



SNAPSHOT

- It's the ECB or bust. We need a quantitative 'euro-zing'.
- Unless the ECB begins to operate a sovereign lender of the last resort (LOLR) function, with massive purchases of euro-zone public debt, the inexorable logic is that the euro-zone will break up.
- Back-door 'lender of last resort' lending to banks is very unlikely to make them purchase large amounts of toxic sovereign debt, given the balance sheet risk.
- There is a systemic hole at the heart of the euro. Member nations don't control the currency in which they issue their debt.
- The situation is now so bad that financial markets are willing a negative economic shock to force the ECB to become sovereign LOLR.
- Proposals for 'fiskalunion' are too little, too late and miss the structural problem.
- The euro-zone has three big gaps – a gaping hole in its original structure, a GDP-debt interest divide which looks like it could get worse not better, and a north-south competitive misalignment.
- All the 'Club Med' economies could be out of the euro-zone by the summer – just in time for some very cheap holidays.

'This sucker is going down'

IoD Chief Economist Graeme Leach examines the past, present and future of the euro crisis.

INTRODUCTION

"This sucker is going down." Those were the words attributed to President George W. Bush at the height of the financial storm in 2008. They signified his fear at the scale of downside risk to the economy.

The purpose of this paper is to show just how apposite those words are to the current euro crisis and the prospects for a break-up of the single currency. Three years after the first 'once in a generation' financial crisis, we may now be entering the end game for a euro of 17 countries.

"Events on the continent have come to feel much like the drift into war." Those weren't the errant words of Jeremy Clarkson on *The One Show*. They were the words of Jeremy Warner in *The Daily Telegraph* – a journalist who has been on top of this crisis throughout.

Obviously Warner isn't forecasting a real shooting war – he's merely highlighting the sense of drift and how it will lead inexorably towards further economic conflict. Warner states that:

"There is a feeling of powerless inevitability about it. Crisis summits come and go with no resolution in sight, but there's always the next one to set the world to rights, though we all know in truth that it won't."

In the recent pre-Christmas instalment to the saga, we were told following the EU summit that politicians had finally grasped the nettle. Chancellor Merkel and President Sarkozy agreed a 'shock and awe' strategy with treaty changes to usher in a fiscal union. In return for this 'Grand European Bargain' or 'Fiscal Compact', there was also the hint of massive intervention by the European Central Bank (ECB) to roll out the printing press and buy Italian, Spanish and other euro-zone bonds.

Forgive me for being sceptical, but that sounds like 'peace in our time'. Or, to take a more recent example, the last few weeks before the UK exited the ERM. We all knew what was coming. As economist Roger Bootle has written, "trying to keep the euro going is like trying to breathe life into a corpse".

Watching the euro crisis unfold I'm reminded of President Clinton's political adviser, James Carville, who, during budget negotiations in the early 1990s, announced that in the next life he wanted to be "the bond market" because it was the most powerful force on Earth. Wonderful EU political assurances aren't worth a cent if they don't change the fundamentals. It's what the bond market thinks, not what politicians say, which matters.

BOX 1

It's only a 'Relief Rally'

Financial markets rallied in December 2011 in the wake of a number of events in close proximity, which helped create a wave of relief that politicians were finally getting to grips with the crisis:

- Coordinated liquidity injections by global central banks – to provide favourable dollar swap facilities to euro-zone commercial banks, following the exit of US money market funds.
- New prime ministers in Italy, Spain and Greece pushing through austerity packages.
- Proposed treaty changes towards fiscal union – to impose automatic sanctions on euro-zone countries running a deficit above 3% of GDP – allowing the European Court of Justice (ECJ) to judge if fiscal rules were being met.
- Assurances from Chancellor Merkel and President Sarkozy that private bond-holders would not face any more losses in future bail-outs.

But the relief rally couldn't be sustained in early 2012:

- In January the ratings agency Standard & Poor's downgraded nine euro-zone economies, including France, which lost its triple-A rating.
- At the time of writing, talks had also stalled over the size of 'haircuts' to be taken by bondholders, increasing the probability of a Greek default.
- Close analysis of the German-orientated 'fiskalunion' proposals showed them to be little more than an enhanced Stability and Growth Pact. Early 2012 reports also suggest a watering down of the proposed fiscal rules, allowing countries temporarily to deviate and with weaker enforcement.
- Doubt as to whether the ECB would ever be given the authorisation to buy bonds.

