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The European Debt Crisis: Can the Euro Survive?

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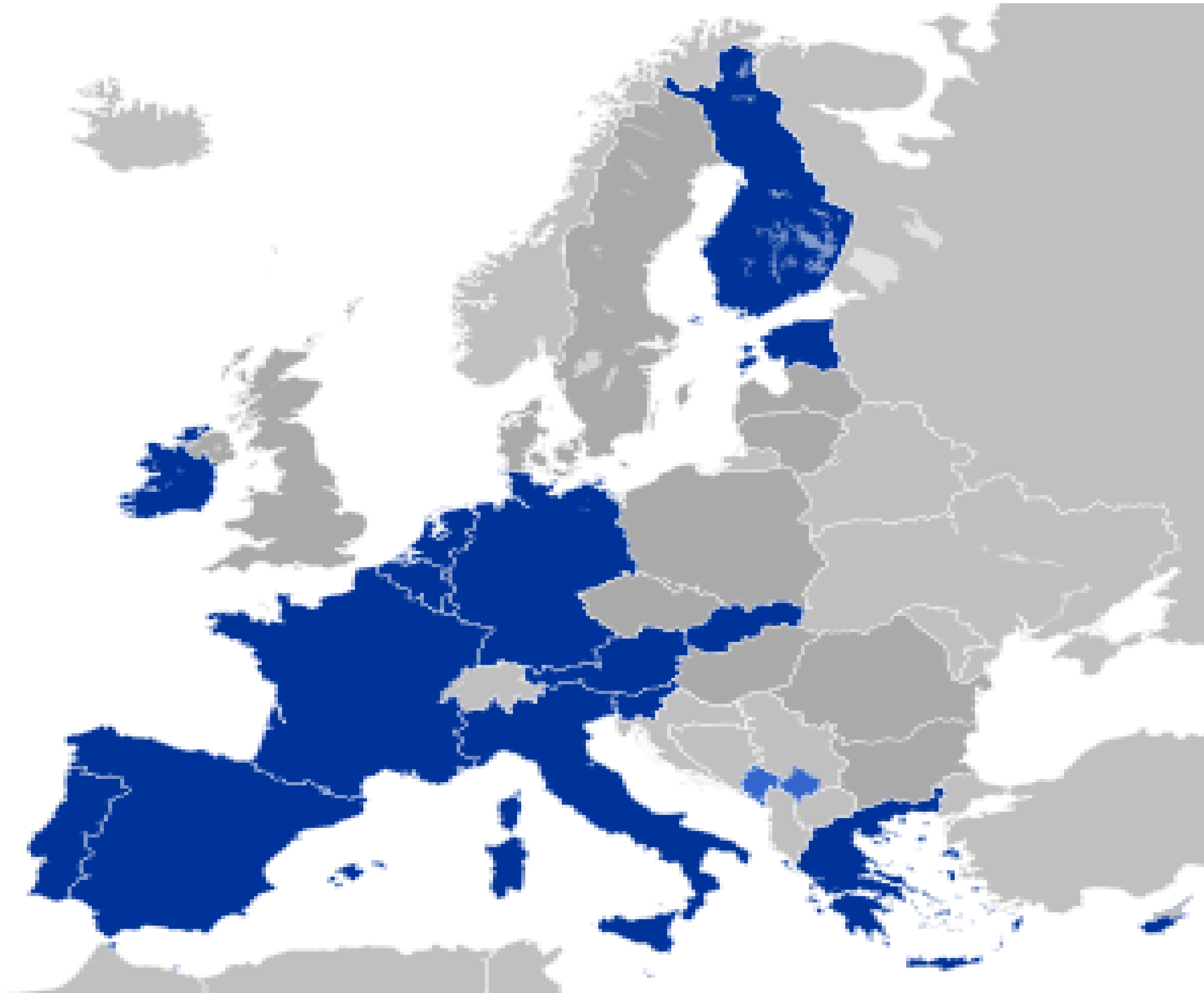
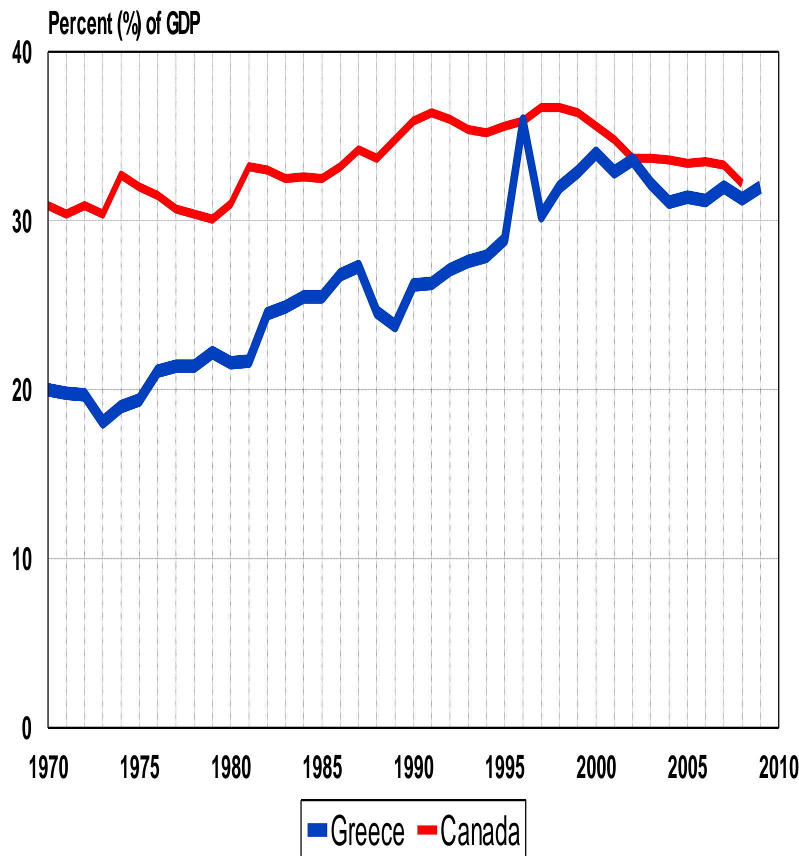
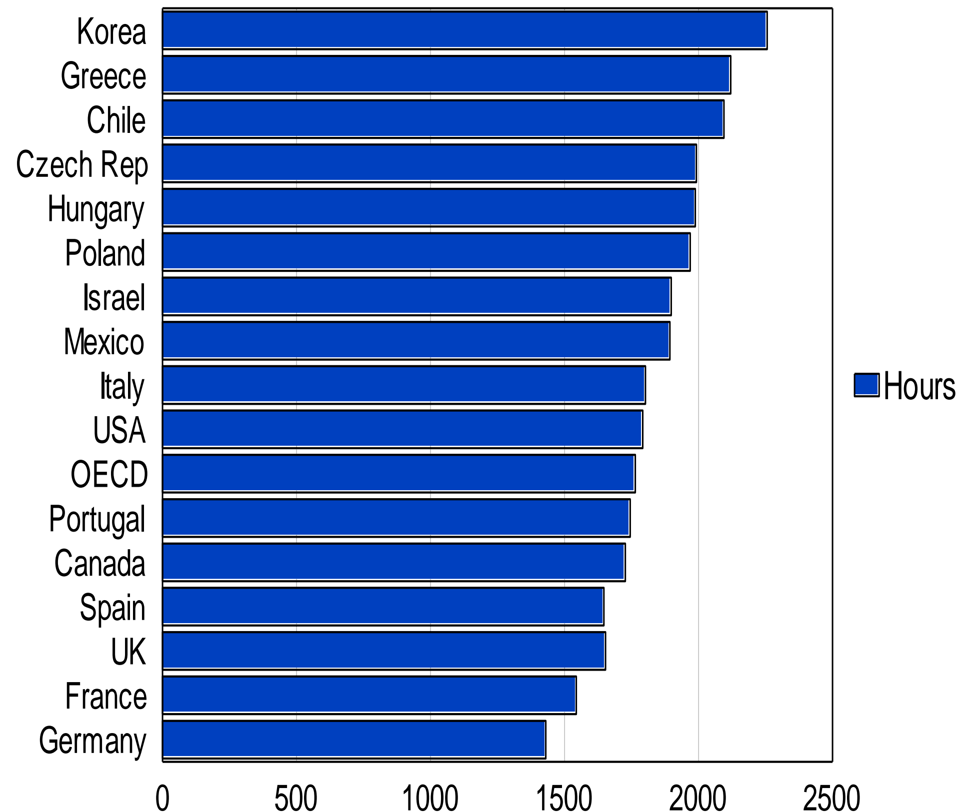


Why is the Euro in Crisis?

