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Can the Euro Survive?

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ABOUT THE AUTHOR

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EXECUTIVE SUMMARY

- The Euro confronts an existential challenge as a sovereign debt crisis rages across Greece, Ireland, Portugal, and Spain. In May 2010, this crisis forced the European Commission to abandon its earlier "no bail out" policy and to establish, together with the IMF, a massive safety net for the European periphery. Despite this safety net, by end-November 2010 markets demanded record high interest rates on the European periphery's sovereign debt.

- Failure over many years of the Eurozone's members to play by the budget rules of the Stability and Growth Pact makes a sovereign debt default of at least one of the peripheral countries almost inevitable. A default by any member country is more than likely to trigger contagion to the rest of the periphery and to lead to the eventual exit from the Euro of Greece, Ireland, Portugal, and Spain.

- The essence of the periphery's present economic predicament is that the countries in the periphery have all run up very large internal and external imbalances. These imbalances will be extraordinarily difficult to correct within the Euro-zone straitjacket. Since, within that straitjacket, these countries cannot resort to currency devaluation either to restore competitiveness or to boost exports as a cushion to offset the highly negative impact on their economies from major fiscal retrenchment.

- The major part of the periphery's budget deficits constitutes "primary" or non-interest payment transactions. As such, even a far-reaching debt restructuring can at best be viewed as a partial solution to the periphery's budget problems in the sense that it will not obviate the need for further substantial budget retrenchment. Countries in the periphery might do well to consider the advantages of an early exit from the Euro, which might facilitate the needed fiscal adjustment without provoking the deepest of domestic economic recessions.

- Although Europe's peripheral economies are relatively small in size, their overall public and private sector debt is large. A substantial portion of that debt sits on the balance sheets of West Europe's banking system. As such, the present debt crisis in the European periphery has the potential to precipitate a major European banking crisis that would almost certainly reverberate throughout the global financial system. It would do so in much the same way as the 2008 sub-prime crisis in the United States precipitated a global banking crisis.

- The Eurozone's periphery has more of a solvency problem than a liquidity problem. It has a solvency problem in the sense that, absent a debt restructuring and an exit from the Euro, the correction of the periphery's public finances cannot be achieved without provoking the deepest and most prolonged of domestic economic recessions. Papering over these solvency issues by simply advancing these countries large amounts of EU-IMF official financing will not address their underlying solvency problem.

- European policymakers understand full well that a default in any peripheral country is almost certain to precipitate a full-blown banking crisis in West Europe. This makes it highly unlikely that European policymakers in the north will lightly turn off the financing spigot that presently keeps the periphery, and thereby the European banking system, afloat. Rather, one must expect that European policymakers will continue to kick the can forward by repeated bailout operations in the forlorn hope that something might turn up to rescue the periphery.

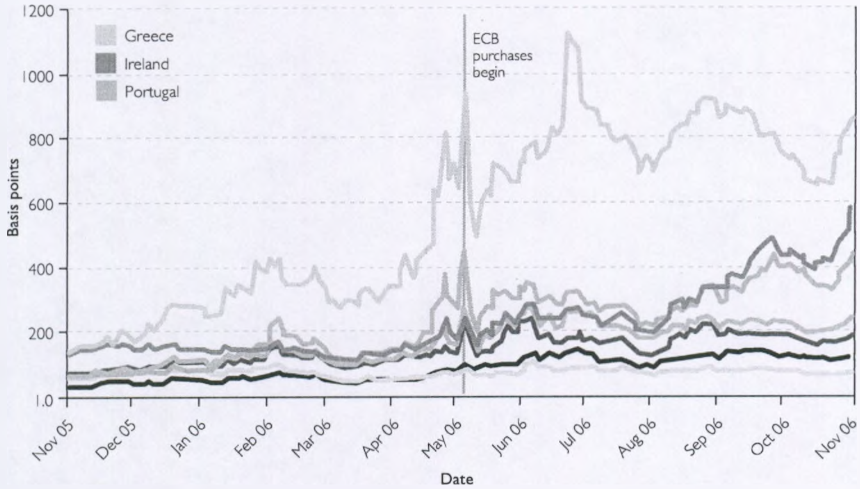
- The more likely trigger for the Euro's eventual unravelling will be in the periphery itself. The Greek, Irish, Portuguese, and Spanish governments already all have the most tenuous holds on political power. A deepening in their economic and financial crises could very well result in the ascendancy of more populist governments, which might be less willing to hew to the hair-shirt austerity programs being dictated by the IMF.

INTRODUCTION

In January 2009, amid much fanfare, Europe celebrated the tenth anniversary of the Euro's launch. Yet, almost two years later, the Euro confronts an existential challenge as a sovereign debt crisis rages across the Eurozone's periphery. In May 2010, this crisis forced the Eurozone to abandon its earlier "no bail out" policy and to establish together with the IMF a EUR750 billion safety net for the Eurozone's weakest members. Despite this massive safety net, however, by the end of November 2010 markets were still demanding record high interest rates on the sovereign debt of Greece, Ireland, Spain, and Portugal.

Until very recently, the idea of the Euro not surviving in its present form was regarded as a fringe idea mainly entertained by a small group of supposedly ill-informed and biased US academic economists. Yet today, markets are pricing in a considerable probability that at least one of the Eurozone's peripheral member countries will default on its sovereign debt within the next three years. And markets are increasingly coming to connect the dots from a sovereign debt default to a break-up of the Euro in its present form.

5 Year Credit Default Swap Spreads



Source: Bloomberg

The main purpose of this monograph is to explore how likely it is that at least one of the Eurozone's peripheral members will indeed be forced to default within the next three years. It also considers what would be the implications of such a default for the survival of the Euro in its present form and for the health of the European banking system. The main conclusion of this monograph is that the failure over many years of the Eurozone's members to play by its rules makes a sovereign debt default of at least one of the Eurozone's peripheral countries almost inevitable. It is also argued that a default by any Eurozone member is more than likely to trigger the exit from the Euro of Greece, Ireland, Portugal, and Spain.

The main thesis of this monograph is that the Eurozone's periphery has more of a solvency problem than a liquidity problem. It has a solvency problem in the sense that, absent a debt restructuring and an exit from the Euro, the correction of the periphery's public finances cannot be achieved without provoking the deepest and most prolonged of domestic economic recessions. Papering over these solvency issues by simply advancing these countries large amounts of EU-IMF official financing will not address their underlying solvency problem. All that it will do is to saddle the periphery with even more public debt, which will complicate the eventual and inevitable resolution of these countries' public debt problems.

This monograph also draws attention to the fact that the major part of the periphery's budget deficits constitutes non-interest payments or "primary" transactions. As such, even a far-reaching debt restructuring can at best be viewed as a partial solution to the periphery's budget problems in the sense that it will not obviate the need for further substantial budget retrenchment. This monograph suggests that countries in the periphery might do well to consider the advantages of an early exit from the Euro which might facilitate the needed fiscal adjustment without provoking the deepest of domestic economic recessions.

At the outset it should be stressed that the crisis presently afflicting the Eurozone's periphery has profound implications for the overall European economy and for the global economic outlook. Although Europe's peripheral economies are relatively small in size, their overall public and private sector debt is large and a substantial portion of that debt sits on the balance sheets of West Europe's banking system. As such, the present debt crisis in the European periphery has the potential to precipitate a major European banking crisis that would almost certainly reverberate throughout the global financial system. It would do so in much the same way as the 2008 sub-prime crisis in the United States precipitated a global banking crisis.

The remainder of this monograph is organised in four main sections. An introductory section discusses how right from the very start the Eurozone lacked those conditions required for the successful functioning of an optimum currency area and how the Eurozone lacked the appropriate institutional arrangements to make it work. This is followed by an analysis of the reasons why unusually large domestic and external imbalances manifested themselves in the Eurozone's peripheral economies and why the correction of these imbalances will prove to be exorbitantly costly within the straitjacket of Eurozone membership. A third section discusses how, in order to avoid a European banking crisis, the Eurozone's stronger member countries will continue to keep kicking the can forward by repeatedly bailing out its weaker members but how these efforts will end in tears. A final section of this monograph discusses the implications that a sovereign debt default would have on both the European and global economies.

CHAPTER 1

A FLAWED IDEA FROM THE START

In 1997, with a considerable degree of prescience, Gordon Brown, then the UK Chancellor of the Exchequer, devised an effective strategy to keep the United Kingdom permanently outside the Euro experiment.[1] By so doing, he revealed that he had a better understanding of the dangers of giving up one's own domestic currency for the Euro than apparently did his counterparts in Athens, Dublin, Lisbon, and Madrid. Rather than succumbing to the allure of lower government borrowing costs and better inflationary discipline that Euro membership held out, he focused more on the dangers of the loss of monetary and exchange rate policy flexibility that was necessarily entailed in Euro membership. Drawing the right lessons from the United Kingdom's unfortunate European Exchange Rate Mechanism (ERM) experience in 1992, he understood full well that adopting the single currency would mean giving up the UK's ability to set its own interest rates.[2] He also understood that it would mean foregoing any use of currency depreciation as an instrument to regain lost competitiveness and to boost export growth.

