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INVESTMENT PUBLICATIONS HIGHLIGHTS

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Investment Publications Highlights

Summarized by the Investment Strategy Research Team

"The Coming Resolution of the European Crisis," by C. Fred Bergsten and Jacob Funk Kirkegaard, Peterson Institute for International Economics, January 2012

The European crisis has embroiled the region in numerous crises, and as a result the future of the euro has come into question. However, fears are overblown. Once Germany and the ECB feel they have gotten the best possible deal, or have run out of alternatives, they will pay whatever it takes to hold the euro together. Neither can afford not to.

Europe is in the midst of several overlapping crises that have caused many to question the future of the euro. These fears are overblown. The European crises are political, and to a certain degree presentational—the key is to watch what the actors do and not what they say. The problem is that by design Europe lacked strong institutions that could deal with fiscal crises; forging these amid a volatile environment is now difficult. It was always assumed greater fiscal union would follow monetary union, and this remains much more likely than a dissolution of the currency union.

European leaders have a daunting task ahead. To complete the original concept of a comprehensive economic and monetary union, they must re-write the rule book on which the European Union was established. For political reasons, the European Union was designed without a sizable central fiscal authority. As a result, it lacks the ability to counter region-specific economic shocks, or deploy significant fiscal resources to re-instill confidence in the midst of a crisis. The reason is that after German reunification, European leaders hastily agreed to monetary union in an effort to foster integration and political stability; they lacked both the time and political support to create powerful centralized institutions. Today, leaders must create such institutions and administer bailouts, as well as strengthen the rules that govern fiscal affairs going forward.

Given the haste with which the euro was established, fiscal rules were relaxed from the very beginning. The recent crises have simply brought the inherent flaws to the forefront. The Maastricht Treaty in principle included at least two hard convergence criteria for Eurozone membership—a 3% limit on general government annual deficits and a 60% limit on gross government debt. However, these limits were loosely enforced. Eurozone countries could exceed these limits if they were moving toward them at a satisfactory pace. Given that it was politically inconceivable to exclude countries like Belgium and Italy, both countries were allowed to join despite having debt levels almost twice the treaty limits.

However, the EU treaty did grant the European Central Bank (ECB) institutional independence, ensuring it did not have to answer to any individual government. This has enabled it to function as a fully independent political actor, interacting with elected officials during the crisis in a manner inconceivable among peers. Saddled with administering a common currency, and endowed with governing institutions flawed by early political compromises, it is hardly surprising that the ECB's dominant concern as it manages this crisis has been to prevent "political moral hazard" and not let Eurozone leaders off the hook. The ECB's primary goal has never been to end market anxieties and, thus, the Eurozone crisis as soon as possible. Rather, its priority has been to force government leaders to fundamentally reform Eurozone institutions and structurally overhaul many Eurozone economies.

Thus far, European leaders have done what has been needed in order to avoid collapse. However, each party has looked after its own interests until the deadlines drew close. This will continue, though both the ECB and Germany will ultimately pay whatever price is necessary to avert disaster. The problem for the markets is that these central players cannot say that this is indeed what they will do because they risk moral hazard by committing to bailouts. Each of the four main classes of creditors—Germany and the other northern European governments, the ECB, private sector lenders, and the International Monetary Fund (as a conduit for non-EU governments like China)—are trying to transfer as many of the financial losses on Greek government bonds or European banks as possible onto the other three creditors, limiting their own costs and risks in the process.

The key decision makers in Europe—the ECB, Germany, France, Italy, and even Greece—are keenly aware of the catastrophic costs of a collapse of the euro. Greek politicians know that, without the euro and outside the European Union, their country would collapse into a politically vulnerable economic wasteland and/or experience a military coup (the collapse would be far worse than the economic crisis seen since 2009). Angela Merkel knows that, if the euro collapses, Germany's banks would also collapse under the weight of their losses on loans to the Eurozone periphery; the new Deutsch mark would skyrocket, undermining the entire German export economy; and Germany would once again be blamed for destroying Europe. The ECB, of course, would not want to put itself out of business.

