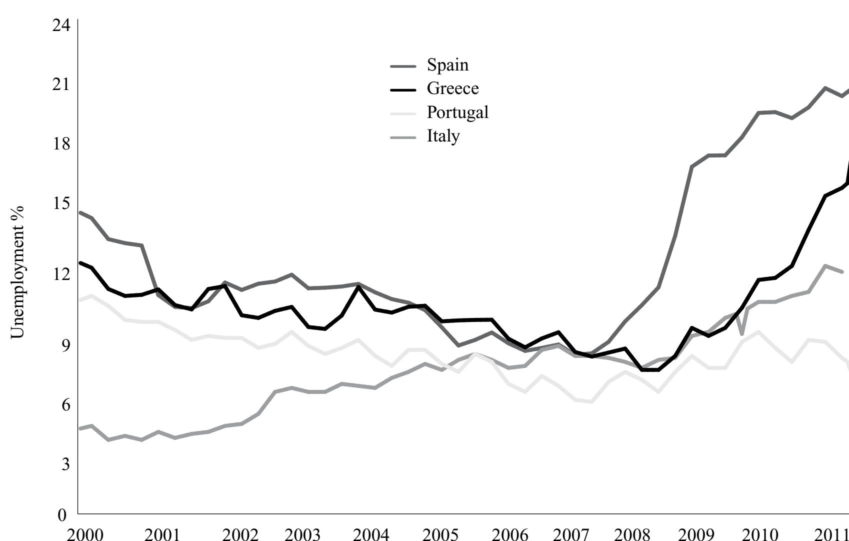
A key question is whether this will apply to the deposits of Greek citizens with non-Greek banks. Either way, the decision will cause uproar. It seems likely that Greeks with assets in foreign banks will become richer than those who left their

deposits at home. Any profits made by those who have transferred their deposits from peripheral to core banks will have their offsetting losses. For the most part, this seems likely to fall on the central banks and thus, ultimately, the taxpayers of the core belt countries.[4]

A refusal to continue this intermediation is unlikely as it would precipitate a disorderly break-up. The peripheral banks would be unable to meet depositors seeking to withdraw funds and their governments would be forced to announce a redenomination of their currencies. Massive losses seem likely to arise from the transfers of deposits and, so long as the redenomination of currencies is delayed, the liability will mount.

Under current conditions, moving a deposit from a peripheral bank to a core bank looks like a form of free insurance. Once made, the move is unlikely to be reversed. We cannot see how this can continue, but as long as it does and is followed by redenomination, the process will affect a large and increasing transfer of wealth from the core to the peripheral belt, as the main losses will fall effectively on the former's taxpayers.

Chart 5: peripheral belt: unemployment



Source: IMF *Global Stability Review*, September 2011

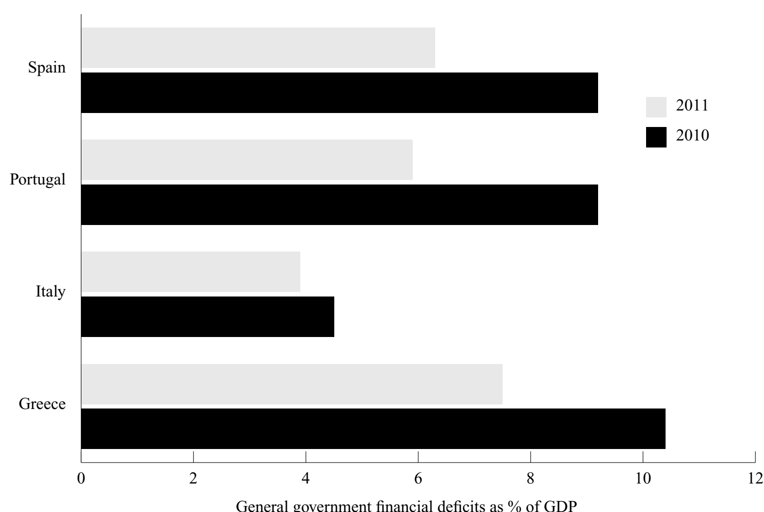
Looking ahead, the following outcomes seem likely. There will either be a eurozone with a central government, though perhaps a smaller one than today, or no eurozone at all. Extensive defaults will have occurred in the euro debts of countries in the peripheral belt and private sector debts will be redenominated in new currencies. Large amounts of new equity will have been raised, particularly for banks, but more widely as part of bankruptcy arrangements, which could require the payment of dividends and bank bonuses or even salaries in shares, rather than cash.

While these seem to me to be the likely outcome, it is possible that the eurozone will survive with all its current members. Many people, bureaucrats and politicians hope that this will be the result, but the policies necessary to achieve this result are not yet in place.