At the time that the Euro was launched in January 1999, a number of prominent US economists, most notably Milton Friedman and Martin Feldstein, expressed the gravest of misgivings about the Euro experiment.[3] They argued that Europe simply lacked the macroeconomic conditions needed to make the Euro work and they confidently predicted that the Euro would not survive its first major economic recession. Drawing on the optimum

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1 In 1997, Gordon Brown drew up 5 economic tests that the UK had to pass before it would agree to join the Euro. The main principle behind these tests was whether or not the conditions were such that the UK could cope with a common monetary policy. The main test was whether the UK had an adequate degree of economic harmonisation with the rest of Europe to allow it to give up monetary policy independence.

2 The European Exchange Rate Mechanism was a semi-fixed exchange rate mechanism with narrow fixed exchange rate margins of 2.25 percent. It was introduced in 1979 to reduce European exchange rate volatility and to achieve monetary stability in preparation for European Monetary Union and the adoption of a single currency. The UK joined the ERM in October 1990 but was forced to exit the program on "Black Wednesday," 16th September, 1992, under major pressure from currency speculators.

3 See for example Feldstein, Martin, (1997a), "The political economy of the European Economic and Monetary Union: Political sources of an economic liability", *NBER Working Paper Series*, no. 6150.

currency theory pioneered by Nobel Laureate Robert Mundell, they noted that Europe differed from the United States in a number of important respects, which made the notion of a currency union for Europe a bad idea. They drew particular attention to the following four considerations:

- Europe does not enjoy nearly the degree of wage flexibility that characterises the US economy. Its **rigid labour markets** and legislative protections mean that wages in Europe are very slow to adjust to rising unemployment and to declining production. This lack of wage flexibility, in the context of a currency union, makes it difficult for individual European economies to regain lost international competitiveness as needed through downward movements in wages. This lack of wage flexibility also makes the European countries vulnerable to sharper declines in output and employment than is the case for the individual states in the United States.
- Considerable language and cultural barriers, combined with poor housing infrastructure, makes **labour very much less mobile** in Europe than in the United States. Unlike the United States, where labour readily moves from states in recession to states enjoying a boom, European labour does not readily move towards job opportunities in other parts of the Eurozone.
- Unlike the United States, Europe is yet to develop an effective **system of fiscal federal transfers**. Lacking the same sense of shared national purpose as in the United States, there is a strong reluctance of the more prosperous European countries to have their tax revenues be transferred to countries experiencing fiscal shortfalls.
- The European economies are characterised by a great degree of diversity which makes them particularly susceptible to **adverse asymmetric shocks**. This vulnerability can prove to be important in a currency union where the central bank can only set one interest rate to satisfy the needs of all of the union's member states. The greater susceptibility to asymmetric shocks in Europe also highlights its greater need for labour market flexibility and labour mobility in a currency union.

At the launch of the Euro in January 1999, European political leaders were not unaware that the Eurozone did not enjoy all of the conditions that would make for a well-functioning currency union. Rather, they believed that the political imperatives for forming a monetary union to maintain forward momentum in European political integration trumped concerns more strictly economic in nature. It was their view, which sadly has not been borne out by the Eurozone's subsequent history, that once a monetary union had been formed the economic conditions would follow. It was also their view, which once again proved to be illusory, that strict institutional constraints and financial market discipline would be imposed on individual member countries' actions, which would prevent undue economic imbalances from developing in the Eurozone.

Toothless Institutional Arrangements

The founders of the Euro were all too aware of the economic policy challenges that countries would face within the straitjacket of Eurozone membership. For this reason, they insisted that countries meet stringent conditions before being accepted into the exclusive Eurozone club. The basic idea of these prior conditions to entry was to ensure that countries joining the Eurozone did so in sufficiently sound economic and financial health to allow them to endure the discipline of a one-size-fits-all European monetary policy. These conditions were enshrined in the 1993 Maastricht Treaty and they included the following five criteria:

- Successful applicants for Eurozone membership were required to reduce their **inflation rate** to no more than 1.5 percentage points above the average inflation rate of the three EU member states with the lowest inflation rate over the previous year.
- **Budget deficits** were required to be reduced to three percent of GDP or below.
- Applicant countries' **public debt levels** were to be reduced to below 60 percent of GDP, although a country with a higher debt level could still adopt the euro provided its debt level was falling steadily.
- **Long-term interest rates** of applying countries were to be no more than two percentage points above the rate in the three EU countries with the lowest interest rates over the previous year.
- Applying countries were required to enter **the ERM exchange rate mechanism** two years prior to entry.

In 1997, in an effort to create stable conditions for the new currency, the European Council decided to extend the public finance principles of the Maastricht Treaty to apply to member states after Euro membership. It did so by adopting a Stability and Growth Pact (SGP) whose primary purpose was to keep public sector spending and borrowing in individual member countries after Eurozone membership under control. More specifically, the SGP required that countries aim at keeping their budget deficits below three percent of GDP and their public debt levels below 60 percent of GDP. It also stipulated that, if a country broke the rules, it had to present a remedial plan to the European Commission and take measures to reduce its deficit. Furthermore, the SGP provided that if a country broke the rules in three consecutive years, the European Commission could impose a fine of up to 0.5 percent of GDP on the offending country.

Europe differed from the United States in a number of important respects, which made the notion of a currency union for Europe a bad idea

Sadly, time has proved the SGP to be nothing more than a paper tiger. This became all too apparent as early as 2003 when France and Germany, the Eurozone's two largest economies, flagrantly breached the SGP's budget limits. Rather than take strong action against these two countries, the European Commission lamely accepted without any punitive action France and Germany's promises to reach the Pact's targets as soon as possible. In 2005, in an effort to restore a modicum of credibility to the SGP, the European Council agreed upon a reformed SGP with more flexible rules. However, even these were soon challenged in 2007, when President Sarkozy looked to revitalise the French economy outside the framework of the SGP.

The sorry saga of Greece's egregious and serial under-reporting of its budget deficit has further seriously tarnished the Eurozone's reputation as having the ability to monitor, let alone to police, its member countries' public finance performance. In October 2009, newly elected Prime Minister George Papandreou effectively triggered the Eurozone sovereign debt crisis, by owning up to the fact that Greece's budget deficit for the year would not be the six percent of GDP that Greece had earlier reported but would rather be of the order of a staggering 12.5 percent of GDP.[4] It was subsequently revealed that Greece had systematically succeeded in duping EUROSTAT, the Eurozone's official budget score keeper, through the use of budget reporting sleight of hand. Aided by Goldman Sachs, Greece had made extensive use of complicated derivative instruments to disguise its true budget position.[5] And, in October 2009, Greece finally came clean by admitting that right from the very start it had resorted to creative budget accounting to gain entry into the Eurozone at a time when its true budget deficit significantly exceeded the Maastricht Treaty's entry limit.

If the Stability and Growth Pact has proven to be a paper tiger, so too has the Eurozone's supposed "no bailout clause". Enshrined in Article 125 of the Lisbon Treaty, the European Commission was supposed to refrain from bailing out member countries in budget difficulty.[6] The basic idea of this provision was to ensure that markets would exercise discipline on errant Eurozone members by denying them access to market financing at reasonable terms in the event that their budget deficits moved to an unsustainable path. However, as we were to learn on 9th May, 2010, the European Commission would buckle when the chips were down as the European sovereign debt crisis came to boiling point. As described more fully below, far from refraining from bailing countries out, in May 2010 the Europeans, together with the IMF, put in place a EUR750 billion bailout fund that would be used for the Eurozone's weakest members.[7]

4 In November 2010, EUROSTAT further revised upwards its estimates of Greece's 2009 budget deficit to 15.3 percent of GDP. At the same time, it revised upward the estimate of Greece's end 2009 public debt to GDP ratio from 115 percent to 127 percent.

5 For a discussion of how Goldman Sachs helped Greece hide its budget deficit the reader is referred to "How Goldman Sachs Helped Greece to Mask its True Debt", Der Spiegel, 28th February, 2010.

6 Article 125 of the Lisbon Treaty provides that "the Union shall not be liable for or assume the commitments of central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of any Member State, without prejudice to mutual financial guarantees for the joint execution of a specific project. A Member State shall not be liable for or assume the commitments of central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of another Member State, without prejudice to mutual financial guarantees for the joint execution of a specific project".

7 In setting up the European Financial Stabilization Facility, the Europeans have legalistically appealed to Article 122 of the Lisbon Treaty to justify their effective abandonment of the no bail out clause. Article 122 provides that financial assistance can be provided to a member country "which finds itself in difficulties or which is seriously threatened with severe difficulties caused by natural disasters or exceptional occurrences beyond its control".