- The crisis first manifested itself in Greece, then it ‘spread’ to Ireland and Portugal; Now it is threatening to engulf Spain, Cyprus and Italy
- Contrary to what German and international media have you believe, Greece did not cause the crisis but is a victim of the crisis
- Will examine the causes of the crisis, what has been done to resolve the crisis and will examine possible solutions and the prospects for resolving the crisis

Greeks pay as much tax as Canadians do and work the longest hours after the Koreans





Yet, Greece has been unfairly vilified in order to turn attention away from the real problem, at a catastrophic cost to Greece! Cumulative output loss: 20%

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What caused the Euro debt crisis?

- It is not an isolated event but part of a larger crisis
- It is a continuation of the **global financial crisis** that broke out **5** years ago on August 8, 2007 when BNP Paribas froze three of its funds after acknowledging their exposure to impossible-to-value CDOs
- After escalating in September, 2008 following the demise of Lehman Brothers and the global recession that followed in 2009, it **metastasized** to become the 'Euro debt crisis'
- It is a 'systemic crisis' afflicting the Euro Zone (EZ) specifically because of **structural faults** in the design of the EMU
- It is endemic in the EZ and it has two sides to it: 1) it is a **sovereign debt crisis** and a EZ **banking crisis** at the same time

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What caused the Euro debt crisis?

- During the 2008-2009 financial crisis and global recession:
- The size of government response in the EZ was much smaller than what we got in the US & the UK
- EZ banks were far more **leveraged** and have remained more leveraged than US banks
- **Misapplication** of Basel II capital adequacy rules by EC Banking supervisory authorities
- **Absence** of fiscal union in EZ and because of **narrow** mandate of ECB
- German **recalcitrance** to see the big picture and reluctance to assume a leadership role

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EZ Banks received far less support from their governments than those in the US and UK

Government Support Packages to Financial Sector United States, United Kingdom and Eurozone				
Trillions of US $	UK	USA	EURO	Total
Central Bank				
- "Money creatio	0.32	3.76	0.98	5.06
- Collateral swa	0.30	0.20	0.00	0.50
Government				
- Guarantees	0.64	2.08	1.68	4.40
- Insurance	0.33	3.74	0.00	4.07
- Capital	0.12	0.70	0.31	1.13
Total (% of GDP)	74%	73%	18%	15.16