So let's get back to basics on the euro crisis:

- *How did the euro-zone get into this mess?*
- *What does this tell us about the way out of the crisis?*
- *Will the euro-zone tear itself apart?*

HOW DID THE EURO-ZONE GET INTO THIS MESS?

I think there are four reasons, all interrelated:

1. RISK ASSESSMENT

In the wake of the 2008-09 crisis, global financial markets have undergone a fundamental re-appraisal of risk. Financial eyes have swept the globe and their attention has been caught by the 'Club Med' economies. And the more they focused on economies such as Greece, the wider long-term interest rate spreads have become. There is a debate to be had as to whether financial markets have overshot – under-pricing risk during the previous age of affluence and over-pricing it during the current age of austerity. But we are where we are. Advanced economy sovereign debt is now seen as far from risk free.¹

¹ Of course, it could also be said that the introduction of quantitative easing in the UK has encouraged financial markets to overshoot the price of risk downwards as well, with a bond bubble – which will have to be carefully deflated when QE is eventually reversed.

2. STRUCTURAL FRAGILITY AND FAILURE

The focus here is the original construction of the single currency. Financial market turmoil has encouraged many participants to dust off their economic textbooks and remind themselves of all the doubts voiced at the outset as to the euro-zone's ability to meet the criteria for an optimal currency area and stability.

These doubts included:

- *No sovereign lender of the last resort role for the ECB (only a banking lender of the last resort role).*
- *Euro-zone countries having no control over the currency in which they issue their debt. Only a country with its own currency can guarantee no public debt default (and then only in nominal terms).*
- *The vulnerability of monetary unions to liquidity and solvency crises.*
- *One-size-fits-all creating destabilising imbalances, e.g. housing market cycles.*
- *National political opposition to fiscal transfers across borders.*
- *No example in history of a lasting currency union without a political union.*
- *Cultural and linguistic barriers to labour market mobility.*
- *No devaluation option – a Club Med historic need – and the implication that this would require 'internal devaluation', i.e. nominal wage reductions.*
- *No guarantee against long-term interest rate spreads widening within a single currency.*

Financial markets have zoomed in on the root of the problem – the first three bullet points above. The primary structural failure at the heart of the euro-crisis is the absence of a sovereign lender of the last resort function for the ECB and the fact that euro-zone economies have no control over the currency in which they issue their debt. This may sound bland but it is helping create the mother of all crises.

The structural gap has been described as “the pain of original sin”.² And without a change in the ECB's role, there will be no salvation from a superior force of last resort.

In the post-financial crisis world, market sentiment has shifted and liquidity outflows (triggered by deteriorating economic news of public finances) have set in motion what Europe's leading academic of monetary union, Professor Paul De Grauwe, calls: “A devilish interaction between liquidity and insolvency”.³

How does the liquidity and insolvency interaction work?

A loss of confidence in Country A pushes money out towards a safe haven in Country B. As a result, the money supply contracts in Country A, creating a liquidity crisis if the government and banks can't roll over debt.⁴ Bond rates rise further and this creates an insolvency crisis with the government unable to service its debt.

“A primary structural failure at the heart of the euro crisis is the absence of a sovereign LOLR function for the ECB.”

² “The Pain of Original Sin”, in B. Eichengreen & R. Hausmann (eds.), *Other people's money: Debt denomination and Financial Instability in Emerging Market Economies*, Chicago University Press, 2005.

³ Paul De Grauwe, *Only a more active ECB can solve the euro crisis*, CEPS Policy Brief 250, August 2011.

⁴ Contrast this with a country such as the UK, which can always print money through the Bank of England to service its debt and therefore avoids the initial exit of funds creating a liquidity crisis. The Bank of England could – if directed – enter the market and purchase gilts, reversing any spike in yields. It has potentially unlimited capacity to print money and purchase gilts, or other assets. Investors cannot precipitate a liquidity crisis in the UK, which would force the UK government into default.