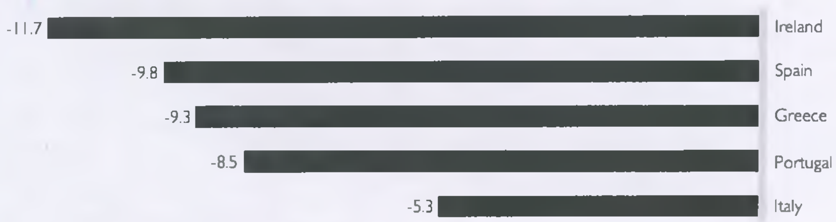
CHAPTER II

A HIGHLY UNBALANCED PERIPHERY

At the launch of the Euro in January 1999, Milton Friedman expressed the gravest of misgivings as to how the Eurozone would operate in practice.[8] However, it is highly improbable that, even in his darkest moments, he would have anticipated how poorly the Eurozone's internal policing of member countries' macroeconomic policy would have worked and how miserably the markets would have failed to exert discipline over wayward fiscal behaviour. Nor would he have anticipated the staggering degree to which domestic imbalances would have been allowed to build up particularly in these countries' public finances. According to the European Commission's estimates, by 2009 Greece and Ireland registered public deficits of the order of 14 percent of GDP. At the same time, the public deficits in Spain had reached 11.5 percent of GDP, while that in Portugal was of the order of nine percent of GDP.

The Euro's Problem Children

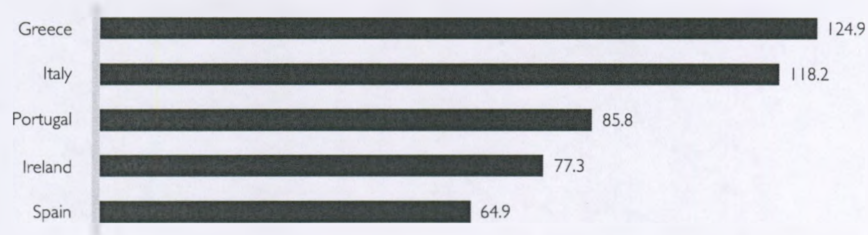
Government Deficit Projection for 2010 (as percentage of GDP)



Source: European Commission

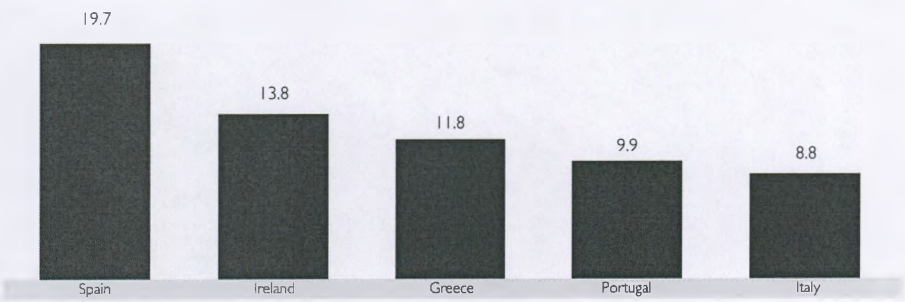
8 Milton Friedman's skepticism is expressed well in "An interview with Milton Friedman. Interviewed by John B. Taylor, May 2000", chapter 6 in P. Samuelson and W. Barnett, eds., *Inside the Economist's Mind: Conversations with Eminent Economists*, Blackwell, Oxford 2007.

Public Debt Projection for 2010 (as percentage of GDP)



Source: European Commission

Unemployment Projection for 2010 (as percentage of GDP)



Source: European Commission

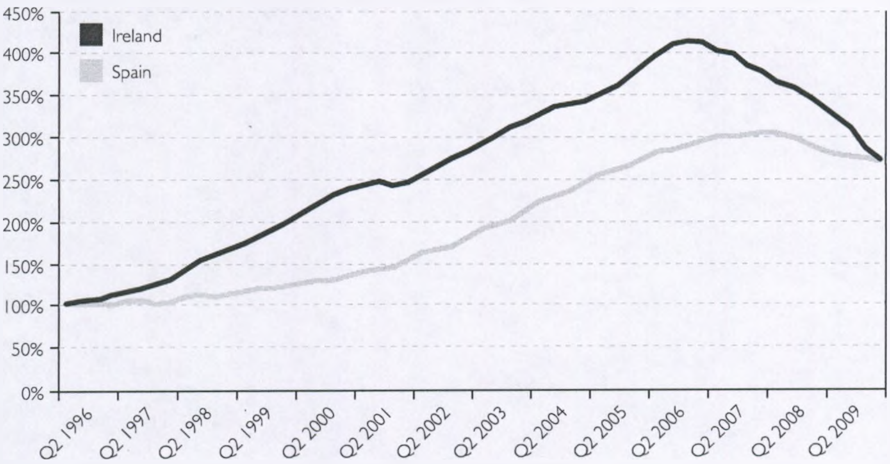
The emergence of massive deficits in Europe's periphery has placed the public finances of the periphery on a clearly unsustainable path that has created great difficulties for these countries in the financial markets. Deficits in the periphery are now a large multiple of the three percent of GDP Maastricht limit and they are around twice the size of the peak level that the public deficit reached in Argentina prior to its spectacular 2001 sovereign debt default.The un-sustainability of the periphery's public finances is most apparent in the Greek case where the country's public debt to GDP has already reached 127 percent or more than twice the Maastricht 60 percent of GDP limit. However, as will be discussed more fully below, the public finances of Ireland and Spain are also on unsustainable paths that also require the earliest of remedial actions. Although the public debt to GDP ratios in Ireland and Spain are presently at reasonable levels, one has to expect that these ratios will be substantially increased by the public support that the very troubled Irish and Spanish banks will require over the next year or two.

A second area where extraordinarily large imbalances have emerged in Europe's periphery has been in the housing markets of Ireland and Spain. Fuelled by easy access to global credit, as well as by an ECB whose one-size-fits-all interest rate policy kept interest rates too low for too long for Europe's periphery, Ireland and Spain experienced housing bubbles that make that experienced in the United States pale.[9] Whereas housing prices in

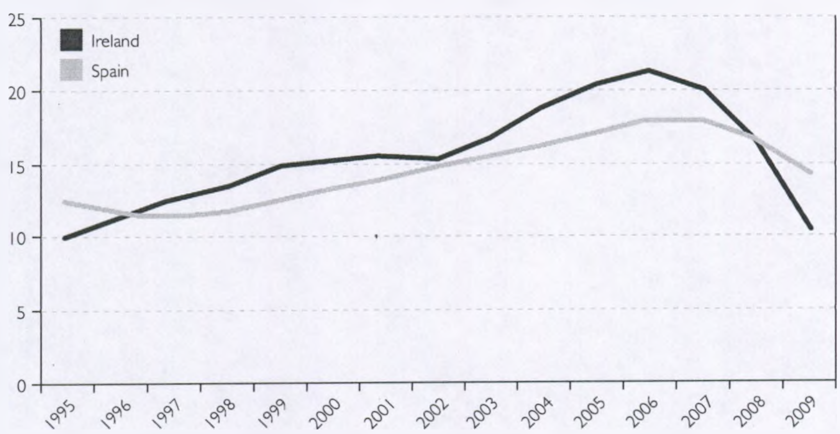
9 A combination of low ECB interest rates and expansionary fiscal policies contributed to a situation of excess aggregate demand in the periphery, which was reflected in persistently higher inflation in the periphery than in the Eurozone's core countries. Ireland and Spain, which over the past decade generally experienced significantly higher goods and asset price inflation than did the Eurozone's core countries, needed higher policy interest rates than did France and Germany to reign in domestic goods and asset price inflation. However, the ECB having only one interest rate instrument set its interest rates more to meet the needs of France and Germany than of the Eurozone's periphery.

the United States increased by around 80 percent between 2000 and 2006, those in Ireland and Spain approximately trebled.[10] And whereas employment in the construction sector peaked at around six percent of the labour force in the United States, that in Spain reached as high as 18 percent. The bursting of the housing bubbles in Ireland and Spain has been a primary driver in the dramatic deterioration in their public finances. It has also been the primary factor in the rise in unemployment in Ireland and Spain to their present levels of around 13 percent and 20 percent respectively.

Cumulated Changes of Home Prices



Construction investment: as percentage of GDP



Source: EUROSTAT

The lack of macroeconomic discipline in Europe's periphery has also given rise to the emergence of acute external vulnerability. Over the past decade, a generally too easy monetary and fiscal policy stance has caused wage and price inflation in the European periphery to be consistently higher than that in the Eurozone's more fiscally conservative

10 See "Housing Prices more Room to Fall", IMF Finance and Development, March 2010.

members. As a result, over the past decade, Greece, Spain, Portugal, and Ireland have all experienced a loss in international competitiveness of at least 20 percentage points. This loss of competitiveness, together with a worsening in public sector savings performance, has manifested itself in gaping external current account deficits that in 2009 were well into double digits as a percentage of GDP for Greece, Spain, and Portugal.