Those political games of chicken are repeatedly being played by all actors to try to extract the best possible deal for themselves. Those who claim that there is no solution to the crisis are mistaken; any of the main players (the ECB, Germany, and the IMF) have the resources to write a check and expand the bailout resources. More importantly, they understand that ultimately that this would be less expensive than a disorderly sovereign default and/or collapse of the euro. In the end, there will be a compromise. But first, each of the main players must feel it has gotten the best possible deal or has run out of alternatives.

"The European Crisis Deepens," Peter Boone and Simon Johnson, Peterson Institute for International Economics, January 2012

One after another, plans by Eurozone and international officials to restore confidence in deeply indebted European countries have failed. The key issue that could allow the European sovereign debt crisis to spiral out of control is the transformation of Europe's sovereign debt markets. The risk premium embedded in troubled Eurozone members' borrowing costs has made the market cost of borrowing unsustainable not only for heavily indebted European sovereigns, but also for European banks. The reality is that the situation in Europe is so dire that a small perceived risk that the Eurozone could break up may rapidly lead to a systemic financial collapse.

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The introduction of a default risk premium into many Eurozone countries' borrowing costs has led to a situation where some European countries and their banks are effectively insolvent without large scale bailouts. As bond markets have stopped considering sovereign debt "risk free," European countries will drastically need to cut their debt loads to continue borrowing from private markets. Recent bailouts have only made things worse for heavily indebted European sovereigns, by attempting to fix a solvency issue with provisions that address a liquidity problem. Subordinating private creditors to official sector creditors is no way to encourage private sector creditors to continue to lend. Additionally, official sector creditors and politicians have effectively given themselves the flexibility to make subjective decisions regarding potential payouts and terms of future restructuring of sovereign debts. The reality for investors and potential lenders to Eurozone sovereigns is that the increased uncertainty has forced them to attempt to forecast not only a borrower's ability and capacity to repay its debts, but also the expected future actions of political and official sector leaders.

As Eurozone governments appear to be reaching their debt limits, there have been calls for the European Central Bank (ECB) to increase its efforts and contribute toward a bigger "bazooka." Thus far, actions by the ECB have been successful in providing adequate liquidity to Eurozone sovereigns. However, there would be two problems with a more significant intervention. First, the sums involved to convince investors that the risk of default had been taken off the table for these countries, for a prolonged period, would be enormous. For example, purchasing 75% of the existing debt of the troubled countries, plus financing their deficits over five years, would cost around €2.8 trillion—equal to 29% of Eurozone GDP. The contingent risks that this would present to countries backstopping the lending (such as Germany) are simply too large to bear.

Second, the crisis in Europe effectively remains a solvency issue, so additional ECB-led action is unlikely to get to the root of the problems in Europe. Overly indebted European borrowers have found themselves in a situation where their economies are structurally uncompetitive; wages must be reduced and labor markets reformed. The inability to devalue currencies to help competitiveness is a significant issue; politically difficult fiscal austerity and reduced spending is the only way heavily indebted sovereigns can reduce debt levels. While previous bailouts have included many measures to help meet these goals, the evidence shows that plans were not sufficiently ambitious and many targets have now been missed. As growth in the Eurozone is already anemic and recession is likely, the problems will worsen and the risk of default will only escalate.

The current crisis in Europe is unique with respect to the size and amount of coordination necessary to solve the problem. While there are potential solutions, none come without significant costs and political risks. For example, more severe wage cuts and changes in fiscal policy could help restore the competiveness of the peripherals, but resistance so far shows how difficult this is to enact. Perhaps more importantly, debt levels could be reduced via further haircuts and lowering interest rates on peripheral sovereign bonds, but doing so would blow a large hole in the balance sheets of European banks, pension funds, and insurance companies, and money to recapitalize them is lacking. At a minimum, this leads us to believe that there will be more sovereign defaults and debt crises that plague Europe over the next couple of years. Given the combination of the harsh realities of prolonged economic stagnation, nervous markets, and highly levered financial institutions, the outcome could be far worse. ■