The core problem here is self-fulfilling prophecy (which could be justified): a country becomes insolvent because investors fear insolvency. The more fear increases, the more money exits and interest rates rise, further embedding the belief that a default will occur. Unfortunately, it gets worse.

In a monetary union financial markets are highly integrated and government bonds of member countries are often held in large quantities outside the country of issue. As has been seen, this can create spill-over effects in other member economies. And that's not the end of the process.

Higher bond yields clearly entail lower bond prices. This results in large losses for the holders of such debt, particularly banks, resulting in large losses on their balance sheets. This intertwines with the previous liquidity squeeze making it difficult for banks to roll over debt and, hey presto, a sovereign debt crisis morphs into a full-blown banking crisis as well.

Throw in the fact that euro-zone banks are probably still sitting on hundreds of billions of euros of unreported sub-prime related losses and the euro-zone interbank market looks like it does today. Paul de Grauwe concludes that:

"There is a need for a fundamental overhaul of the euro-zone's institutions. It is essential that the ECB take on the full responsibility of lender of last resort in the government bond markets of the euro-zone. Without this guarantee, the government bond markets in the euro-zone cannot be stabilised and crises will remain endemic."

This analysis helps provide an explanation as to why a country such as Spain, with a lower public debt-to-GDP ratio than the UK, can experience a liquidity squeeze and rising bond yield spreads.

3. DEBT DYNAMICS

This influence centres on some very simple algebra. If the rate of interest on public debt exceeds the GDP growth rate, the government has to run a primary surplus in order to prevent an exponential rise in the debt to GDP ratio:

$$(r - g) \text{ Public debt/GDP} = \text{Primary surplus/GDP}$$

If you begin to play with this equation and plug in realistic numbers for interest rates and GDP growth, you very quickly lose confidence in the ability of EU politicians to run significant primary surpluses on the scale required (and on a permanent basis) to stabilise the overall debt-to-GDP ratio.

The message is clear. Governments with existing debt will need to run primary surpluses at some point in the future to keep the debt-to-GDP ratio from exploding. It's easy to see how investors can become fearful in such an environment.

Demographics compound the fiscal outlook

Related to the GDP-debt interest divide is the future burden of an ageing population and a growing realisation that something previously perceived as an over-the-horizon event was actually just around the corner.

The ageing population poses huge challenges to public finances across the globe, but in the EU they are particularly acute. In many EU economies working populations are projected to decline over coming decades, placing an ever-greater burden on the existing workforce. If the labour supply is contracting, economies need a faster rate of productivity growth in order to make up for the lost output.

But if productivity can't be improved, the tax burden will have to edge ever higher in order to pay for the costs of an ageing population. An ever-higher tax burden also erodes the incentive to work, save and invest, simultaneously undermining, not improving, productivity and GDP growth. It's not called the death spiral for nothing!

Mind the gaps

We've already examined two big gaps at the heart of the euro crisis – a gaping hole in its original structure and a GDP-debt interest divide which looks like it could get worse not better. We'll now examine the third gap, and the fourth explanation of how the euro-zone got into the current mess.

4. COMPETITIVENESS

When the Club Med economies joined the euro they essentially received German interest rates – something inconceivable beforehand. The implicit deal was that in return for the GDP growth dividend from lower interest rates (and the political cover this provided), these economies would undertake the structural reforms necessary to remain competitive in a single currency where the old option of devaluation was no longer available. Instead, the Club Meds took the easy road – little or no reform – and this resulted in a huge deterioration in competitiveness against Germany. There is a 20-30% north-south currency misalignment within the euro-zone.

This loss of competitiveness is so great that questions about the ability of these economies to remain within the euro would have arisen regardless of the financial crisis. The financial crisis merely brought forward the day of reckoning.

Bond markets have interpreted this process quite simply. If EU politicians can't take difficult decisions when they're under little political pressure, how on earth can we expect them to take tough decisions when they're under intense pressure not to?

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“Three years ago governments were able to be part of the rescue force. Three years on, many of these governments need rescuing themselves.”

WHAT DOES THIS TELL US ABOUT THE WAY OUT OF THE CRISIS?