Greece's Road to Default

The essence of the Eurozone periphery's present economic predicament is that the countries in the periphery have all run up very large internal and external imbalances that will be extraordinarily difficult to correct without the benefit of having their own separate domestic currencies. Stuck within the Euro-zone straitjacket, these countries cannot resort to currency devaluation to restore the very sizeable losses that they have registered in international competitiveness.[11] Nor can they devalue their currencies to boost exports as a cushion to offset the highly negative impact on their economies from the major fiscal retrenchment that the IMF and the EU are requiring as a condition for their financial support. Attempting to adjust under these conditions must be expected to entail many years of painful deflationary and recessionary conditions for these countries that will only compound their indebtedness problems.[12]

The Greek case, where the economic imbalances are the greatest, illustrates most vividly the futility of trying to hew to the IMF's prescription of painful budget adjustment without resort to either currency devaluation or debt restructuring. Greece's two basic problems are its extraordinarily bad public finances and its large loss in international competitiveness. As already mentioned above, despite the European Stability and Growth Pact's strictures, by 2009 Greece's budget deficit had ballooned to around 15 percent of GDP, while over the past decade it has managed to lose over 20 percent in wage and price competitiveness.

Not wishing to countenance the idea of either debt restructuring or Euro exit as part of its May 2010 US$140 billion support package for Greece, the IMF and the European Union are presently prescribing draconian fiscal retrenchment as a cure-all to Greece's many economic ills. Indeed, they are requiring Greece to cut its budget deficit by no less than 11 percent of GDP over the next three years, with half of that adjustment to occur in the program's first year. And recognising that fiscal retrenchment will entail a significant recession that will erode Greece's tax base, the IMF is insisting that Greece implement tax hikes and public spending cuts that total as much as 10 full percentage points of GDP

11 The sizeable loss in international competitiveness experienced by the Eurozone's periphery over the past decade has rendered its exports to be uncompetitive in international markets and it has facilitated a great degree of import penetration in the domestic market. The net result has been a substantial widening in these countries' external current account deficits. In the absence of an exchange rate devaluation that might help restore international competitiveness, correcting these external deficits is likely to entail many years of painful wage and price deflation.

12 There are a number of countries like Belgium, Canada, New Zealand, and Sweden, which in the past two decades all have successfully reduced very large public sector deficits without experiencing unduly painful domestic economic recessions and without experiencing a meaningful pick-up in inflation. However, all of these countries operated under floating exchange rate systems that facilitated large exchange rate depreciations, which created the conditions for substantial export booms. They were also helped by very much more favorable international economic environments than presently confronts the Club-Med countries. In this regard, it is also worth recalling the experience of countries under the gold standard in the 1930s. As Barry Eichengreen has noted, those countries that left the gold standard first experienced less severe economic recessions than those countries that remained on the gold standard longer.

in 2010.[13] Adjustment of this order of magnitude, and in so short a space of time, goes considerably beyond what the IMF has ever prescribed before for any other of its economic clients under a fixed exchange rate system.

By now one would have thought that the IMF would have learnt that undertaking a Herculean sized budget adjustment, without the benefit of a currency depreciation to boost exports, will plunge the Greek economy into a major economic recession that will sap Greece's political willingness to endure many years of painful austerity. One would also have thought that this would be particularly the case at a time when Greece's borrowing costs have soared, its banks are losing deposits, and labour disturbances have become the order of the day. It is difficult to understand how the IMF can be seriously thinking that the Greek economy can possibly avoid the deepest of economic recessions. After all, its economy is being subjected to 10 full percentage points of fiscal measures in a single year. And this is occurring at the very time that the markets have in effect brutally tightened monetary policy for Greece by raising borrowing costs since the beginning of the year by over six percentage points.

Stuck within the Euro-zone straitjacket, these countries cannot resort to currency devaluation to restore the very sizeable losses that they have registered in international competitiveness

If there was ever any doubt that the IMF program would lead to a collapse of the Greek economy, all one need do is look at the sorry experience of Argentina under the IMF's tutelage in the late 1990s.[14] Argentina, like Greece today, got itself into deep economic and financial trouble, though not nearly to the extent that Greece has done so today.[15] And, like Greece today, it did so by profligate public spending within the context of an "immutable" currency peg to the US dollar. Yet, very much smaller might Argentina's economic imbalances have been than those in Greece today, it subsequently found that attempting to address those imbalances through IMF-style fiscal austerity, while maintaining its currency peg, was an exercise in futility. Since, without the benefit of a currency depreciation to boost exports, fiscal austerity produced a deep economic recession that undermined its political willingness to stick with austerity policies. The ensuing domestic financial crisis plunged the Argentine economy into an economic depression that saw the country's GDP decline by 25 percent in the early 2000s.

Closer to home, one would have thought that before embarking on an IMF style hair-shirt adjustment program, Greece might have wanted to take a close look at the more recent adjustment experiences in Latvia and Ireland. Over the past two years, output has collapsed by over 20 and 12 percent in Latvia and Ireland, respectively. It has done so precisely as a result of IMF-style budget deficit reduction in the context of a fixed exchange rate system on a very much lesser scale than that now being proposed for Greece. Given the very much larger fiscal adjustment now being required of Greece than was the case in Ireland and Latvia, extrapolating from the Irish and Latvian experience one must expect that Greece's economy

13 Cutting public spending and increasing taxes in the midst of an economic recession is almost certain to deepen that recession by reducing overall aggregate demand. This is particularly the case if households are in the process of deleveraging and if companies are reluctant to invest at a time of close to record levels of spare capacity.

14 For an excellent account of the IMF's involvement in Argentina, the reader is referred to the Report on the Evaluation of the Role of the IMF in Argentina, 1991–2001 by the IMF's Independent Evaluation Office, July 2004.

15 At its peak Argentina's domestic imbalance were around half those of Greece today. Argentina's budget deficit did not exceed 6 percent of GDP while its public debt to GDP ratio did not exceed 65 percent.

could very well contract by 15 percent over the next two years. Such a contraction would be more than double the six percent contraction that the IMF is targeting in its Greek stand-by arrangement, which would almost certainly put the IMF program well off track.

At the same time that the IMF is proposing draconian budget adjustments for Greece, it is also urging Greece to restore the 20 percent that it has lost in international competitiveness over the past decade through an "internal devaluation." Given the limitations on Greece's ability to increase labour productivity through structural reform, the IMF would like to see wages and prices fall in Greece over a prolonged period of time so as to restore its competitiveness.

The basic flaw in the IMF sponsored Greek adjustment program is that if successfully implemented it will have the unwanted effect of substantially increasing rather than reducing Greece's public debt to GDP ratio. Since, if Greece's nominal GDP were to decline over the next few years by 20 percent as a result of a deep recession and price deflation, Greece's public debt to GDP ratio would arithmetically rise from its present level of around 127 percent towards 180 percent.[16] It is calculations of this sort that have recently led Standard and Poor's to warn Greek bond holders that they might eventually retrieve only 30 to 50 cents on the dollar on their bond holdings. It is also calculations of this sort that are inducing markets to assign a 75 percent probability to a Greek sovereign restructuring within the next five years despite the massive IMF-EU Greek bailout package.

It is difficult to understand why the Greek government is allowing the IMF to lead it down a path that failed so spectacularly in Argentina. This is all the more so the case when one considers the very much larger fiscal adjustment that the IMF is requiring of Greece than it did of Argentina. If Argentina's experience is any guide, over the next few years Greece's economy will be put through the severest of wringers as the brutal IMF fiscal adjustment takes fuller effect in the context of very high domestic interest rates. At the same time, the country will be saddled with a mountain of IMF and EU debt as official financing replaces private financing thereby making Greece's sovereign debt all the more difficult to restructure. Yet, in the end, it is all too probable that Greece will be forced to default on its sovereign debt and to exit the Euro as a means to improve its competitive position.

What makes Greece's economic outlook all the more tragic is that the Greek government does have viable policy options, which, inexplicably, it is choosing not to exercise. Principal among these is Greece's option to restructure its US$420 billion sovereign debt in an orderly way as a means of reducing the fiscal adjustment required to restore fiscal policy sustainability. Unlike the 2001 Argentina case, where almost the entirety of Argentina's debt was covered by American or English law, around 90 percent of Greece's debt is covered by Greek law.[17] By changing its domestic law, Greece can restructure the overwhelming majority of its sovereign debt without fear of having to pay Argentina's price for irresponsible public sector borrowing by being shut out of the international capital market.

This is not to say that there would not be a very large cost from a Greek default. Rather, it is to say that the cost of such a default would be shifted by Greece mainly to the European

16 It might be noted that with all of its optimistic assumptions about economic growth and budget adjustment in Greece, the IMF's stand-by arrangement for Greece concedes that by 2012 Greece's public debt to GDP ratio will have risen to the neighborhood of 150 percent of GDP.

17 For an interesting discussion of how very much more amenable Greece's sovereign debt is to restructuring than was the case in Argentina, see "How to Restructure Greek Debt" by Lee Buchheit and G. Mitu Gulati, 7th May, 2010.

banks, the largest holder of those bonds. And ultimately that burden would be shifted to the European taxpayer, who in all probability would be needed to bail out the European banks. To be sure, having the IMF prolong the status quo in Greece thorough large scale official financing might be in the immediate interest of the European banks. However, it remains difficult to understand why Greece is allowing the IMF to put the Greek economy through the severest of recessions when the most that is being achieved is the delay of an inevitable Greek debt restructuring and of an all too likely Euro exit.