One key problem is that the need for fiscal union seems to be confused with

fiscal austerity. The apparent plan is to limit the ability of member states to run fiscal deficits. At the moment this appears more like a wish than a policy. As Chart 6 shows, it will be extremely difficult to bring down current deficits to the near-zero levels that are needed. But, even if it were to prove possible, it would not render the debts of member countries as risk-free assets that the ECB could buy and sell to control interest rates. As pointed out above, the experience of Ireland shows that private sector debts can precipitate a dramatic rise in government debt ratios, even if a country is running a budget surplus.

Chart 6: peripheral belt: fiscal deficits



Source: National accounts via Ecowin

It is, of course, possible that an agreement to limit budget deficits will buy time and bond markets will respond by keeping interest rates at less than 7%, which seems to have become accepted in a rather biblical manner as the key number. Banks could be persuaded to buy bonds in the market and, with large-scale finance provided by the ECB to fund their purchases, banks would make large profits so long as the game continues. But the game will involve huge and rising risks, which fall on the governments that guarantee the deposits of their banks.

Vestigial capital ratios

It is unlikely that anywhere in the world banks are sufficiently well capitalised to be able to raise money from depositors without the implicit or explicit guarantees of governments. According to Roland Vaubel, professor of economics at the University of Mannheim, Deutsche Bank had an equity-to-total assets ratio of 30% in 1929 and still needed bailing out by the German government within three years. Banks today are required to have only vestigial capital ratios and survive on government guarantees. If these guarantees are believable, they do not need any equity but, if the guarantees were to become questioned, they would need multiples of their current equity capital. But the guarantees that governments give to banks are no better than those they give to their bondholders and the returns that peripheral banks offer to depositors are no better than those offered by German banks. As long as the present system remains unreformed, depositors will switch and the liabilities of German taxpayers will mount.

It seems reasonable to assume that German taxpayers will be unwilling to assume all the risks that would devolve upon them if all the deposits within the eurozone should become deposits of German banks. Some longer term reform of the current system thus seems inevitable and essential, and it will involve the recognition that fiscal union, not just fiscal austerity, is essential if the eurozone is to remain intact.

If we now have a period during which the sense of crisis relaxes, it will provide the opportunity for moves towards long-term solutions, with steps towards real fiscal union and the refinancing and reform of the eurozone's banks being the most important. Judging from their performance so far, it seems unlikely the eurozone's bureaucrats and politicians will take advantage of any breathing space. Ever since the financial crisis started, the eurozone's leaders have responded with denial rather than reform, with denial taking the usual form of blaming messengers and bystanders.

In the discussions over Basel III, the French and Germans fought hard, and with much success, to prevent serious reform of banks' capital requirements. They then sought to blame and regulate hedge funds, which came through the crisis without causing trouble, rather than the banks, which caused a lot.

The next step in this history of folly was when Michel Barnier, the European Commissioner for the Single Market, announced that the UK should not require banks to have better balance sheets than those in the eurozone, to the opposition and disdain of the Bank of England.[5] He followed this with the absurd claim that eurozone banks were well financed and a ridiculous statement that credit agencies should not be allowed to comment on sovereign risks. The next idea was the Tobin tax, which was seen as another example of attacking the innocent bystander – in this case the City of London. Finally, we had the French finance minister and governor of the Bank of France appearing to call on the credit agencies to downgrade UK government debt.

These events are sure to have made even the most uncritical enthusiast for the European ideal suffer considerable unease about the ability of the eurozone's leaders to accept the reality of the problems and to deal with them sensibly. ❑

Notes

1. The Federal Reserve's 'operation twist' has had little impact on flattening the yield curve, which suggests that the ability to do this may be limited.
2. The following 19 countries are included as in the developed world: Australia, Belgium, Canada, Denmark, Finland, France, Germany, Ireland, Italy, Japan, Netherlands, New Zealand, Norway, South Africa, Spain, Sweden, Switzerland, UK and US. They currently account for 40% of world GDP. Economic theory, which has been robust in practice, requires that rapidly growing economies will have rising real exchange rates compared with those that grow more slowly (the Balassa-Samuelson effect).
3. We assume here and later that the value of the currencies exiting the eurozone will fall relative to the euro.
4. The ECB does not intermediate payments between eurozone countries. Funds are transferred directly through the Target 2 payment system, with national central banks (NCBs) automatically providing the necessary liquidity. On the latest available data the Bundesbank provides the vast majority of the necessary liquidity to the Banque de France and the periphery NCBs. However, this 'residual risk' as it is called by the ECB, is shared by all NCBs in proportion to their shares of the ECB's capital.
5. The Bank of England's discussion paper of December 2011, *Instruments of Macroprudential Policy,* remarked: "The rationale for maximum standards is not clear… the approach risked impeding its ability to meet its proposed statutory objective. It urged HM Treasury… to alter the course of European legislation in this area…"