The key conclusion here is quite simple. There is no route out of this crisis which does not involve very serious economic and political pain. Moreover, the 2011-12 crisis has one fundamental difference with that of 2008-09. Three years ago governments were able to ride over the hill and be part of the rescue force. Three years on, many of these governments need rescuing themselves. And far too many euro-zone banks are in deep trouble, over-leveraged and in a far worse state than the headline stress tests suggest.

We are now at a fork in the road, faced with five potential exit routes ahead:

- **Route 1** – full political union with a common budget, automatic fiscal transfers, consolidated national budgets into a supra-national one, with the federal government achieving the status of ‘stand alone’ countries issuing debt in a currency they control. This is obviously politically impossible so we’ll leave it there.
- **Route 2** – banking solutions – ‘haircuts’ and recapitalisations.
- **Route 3** – fiscal solutions involving debt purchase and loans, e.g. the European Financial Stability Facility (EFSF), Eurobonds and calls for a fiscal union.
- **Route 4** – monetary solutions involving ECB lender of the last resort facilities to financial institutions (injections of liquidity) up to lender of the last resort facilities for sovereigns (potentially printing money on a vast scale to purchase government debt). Variants on this government debt model, to provide political cover in Germany, might include an ECB guarantee of a maximum interest rate spread.
- **Route 5** – the euro-zone begins to break apart as economies choose the devaluation option and the ability to guarantee they won’t default on future (non-euro-denominated) public debt, due to their ability to print national currency.

Route 2 does not look good. Euro-zone banks have enormous unreported sub-prime losses, without a doubt. But a massive recapitalisation of the banking system, funded by the non-bank private sector, is the last thing we need right now.

The public sector has no money to fund a recapitalisation and if the non-bank private sector could be persuaded to fund it – a somewhat big ‘if’ but let’s leave that aside – the negative impact on the money supply could be devastating. Right now we need a massive recapitalisation like a hole in the head.

What about Route 3? That doesn’t look good either. Sovereigns either have no fiscal leverage (they’re in the middle of the debt storm already, e.g. Italy & Greece) or no fiscal manoeuvre (they have some fiscal leverage but it’s inadequate and they have no political mandate, e.g. Germany).

There is much talk of fiskalunion, but don’t get your hopes up. It’s an asymmetrical concept. To the Germans it means increased powers to police the budgets of sinner states, prior vetting of budgets, automatic fines, mandatory cuts in EU funds and loss of EU voting rights. But, as we have seen, the proposals fall short of this. It does not mean joint debt issuance, Eurobonds or fiscal transfers. The French view of fiscal



union, limited intrusion and a German blank cheque book, simply isn't going to happen.

Chancellor Merkel is boxed in by German public opinion and German Constitutional Court rulings in September. Chief Justice Andreas Vosskuhle stated:

"The sovereignty of the German state is inviolate and anchored in perpetuity by the Basic Law...there is little leeway left for giving up core powers to the EU. If one wants to go beyond this limit...then Germany must give itself a new constitution."

And Chancellor Merkel has stated in strong terms that joint liability is not possible, ruling out Eurobonds and fiscal transfers. Regardless, events have moved on too far for the fiscal option to be credible. Many of the countries which contribute to the EFSF need a bail-out themselves, forcing an ever greater (and politically impossible) burden on other countries.

But could proposals for sweeping losses in fiscal sovereignty ever work in practice? Will national electorates accept binding rules from Brussels? I doubt it. The democratic deficit in the EU is already stretched to breaking point.

What we've seen on the streets of Athens would pale against future political unrest. There is a natural reluctance to riot against your own government but there are few constraints when it's a foreign power. Athens, Rome, Madrid, Lisbon...Dublin? And a number of euro-zone economies would surely revolt at having to submit to Brussels control when their fiscal circumstances would not appear to justify external intervention.

So we're back to Route 4 and the monetary options look just as bad because, as we have seen, unlike the Bank of England or the Federal Reserve the ECB is prevented from operating a lender of the last resort facility for sovereign debt.



This touches a deeply sensitive point in the German psyche. Printing money is associated with hyperinflation, the collapse of the Weimar Republic and the rise of Hitler.

There is a German *nein* to both fiscal and monetary solutions. Understandably, the Germans don't want to write a big cheque or print lots of money. From a German perspective the question is that, once the ECB has lost its virginity printing money, just how promiscuous could it become?