Ireland's Hangover

In a number of important respects, after Greece, Ireland appears to be the Eurozone member country most likely to default on its sovereign debt. As was the case in Greece, Ireland's budget deficit increased sharply to 14 percent of GDP by 2009. And despite the early adoption of bold fiscal measures to address the country's public finance imbalances, the Irish budget deficit (excluding the one-off 20 percentage points of GDP support to the banks) is still expected to remain at an unsustainably high 12 percent of GDP in 2010 or at the highest level in the Eurozone. However, unlike the Greek case, Ireland's public finance problems were not the result of budget profligacy. Rather they have been the product of a hangover from an uncontrolled credit binge.

In the early part of this decade, an orgy of Irish bank lending both helped to fuel the Celtic Tiger's economic miracle and gave rise to one of the world's most pronounced property speculative bubbles.[18] In the two years since that bubble burst in early 2008, the Irish economy contracted by a cumulative 12 percent and unemployment rose to 14 percent.[19] Meanwhile, the country's public finances deteriorated sharply as the government's property-based tax revenues collapsed and as income tax collections were severely impacted by rising unemployment and declining incomes.

More ominously yet for Ireland's future public finance outlook, at the end of September 2008 the government announced a blanket guarantee on all of the liabilities of the main Irish-controlled banks. It did so in response to the inability of Anglo-Irish Bank, a major Irish bank, to rollover its debt and to fears of a contagious reaction onto the other banks. Subsequent revelations of balance sheet window-dressing at the Anglo-Irish bank and some dubious transactions related to share purchases, contributed to the government's decision to take full ownership control of Anglo-Irish in early 2009. Since the gross bank liabilities guaranteed by the government amounted to well over twice Ireland's GDP, the open-ended nature of the possible bank losses constituted a very large potential charge on the Irish government's finances. That blanket guarantee is now proving to have been a very costly policy mistake and is raising serious political questions as to why the government agreed to guarantee all creditors, including unsecured creditors, as opposed to only depositors in the Irish banking system.

18 Between 2000 and 2007, Irish bank credit grew at an average annual rate of 25 percent and this credit boom was fueled to a considerable degree by large scale external borrowing. This rapid credit growth fed a housing price bubble, which in turn fed back into more credit growth and resulted in a more than 250 percent increase in house prices. This led to a disproportionately large contribution by both the construction and the financial sectors to the Irish economy and consequently to real Irish GDP growth rates well above the country's potential.

19 For an excellent description of recent Irish economic developments, the reader is referred to the IMF's Staff Report on its Article IV Consultation with Ireland, July 2010.

Until very recently, markets turned a blind eye to Ireland's highly compromised public finances and to the massive potential cost to the Irish exchequer of the blanket bank liability guarantee program. Instead markets lavished praise on the Irish government for the bold and timely fiscal measures that it took in an effort to correct its rapidly eroding public finances. Markets were particularly impressed with the deep public spending cuts, especially in the area of public wage and benefit cuts, as well as with the government's capacity to withstand considerable economic pain. Ireland was amply rewarded for its efforts by the market as is reflected in the relatively low interest rates that the market demanded for purchasing Irish government bonds.

In August 2010, there was an abrupt turnaround in market sentiment towards Ireland as doubts began to surface as to whether Ireland was anymore solvent than was Greece. These doubts were reflected in a widening in the spreads on Irish bonds relative to those on German bonds to as wide as 400 basis points or to their widest levels since Ireland joined the Euro. The factor triggering the sea change in the market's attitude was a further downgrading of Ireland's sovereign debt by the S&P rating agency. The market was particularly taken aback by S&P's estimate that Ireland's blanket guarantee could in the end cost the Irish government between a staggering EUR80 billion and EUR90 billion, or the equivalent of between 50 and 58 percent of Ireland's GDP.[20] The market was also shocked by S&P's estimate that Ireland's banking sector problem could raise the country's public debt level to 130 percent of GDP by 2012, or to a level not very different from that presently prevailing in Greece.

The Irish government is hoping that Ireland will somehow grow its way out of its public finance and public debt problems after having seen its GDP contract so sharply over the past two years. However, such hopes would seem to be fanciful in light of both the substantial amount of budget deficit cutting that lies ahead as well as of the effective monetary policy tightening being forced on Ireland by the mounting financial market scepticism about Ireland's longer-run solvency. The IMF estimates that Ireland needs further fiscal tightening of at least 6.5 percentage points of GDP over the next two years if the country is to hope to regain fiscal policy sustainability. At the same time, since the start of the year Irish interest rates have increased by more than 250 percentage points while credit has become considerably more difficult to obtain. Further compounding Ireland's economic problems is the fact that deflation has now taken hold in the Irish economy, which both increases the real cost of borrowing and aggravates Ireland's real debt burden.[21]

Spain's Balance-of-Payments Problem

Spain poses a much greater threat to the long-term survival of the Eurozone in its present form than does Greece or Ireland. After all, its economy is five times larger than Greece's, while at around US$1 trillion, its sovereign debt is three times larger. In addition, the Spanish

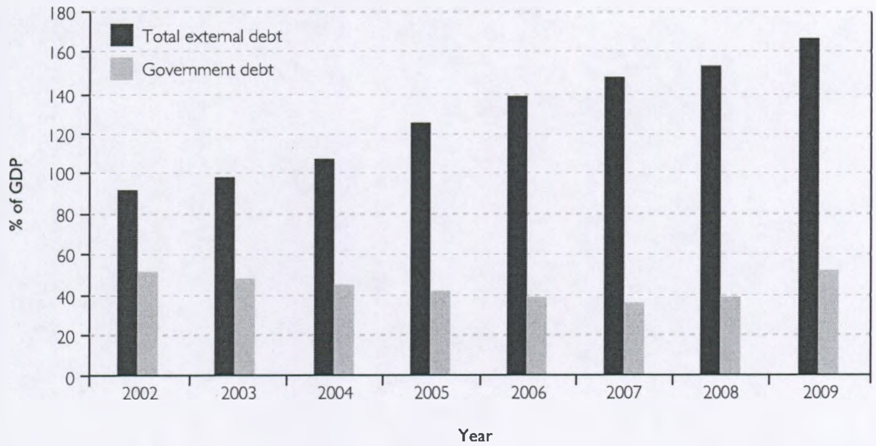
20 "Republic of Ireland Long-Term Rating Lowered to 'AA-' On Higher Banking Sector Fiscal Costs; Outlook Negative", Standard and Poor's, 24th August, 2010

21 Over the past year, Ireland's consumer price index has declined by around 2 percent. Since Ireland's unemployment rate is almost certain to remain unusually high over the next few years, there is the real danger that the pace of Irish deflation could accelerate.

economy is burdened by an excessively high level of public- and private-sector external debt, which makes it vulnerable to the whims of the international capital market.

Unlike the Greek case, the parlous state of the Spanish economy is not the result of years of government profligacy. Rather, it is the result of a massive housing boom, which over the past decade saw a trebling in Spanish home prices as well as an increase in its construction sector to a staggering 18 percent of the Spanish economy. It is also the result of an associated 20 percent loss in international competitiveness that contributed to a ballooning external current-account deficit and an increase in Spain's gross external debt to around 135 percent of GDP.

Spanish Debt



Source: World Bank, World Development Indicators, and Spanish National Bank.

Since September 2008, the bursting of the Spanish housing bubble, together with the onset of a deep domestic recession, has revealed the weak underbelly of the Spanish economy. As housing-related tax collections plummeted, Spain's budget position swung dramatically from a small surplus to a deficit of 11.5 percent of GDP by 2009. At the same time, in large measure due to structural rigidities in the labour market, unemployment surged from less than 10 percent before the crisis to over 20 percent in 2010.

More disturbing still, the incipient housing market bust has drawn attention to the fact that Spain's banks in general, and its savings and loans (*cajas*) in particular are overly exposed to its crumbling housing sector. Construction loans made by the Spanish banking system are estimated to be the equivalent of 45 percent of the country's GDP. Unsettled by this large exposure, foreign banks virtually have stopped lending to Spanish banks and corporations. This has forced the ECB to rediscount around €125 billion in Spanish bank loans to forestall a full-blown Spanish funding crisis.

Spain now finds itself in a similar predicament to that of Greece and Ireland. It is forced to engage in severe budget cutting to bring its budget deficit down to a more sustainable level without the benefit of a cheaper currency to boost exports to cushion the economic blow. Similarly, Spain is forced to go down the painful path of price deflation to restore competitiveness, even though that path will compound the country's public- and private-debt problems. Further complicating Spain's daunting economic challenges is the prospect that it will have to engage in serious budget tightening at a time when unemployment is already around 20 percent and when the housing bust still has a long way to go. After increasing threefold, Spanish home prices have only declined by around 15 percent to date.