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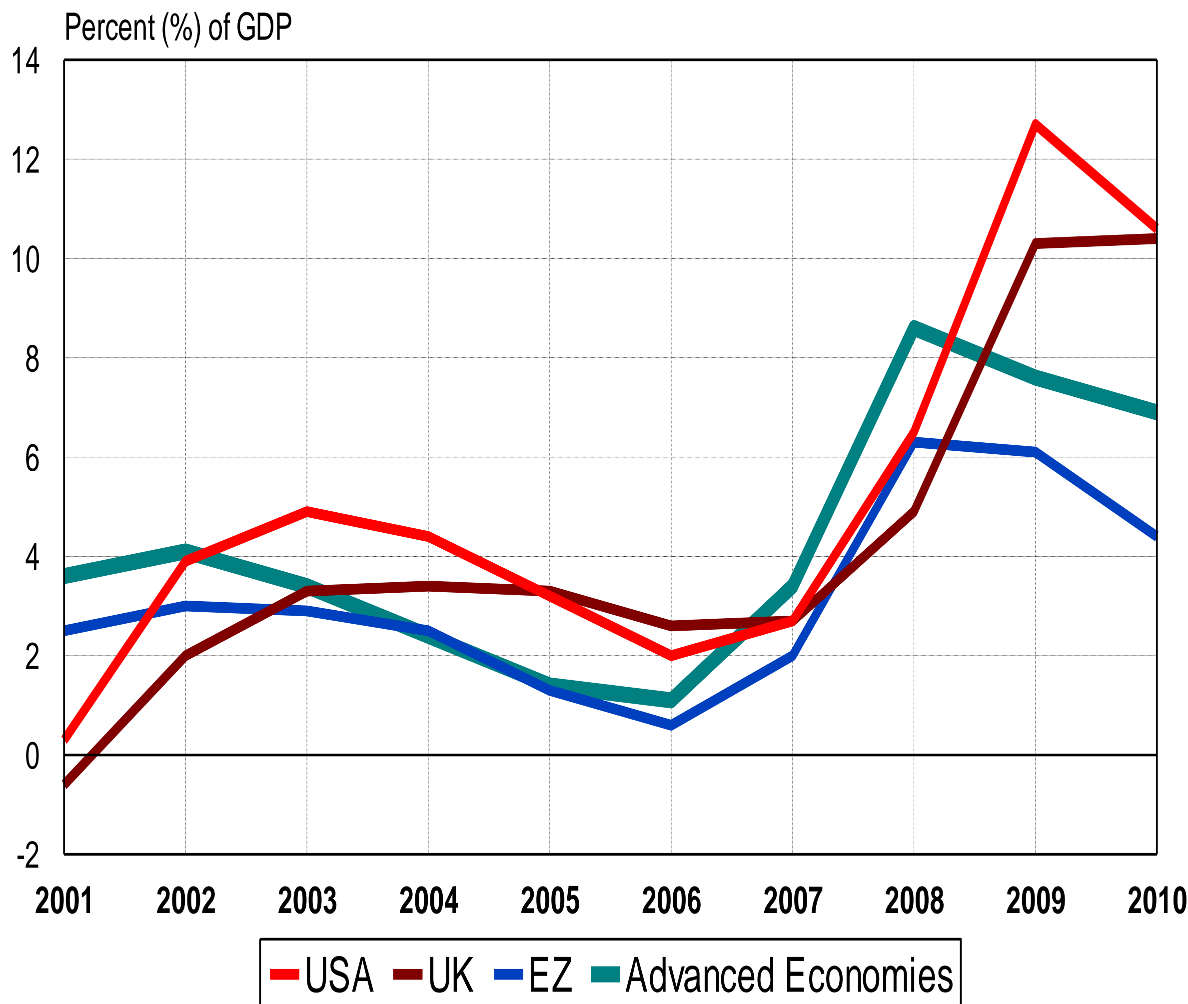
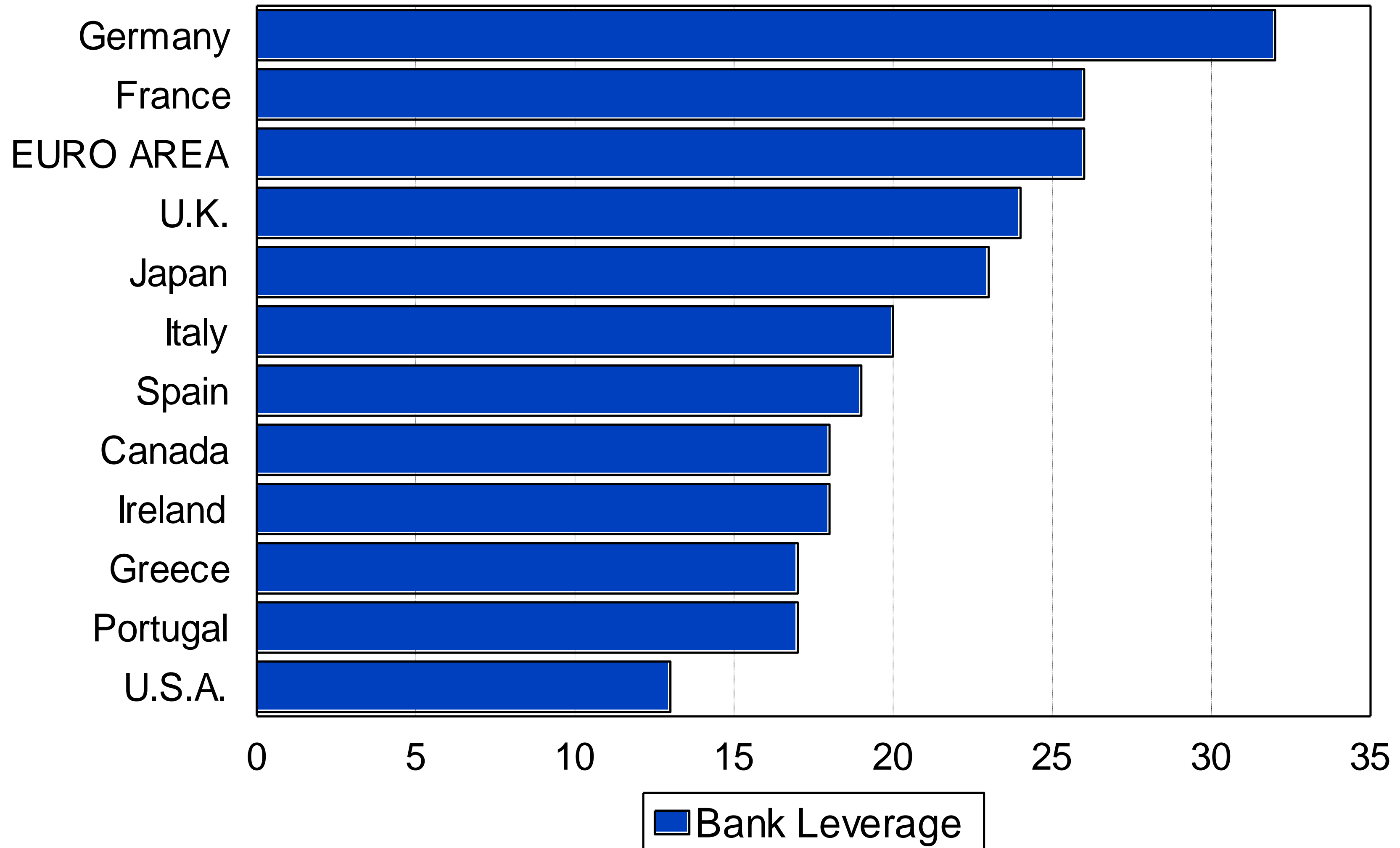
Fiscal Support in the EZ was less than half that given in the US and UK and less than other advanced economies