On this issue I agree with Nobel Prize-winning economist Paul Krugman that: "It's ECB or bust". We need a quantitative 'euro-zing'.

Consequently we are left in the unusual situation of waiting for some form of catastrophic event to change Germany's mind. Is there some way of persuading Germany to sanction massive quantitative easing across the euro-zone?

The ECB has already purchased hundreds of billions of sovereign debt. It has justified this by saying it was through the secondary market and the ECB has also engaged in considerable sterilisation of these purchases to neutralise the impact on the money supply. But even if we assume German political opposition can be overcome – another very big 'if' – there remain huge obstacles.

The ECB's balance sheet is already shot to pieces. It's massively over-leveraged and will look in horror at any attempt hugely to expand its balance sheet with assets of dubious quality. Wiping out the equity of a central bank is very different to that of a commercial bank and so this isn't a fundamental obstacle, but again, it would fire up German angst about a loss of control.

A benign outcome is possible, the ECB's role could be expanded, but I don't think it's probable. Financial markets expect the ECB to peer over into the abyss and make a fundamental change, for fear of the alternative. But what if the Germans really do mean *nein* when they say it?

Some say that the ECB introduced a game-changer in December. Its decision to offer unlimited three-year loans at 1% isn't a game-changer in our view, but it's the closest we've come to one throughout this crisis. ECB President Mario Draghi didn't walk outside his front door and shout that he would operate a lender of last resort role for sovereign debt. That was never going to happen. Instead he walked out the back door to signal that the ECB will use its lender of last resort role for banks.

The IoD has consistently argued that direct ECB sovereign debt purchase is the route out of the crisis, but the indirect route shouldn't be dismissed. Borrowing at 1% and investing in peripheral euro-zone debt at 6% is a very profitable carry trade. The question is: will it work? Euro-zone banks,

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with their balance sheets in an almighty mess, will be equally aware of the risk that they can lose even more money if the value of these bonds falls.

Euro-zone banks are engaged in massive de-leveraging and need to roll over more than €700bn in funding this year. In such circumstances it is not obvious that they would use any money from the ECB to purchase high-risk sovereign debt. The thought that they might rallied financial markets before Christmas, but we have great doubts that these funds will pour into public debt. Back-door quantitative easing won't work, in our view, because the banks will hoard the ECB cash.

WILL THE EURO-ZONE TEAR ITSELF APART?

The structural hole and the liquidity-solvency issues at the heart of the euro crisis are very likely to bring the Club Med economies (and maybe others as well) to the point where they deem it in the national interest to exit the euro. But whilst they may be drawn by the benefits of devaluation and the ability to print their own money, they will also be alarmed by the immediate economic, political and practical consequences.

A euro-zone break-up would be a ghastly affair of chaos and confusion:

- *Bank runs;*
- *Contagion in the interbank market;*
- *Forcible redenomination of deposits;*
- *Collapsing 'new' Club Med currencies and soaring inflation;*
- *Collapsing EU output;*
- *ATMs unable to operate, financial software issues;*
- *Massive contractual disputes.*

Faced with these challenges, would the 'exiters' have second thoughts? They probably would, but if the alternative is draconian fiscal measures, large interest rate spreads and pressures for internal devaluation (nominal wage reduction), the implosive initial impact could be traded for explosive future prospects – a very deep V-shaped cycle. But there is an issue here as to the nature of the tipping point for exit and what would finally push a country into leaving.

Over recent months many economic reports have been pushed around the City suggesting potential GDP collapses of 20-30%, even 40-50% in some worst-case scenarios, for the exiting economies. These are completely speculative numbers, probably somewhat wide of the mark, but the financial market contagion risks are enormous and explain why the Governor of the Bank of England has been about as blunt, direct and plain scary as he could be.

The final issue is timing and, like the Governor, I have a problem at present forecasting tomorrow, let alone next week, month or year. Nobody knows. But it's looking much more sooner than later. If it happens I think it will happen in the next six months. All the Club Med economies could be out of the euro-zone by summer – just in time for some very cheap holidays.

This article updates the December 2011 edition of Pulse, the IoD's monthly report on the UK's economic outlook.