Precarious Domestic Politics

The European sovereign debt crisis is playing out against the backdrop of the most tenuous holds on political power by the various governments in the periphery. The consequent lack of political stability is hardly conducive to retaining market confidence that countries in the periphery will stick the course of fiscal austerity. This has been vividly illustrated by recent political developments in Portugal. At the end of October 2010, financial markets were rattled by the refusal of the Portuguese opposition parties to support the 2011 budget proposal of Jose Socrates, the prime minister of Portugal's minority socialist government. Only after protracted negotiations, which raised basic questions as to Portugal's political willingness to stay the course, did the Portuguese government finally secure approval for a budget aimed at reducing the budget deficit from an estimated 7.3 percent of GDP in 2010 to 4.6 percent of GDP in 2011.

Recent political developments in the rest of the periphery raise further questions about the periphery's political willingness to persevere with painful adjustment measures

Recent political developments in the rest of the periphery raise further questions about the periphery's political willingness to persevere with painful adjustment measures. In Ireland, the opposition parties have made no secret about their opposition to the 2011 budget proposals of the minority Fianna Fail government, raising the prospect that the Irish government will soon fall. In early November 2010, Greek voters on both the left and the right registered considerable unease in local elections about the policy direction of George Papandreou's socialist government. Meanwhile, in Spain, the socialist-led minority government of Jose Luis Rodriguez Zapatero remains highly dependent on the support of Spain's fractious regional parties to secure passage of its legislative agenda.

CHAPTER III

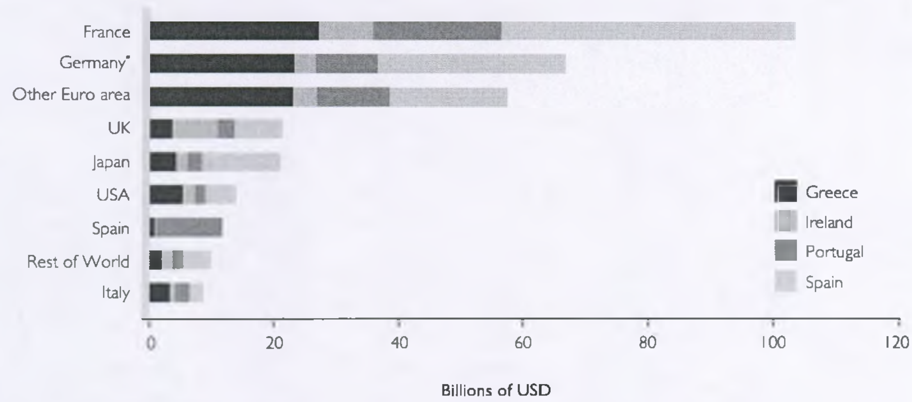
EUROZONE BANKS AT RISK

In 2007, Ben Bernanke, the Chairman of the US Federal Reserve, spent most of the year reassuring markets that the sub-prime mortgage loan problem would be contained and that it would not materially impact the overall US economy. Now, in a manner all too reminiscent of Mr Bernanke's hollow reassurances of 2007, Jean-Claude Trichet, the President of the European Central Bank keeps asserting that the Eurozone's sovereign debt crisis will not pose a significant threat to the overall Eurozone economy. He does so by emphasising that the peripheral economies constitutes only a relatively small part of the overall Eurozone economy. In particular, he keeps reminding us that Greece constitutes less than two percent of the overall Eurozone economy while, including even Spain, the periphery accounts for less than 15 percent of the overall region's GDP. As such, Mr Trichet would want us to believe that a deepening in Europe's sovereign debt crisis should be a relatively contained matter.

The crucial point that Mr Trichet disingenuously glosses is that while the Eurozone's peripheral economies might be relatively small, their governments are highly indebted.[22] Indeed, Greece's sovereign debt alone amounts to over US$420 billion. As a result, were Greece to default on its debt, it would constitute the largest sovereign debt-default on record. It would also be over four times the size of the Argentine sovereign debt default of 2001, the largest sovereign debt default to date, which sent ripples through the global financial system. A Greek default might also be expected to accentuate the sovereign debt difficulties in Ireland, Portugal, and Spain, which between them have a combined sovereign debt totalling around US$1.5 trillion. In short, a Greek sovereign default, or for that matter an Irish sovereign debt default, could bring into serious question the serviceability of around US$2 trillion of European sovereign debt, a magnitude that one would think should not be lightly dismissed for its potential impact on the Eurozone's overall economy.

22 Mr Trichet also glosses over the fact that between 2000 and 2008, the European periphery was the major engine of European economic growth and a principal market for Germany's export machine. Over this period, the Irish and the Spanish economies consistently registered GDP growth rates considerably above the Eurozone average.

Bank Exposure to PIGS by Nationality in 2010 Q1



* Statistics for Germany are on an immediate risk basis, while that of others are on an ultimate risk basis
Source: BIS Quarterly Review, September 2010

Consolidated foreign claims of reporting banks, end of 04 09 (% of GDP)						
Lending from banks in:	Lending to:					
	Greece	Portugal	Spain	Ireland	Italy	Total PIIGS
Austria	1.3	0.8	2.5	2.4	7.2	14
Belgium	0.8	0.7	5.0	14.1	6.9	28
Denmark	0.1	0.1	0.8	7.3	0.2	8
France	3.1	1.8	8.9	2.5	20.8	37
Germany	1.5	1.5	6.2	6.0	6.2	21
Greece	0.0	0.0	0.1	0.3	0.2	1
Ireland	4.0	2.6	14.5	0.0	22.1	43
Italy	0.4	0.3	1.6	0.9	0.0	3
Netherlands	1.6	1.7	16.4	4.2	9.4	33
Portugal	4.7	0.0	13.4	10.3	2.5	31
Spain	0.1	6.4	0.0	1.2	3.5	11
Sweden	0.2	0.1	1.6	1.3	0.7	4
Switzerland	0.8	0.9	4.0	3.6	3.6	13
UK	0.8	1.2	5.7	9.4	3.8	21
European banks	1.3	1.7	6.0	4.5	7.3	21

Note that the numbers must be interpreted with caution as there are large changes in the figures from quarter to quarter in some countries (e.g. Switzerland from Q3 to Q4). Source: BIS Quarterly and Danske Markets

A further inconvenient truth that Mr Trichet chooses to downplay is that a major part of the periphery's debt is held by the European banking system. This necessarily implies that a wave of sovereign debt defaults in the periphery would deal a serious blow to the European banking system at the very time that the European banks are yet to fully recover from their 2008-2009 loan losses.[23] The potential severity of this problem is underlined by

23 In its April 2010 Global Financial Stability Report, The International Monetary Fund noted that the European banks have been much slower than their American counterparts to recognise the loan losses sustained from sub-prime mortgage lending.

the disturbingly high exposure of a number of individual countries to the Eurozone debt crisis. According to data from the Bank for International Settlements, the European banking system's exposure to Greece, Ireland, Italy, Portugal, and Spain exceeds 20 percent of the Eurozone's GDP, while that of the Dutch and French banks exceeds 33 percent of their respective GDPs. This would suggest that the European banking systems would need to be bailed out at a high cost to these countries' exchequers in the event that countries in the periphery were to default.

In August 2010, European policymakers undertook a stress test of Europe's 91 most important banks, in order to address the rising market concerns about the potential damage that would occur as a result of a sovereign debt crisis. Their hope was that conducting such a test might allay market concerns about the state of the European banking system in much the same way as US Secretary Treasury Timothy Geithner's stress test in March 2009 succeeded in defusing the US banking crisis. On completing the test, the European policy makers announced that the European banking system was adequately capitalised to withstand a "worst case" scenario and that only five relatively small banks, mainly in Spain, could be judged to be inadequately capitalised. Judging by the market's very lukewarm reaction to the announcement, it appears that the markets were not particularly convinced by the stress test results. A frequent criticism voiced by market analysts was that these tests were far from realistic. In particular, there was disappointment that the tests excluded the possibility of any country defaulting on its sovereign debt and that, where haircuts on sovereign debt were considered, they were applied only to the banks' sovereign debt holdings in their relatively small trading books as opposed to their more important banking books.

Bailing Out the Periphery

Among the more important of the early casualties of the sovereign debt crisis has been the Eurozone's supposedly immutable "no bailout clause". Enshrined in Article 125 of the Treaty of Lisbon, this clause was supposed to preclude any individual Eurozone sovereign government from being bailed out by other European country governments. The basic rationale of this clause was to create the conditions that would subject individual countries to the full force of financial market discipline. If financial markets knew that the Eurozone governments would in no circumstances be bailed out, they would be extremely careful in lending to those governments and they would demand higher interest rates the more profligate a government became.

The Greek sovereign debt crisis in the first half of 2010 revealed in no uncertain terms how much of a paper tiger the "no bailout clause" was. After several months of insisting that the Greek crisis could be managed without the need for outside financial support, by early May 2010 the European Commission announced a bailout package for Greece of epic proportions. Under this plan, the European Union committed itself to providing EUR80 billion to Greece over the next three years. And it did so in conjunction with the International Monetary Fund, which committed itself to providing Greece an additional EUR30 billion in the context of a three year IMF stand-by arrangement.