EZ banks were more leveraged and less capitalized than US or UK banks



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Misapplication of Basel II Capital Adequacy Rules by EU Banking Authority

- Basel I & II capital adequacy rules require that bank assets are risk-weighted for determining Tier **1** & Tier **2** minimum capital requirements, e.g. 8% Tier 1 rule
- E.g.. Risk weighting was 50% for first mortgage loans; 100% for consumer and unsecured commercial loans; 0% for 'home country' bonds and 20% for OECD country bonds
- Home country bonds are rated as **risk-free** because home country can print money and redeem these bonds in home currency as a last resort
- Implication of this rule is that a bank can buy as many bonds as it wants to earn interest income without tying up any of its own capital, hence make more money without taking risk or raising additional capital

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Misapplication of Basel II Capital Adequacy Rules by EU Banking Authority

- When EMU was created, the EU banking authority determined that the 0% risk weighting should apply to all EZ member banks when they purchase bonds issued by other EZ governments since they shared a common currency and central bank

- The practical effect of this interpretation was that Greek, Italian and Portuguese bonds became as secure to invest in as German or French bonds

- This drove demand for EZ-periphery country bonds up and drove yields down to levels almost equal to those of German bonds

- The investment banking divisions of EZ and UK banks earned fees issuing bonds to the EZ-periphery and earned interest income and capital gains by driving up the price of these bonds

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Misapplication of Basel II Capital Adequacy Rules by EU Banking Authority

- In hindsight this interpretation proved extremely hazardous, the ‘Achilles heel’ of EZ bank regulators, Why?
- 1) Because even though currency risk had been eliminated by creating a common currency, credit risk was still present as each government was singularly liable for its own debts
- 2) Because the ECB is <u>un</u>like other central banks in that it has <u>no</u> mandate to print money to redeem any of its member country sovereign debts; its only mandate is to issue the currency and price stability
- 3) It created the impression that there was no risk in purchasing any EZ country bonds