The combined EUR110 billion EU-IMF financing program was sufficient to fully cover Greece's public financing needs over the next three years and to ensure that the Greek government would not need to return to the capital market before 2013. At the insistence of the German government, which faced strong domestic political opposition to bailing Greece out, the disbursement of money under the Plan was to be done in a strictly phased manner and was only to be made available subject to Greece's complying with the strict terms of an IMF stand-by arrangement. The German government also insisted that Greece be charged a five percent interest rate for the money borrowed under this program, which could be sold domestically as being a loan extended to Greece at a market related rate.

On 9th May, 2010, the final death knell was sounded for the Eurozone's "no bailout clause". In the context of fears that contagion from the Greek crisis would soon envelope Ireland, Portugal, and Spain, the European Commission and the IMF put in place a EUR750 billion safety net for the Eurozone's peripheral countries. The basic idea of this safety net was to assure the markets that official money was available in the event that it was needed to fully cover the public finances of the Eurozone's periphery over the next three years. Once again, monies made available under this plan were to be made subject to strict IMF conditionality and the countries drawing on this safety net were to pay market related interest rates. While the announcement of the safety net did have the immediate desired effect of defusing the crisis at least temporarily, it did not succeed in reducing the high interest rates spreads that markets demanded of the periphery. By September 2010, market interest rate spreads for Greece, Ireland, Portugal, and Spain were again back close to their pre-9th May, 2010 highs.

A central plank of the EU-IMF safety net is the creation of a EUR440 billion European Financial Stability Fund (EFSF). In essence, the EFSF is a special purpose vehicle that would borrow in the markets as needed to provide financing to the peripheral countries, which might require access to the safety net. The borrowing that the EFSF would undertake would be guaranteed by those Eurozone countries not accessing the safety net and those guarantees would be provided in proportion to those countries' relative position in the European Central Bank. Those guarantees were set to total 20 percent more than the EUR440 billion size of the EFSF in order to secure for the EFSF an AAA rating from all three major rating agencies. A glaring weakness of the EFSF is that it is relying for around 20 percent of the total guarantees from Ireland, Portugal, and Spain, the very countries which might themselves soon need to tap the safety net. This weakness has the potential to jeopardise the EFSF's AAA rating since markets will come to question whether the EFSF is adequately back stopped by the member countries.

Bailing out through the backdoor

Another serious casualty of the sovereign debt crisis has been the integrity of the European Central Bank as a supposedly independent pillar of Eurozone monetary stability. At the time that the ECB was set up in 1999, its founding statutes precluded the ECB from directly subscribing to member government bond issues in order to safeguard the integrity of the ECB and to avoid moral hazard. This preclusion was to be a complement to the Eurozone's no bail out clause in the sense of being a further means to subject member governments to the full force of financial market discipline. However, nothing in the ECB's charter prevented that institution from engaging in rediscount operations with member country's banks, even though those banks may on-lend the proceeds of such operations to their domestic governments.[24] Nothing in the ECB's charter also prevented it from supporting member country governments by buying their paper in the secondary market.

Over the past two years, the ECB has liberally availed itself of the loopholes in its charter in order to provide massive support to those governments in the Eurozone's periphery that encountered considerable difficulty in raising private sector financing. The ECB has also substantially relaxed the standards of the paper that it accepts as collateral for its rediscount operations in a further effort to support the banks in the Eurozone's periphery. While the initial provision of unlimited liquidity to Eurozone banks was introduced in June 2008 in response to the global financial crisis, in the past year, it has mainly been the banks in the Eurozone's troubled periphery that have availed themselves of the ECB's discount window. As an indication of the degree to which the periphery has used the ECB's window is the fact that by August 2010 the periphery, which only accounts for 15 percent of the Eurozone's overall economy, accounted for a full 37 percent of the ECB's considerably expanded loan book.[25] The ECB's lending to Spain alone rose to EUR125 billion by August 2010 as the ECB stepped in to fill the gap created by the virtual drying up of private foreign lending to Spanish banks and corporations during the summer of 2010.

Another serious casualty of the sovereign debt crisis has been the integrity of the European Central Bank as a supposedly independent pillar of Eurozone monetary stability

In the heat of the Spring 2010 Eurozone debt crisis, the ECB gave up any pretence of maintaining its lending standards to aid troubled peripheral governments. After weeks of indicating that the ECB would not purchase government bonds of member countries in the secondary market, on 9th May, 2010, in a dramatic about face in conjunction with the EU-IMF announcement of the financial safety net for the periphery, Jean-Claude Trichet announced that the ECB would begin such purchases as need be to stabilise financial markets. By September 2010, the ECB had purchased a total of EUR60 billion of government bonds in the secondary market although the pace of such purchases has tapered off to a trickle.

Closing the Stable Door after the Horse has Bolted

Rather than contemplate how the peripheral countries might exit the Euro in an orderly fashion, European policymakers are now proposing to fortify the Eurozone's architecture through treaty modification. At a recent European Summit, agreement was reached to extend the European Financial Stability Fund when it expired in 2013 and to require that private bondholders bear their share of the burden of future bailout exercises. In addition, it was agreed to introduce real penalties for country's that were in repeated violation of the budget limits of the Stability and Growth Pact.

24 The ECB's rediscount operations are essentially loans extended by the ECB at a discount to a member country's banks against the collateral of high quality paper tendered by the bank requesting the loan.

25 See "Eurozone: Standing Out", BNP Paribas, 7th July, 2010.

While the treaty modifications now being proposed would have had great merit when the Euro was launched in January 1999, how relevant they are today at a time when the periphery's public finances have been compromised beyond repair and when there is every indication that the periphery's crisis is deepening is questionable. While the periphery's sovereign debt crisis is playing out in real time, past experience would suggest that treaty modification, which requires unanimous ratification by all European Union members, will take years to effect. In addition, it would appear that the proposed reforms overlook the fact that the major part of the periphery's budget deficits is primary in nature. As such, even if the debt of the periphery were to be substantially written down, the periphery would still be left with very large budget deficits. And reducing these very large budget deficits to sustainable levels would still involve very deep recessions if such an exercise were attempted within the straitjacket of continued Euro membership.

CHAPTER IV

THE END GAME

The late Herb Stein, a well-known American economist, was fond of observing that if something cannot go on forever it will stop. This aphorism appears to be particularly apt for the current Eurozone situation. Since it would seem unreasonable to expect that voters in the Eurozone's north, and especially in Germany, will indefinitely acquiesce to the transfer of large amounts of bailout money to the Eurozone's south in an effort to keep those countries afloat. And it would seem even more unreasonable to expect voters in the south to indefinitely endure the severe economic and social pain associated with the austerity measures attached to the financing that they receive from the north. This would seem to be especially true if voters in the south were to perceive (a) that they were being taxed so that onerous debt repayments could be made to foreign banks; and, (b) that there was little prospect of their economies emerging anytime soon from depression like conditions without the benefit of either a debt restructuring or an exit from the Euro straitjacket.

In May 2010, a cautionary warning was sounded for Eurozone policymakers in the Westphalian state elections. The voters of Westphalia, Germany's largest state, handed Angela Merkel's Christian Democratic Union a crushing defeat largely in protest at Mrs Merkel's active role in the Greek bailout package. It would seem that electoral considerations of this sort would make it all but impossible to enlarge or to extend the EFSF when it expires in three years time.

As recent ECB experience amply attests, in principle European policymakers can use ECB financing to the periphery as a very much less transparent form of keeping the periphery afloat. The obvious advantage of using the ECB for that purpose is that the ECB's rediscount operations are not subject to the same close parliamentary scrutiny as are the budgetary appropriations required for the Eurozone's other bailout operations. However, one would think that there have to be limits as to how much further the ECB can bend its rules. There also have to be limits as to how much further the ECB might be prepared to contaminate its balance sheet by accepting more collateral of lesser quality from the periphery's banks. Already serious voices within the ECB, most notably that of Alex Weber the President of Germany's Bundesbank, have been publicly raised about the longer term advisability of further compromising the ECB's balance sheet and of using the ECB to conduct what are essentially budgetary operations.

European policymakers understand full well that a default in any peripheral country is almost certain to trigger contagion to the rest of the periphery. They are also highly cognisant of the fact that a wave of defaults in the periphery would more than likely precipitate a full-blown banking crisis in West Europe. These considerations would make one think that European policymakers in the north will not lightly turn off the financing spigot that presently keeps the periphery, and thereby the European banking system, afloat. Rather, one must expect that European policymakers will continue to kick the can forward in the forlorn hope that something might turn up to rescue the periphery. They might also do so in the hope that time might allow the West European banks to strengthen their balance sheets in a manner that would allow them more easily to absorb the shock of a sovereign debt default in the periphery.

> The departure of any individual peripheral country from the Euro would almost certainly result in severe contagion to the other countries in the periphery

The more likely trigger for the Euro's eventual unravelling will be in the periphery itself. The Irish, Portuguese, and Spanish governments already all have the most tenuous holds on political power. A deepening in their economic and financial crises could very well result in the ascendancy of more populist governments which might be less willing to hew to the hair-shirt austerity programs being dictated by the IMF. This is essentially what precipitated the demise of Argentina's Convertibility Plan in 2001. More recently, the new Hungarian government's spurning of the IMF in September 2010 would seem to be a poignant reminder that countries in the Eurozone's periphery might very well also be tempted to turn their backs on IMF austerity. Another plausible trigger for the Euro's eventual unravelling could be a heightening of the capital flight that already is underway in Greece and Ireland. Ample experience in earlier fixed exchange rate regimes suggests that capital flight can reach such proportions that countries are left with little alternative but to restructure their debt and to exit their fixed exchange rate arrangement.[26]

The Euro in a post-default world

At the Euro's launch in 1999, European policymakers understandably did not negotiate a Plan B to deal with the contingency that the Euro might eventually unravel. The very idea of the Euro was to foster a permanent economic and political union, whose attainment would have been seriously undermined by any official suggestion that the bold monetary experiment on which Europe was embarked might eventually unravel. This now leaves the greatest of uncertainties as to what might happen to the Euro should any of the peripheral countries be forced to exit the Euro. In a recent legal paper, the most that the ECB has indicated on this topic is that individual countries may voluntarily choose to leave the Euro but that no

26 Capital flight from the Eurozone's periphery can be expected to intensify as domestic bank depositors increasingly fear that their deposits might be frozen and forcibly converted from Euros into a newly issued domestic currency at an unfavorable exchange rate.

individual country can be forced to leave the Euro by other member countries.[27] Further the ECB has indicated that its interpretation of the Treaty of Lisbon is that should an individual country choose to leave the Euro, it will also be obliged to leave the European Union.

Over the past few years, a clear pattern has emerged as to how the Eurozone applies its rules at a time of stress. In the event of a real crisis, the rules have been bent consistently in an effort to find a political solution to defuse the crisis. As discussed above, this has certainly been the case with the Stability and Growth Pact, the "no bailout clause", and the ECB's adherence to pursuing strictly monetary policy objectives. On this basis, it would seem reasonable to expect that were an individual country to leave the Euro, the same pragmatism would be applied to finding a political solution that would limit the damage to the rest of the Euro area.

In considering what might happen to the Eurozone in the event that any of its peripheral member countries were to lose the political willingness to persevere with IMF-style fiscal austerity measures, it is well to recall the nature of their public finance problem. A striking feature of the public finances of Greece, Ireland, Portugal, and Spain, is how very large are the "primary" or non-interest payment components of their budget deficits. This feature of their public finances limits the degree to which these countries might rebalance their public finances through debt restructuring. For any such restructuring would not affect the non-interest part of their budgets which constitutes the major part of their public finance problem.

As an illustration of the limits of debt restructuring, one might consider that had Greece and Ireland successfully managed to halve their public debts through restructuring in 2009, they would have still been left with budget deficits of over 10 percent of GDP. This would have left these countries with the basic problem after debt restructuring of still having to undertake a very sizeable amount of fiscal adjustment within a fixed exchange rate system in order to restore fiscal sustainability. It is considerations of this sort that must make one expect that, in the event that any of the peripheral countries were to lose the political willingness to stick to IMF-style austerity measures, not only would they substantially restructure their debt but they would also choose to exit the Euro. They would do so in the hope that a cheaper currency would allow them to boost their exports as a cushion to the negative effects on their economies of the still needed fiscal policy tightening.

The departure of any individual peripheral country from the Euro would almost certainly result in severe contagion to the other countries in the periphery. This would occur as the result of an unleashing of severe market pressure on those countries, which would now be viewed as more likely than before, to leave the Euro, sharing as they do the same basic structural weaknesses as the country that chose to exit. It would also occur as a result of the very likely intensification of domestic capital flight. The prohibitive interest rates that these countries would now have to pay for their market borrowing would create the very conditions that would make it all but impossible for these countries to continue servicing their sovereign debt.

Since the Treaty of Lisbon is silent on the matter, it is far from clear what would happen to the Euro in the event that several of the peripheral member countries were forced to

27 "Withdrawal and Expulsion from EMU and the EU, Some Reflections", Phoebus Athanassiou, ECB Legal Working Series Paper, December 2009.

exit the Euro. A very probable scenario is that the Euro would survive, albeit in a reduced form. While Greece, Ireland, Italy, Portugal, and Spain might all be expected to leave the Euro, one could envisage a scenario where the Eurozone's stronger northern member countries, including France, Germany, and the Benelux countries would remain in the currency arrangement. However, one cannot exclude the possibility that the breakup of the Euro would prompt Germany to rethink its continued Eurozone membership. The Euro was never popular with the German public, who retain fond memories of the role that the Deutsche Mark and the Bundesbank played in Germany's post-war economic miracle. The turmoil in the Eurozone's periphery will only have served to validate the German public's initial grave misgivings about Euro membership at the time that Germany gave up its treasured Deutsche Mark.[28]

A Euro comprised only of Europe's stronger northern member countries could be expected to be a very strong currency in the long term. However, in the near term, one should expect that the Euro will experience considerable weakness. A series of sovereign debt defaults in the Eurozone's periphery would almost certainly cause a major European banking crisis that in turn would seriously undermine the European economy. At the same time, one must expect that markets would become very unsettled in an environment where it was far from clear as to the form in which the Euro would survive in the aftermath of the exit of its peripheral member countries.

Policy Implications

European policymakers seem to be in denial about the periphery's solvency problem. Sadly this state of denial can lead to serious policy mistakes that could cost the Eurozone economy dearly. This would certainly seem to be the case for the peripheral countries themselves. For if Argentina's 2001 experience is any guide, these countries will find that they will experience the deepest of economic recessions over the next year or two as they apply IMF-style fiscal austerity while still within the Euro. Yet in the end, they will find that they will still be forced to restructure their public debt and to exit the Euro as deep recessions both erode their tax bases and sap their political willingness to persevere with austerity. If debt restructuring and exiting the Euro is indeed inevitable for the peripheral countries, it would be better for them to do it sooner rather than later. This would seem to be clearly preferable to their prolonging the agony and delaying the putting in place of those conditions that could offer hope of an eventual economic recovery.

In considering policy options for the countries in the periphery, it is important to recognise that the major part of their budget deficits is "primary", or non-interest related payment transactions, in nature. As such, even a large write down in their sovereign debt, while helpful, will not obviate the need for major fiscal adjustment to bring the primary budget back into balance. To illustrate this point, one might consider that in 2009 only around 6.5 percentage points of Greece's 15.3 percent of GDP budget deficit constituted

28 It might be recalled that in 1999 Germany joined the Euro as the price it had to pay for France's acquiescence to German reunification. Now that Germany has been successfully reunified, Germany's incentive for remaining in the Euro has been diminished.

interest payments. As a result, even if Greece's public debt were to have been written down by 50 percent, Greece would still have been left with a budget deficit of 12 percent of GDP, which would have still required a major fiscal policy adjustment.

Experience over a wide range of countries strongly suggests that large scale fiscal adjustment in a fixed exchange rate system generally involves the deepest and most protracted of economic recessions. For this reason, one would think that the periphery countries should seriously consider the option of an early exit from the Euro as a means to incentivise their export sectors. Since a strong boost to these countries' external sectors could serve as a much needed cushion to the major fiscal policy adjustments that are needed to restore fiscal sustainability. One would not of course want to minimise the short-run costs involved in exiting the Euro since this would necessarily involve the forced redenomination of bank deposits and all contracts at a less favourable exchange rate. However, it would seem that if the abandonment of the Euro is the inevitable end game, it would be preferable that such an exercise be carried out in a controlled manner, preferably with the support of the IMF and the periphery's European partners, rather than in a disorderly manner in the wake of the collapse of these countries' adjustment programs.

While the delay in the periphery's inevitable debt restructuring would not be in the interest of Europe's peripheral countries, a persuasive case can be made that it would be in the interest of the Eurozone's northern member countries. Such a delay could afford those countries time to strengthen their banking systems in a manner that would allow their banks to better absorb the large loan losses that would be associated with debt defaults in the periphery. This would especially appear to be the case since, as mentioned above, the European banking system is still relatively weak as it is as yet still to fully recognise the losses associated with the September 2008 Lehman collapse.

There is the very real danger that the European policymakers' present state of denial about the likelihood of a wave of sovereign debt defaults in the periphery will breed a sense of policy complacency. Such a state of complacency could lead them to contemplate too hasty an exit from the stimulus policies that were put in place over the past two years to support the European economic recovery. It could also induce European policymakers not to fully avail themselves of the breathing room that they are being afforded to strengthen their banks in anticipation of the all too probable wave of sovereign debt defaults that lie ahead. This would be the greatest of shames not only for the European economy but also for the global economy as a whole. As we have painfully learnt from the 2008 Lehman experience, the world's financial system is all too inter-connected and a major banking crisis in Europe must be expected to seriously reverberate throughout the global economy.

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