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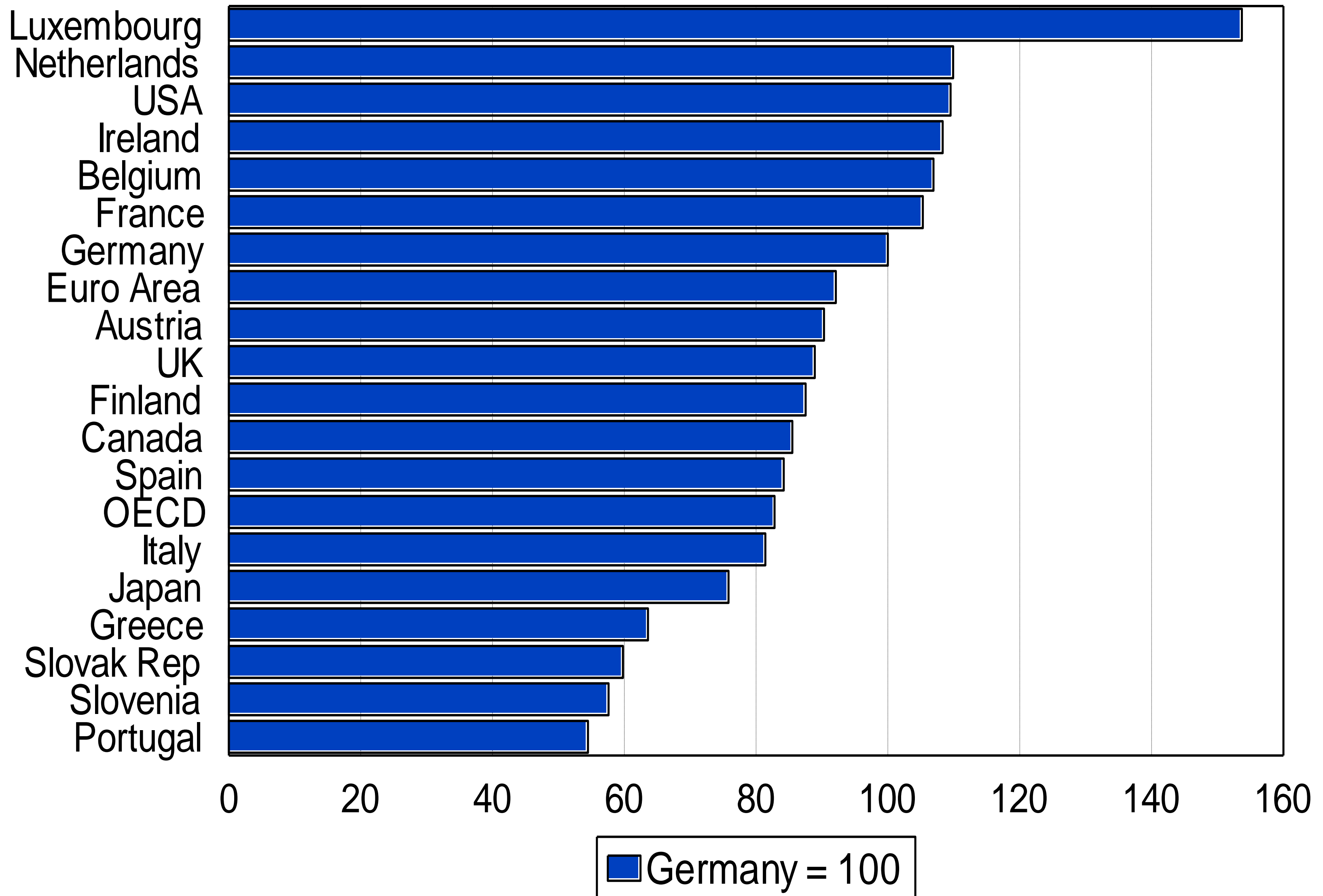
The EZ is a common currency area but not a fiscal union

- A common currency regime such as the EMU is like the gold exchange standard that was in place under the Bretton Woods system (BWS) of fixed parities from 1944-1973
- While the BWS allowed countries to revalue or devalue their currencies in case of fundamental disequilibrium, there is no such provision in the EMU, nor is there any provision for exiting the union.
- While the BWS had the IMF in place to assist countries in overcoming liquidity crises, the EMU has not
- The only option is internal revaluation or devaluation: either the core must raise salaries and spending or the periphery must lower salaries, reduce expenditures and increase productivity or a combination of both

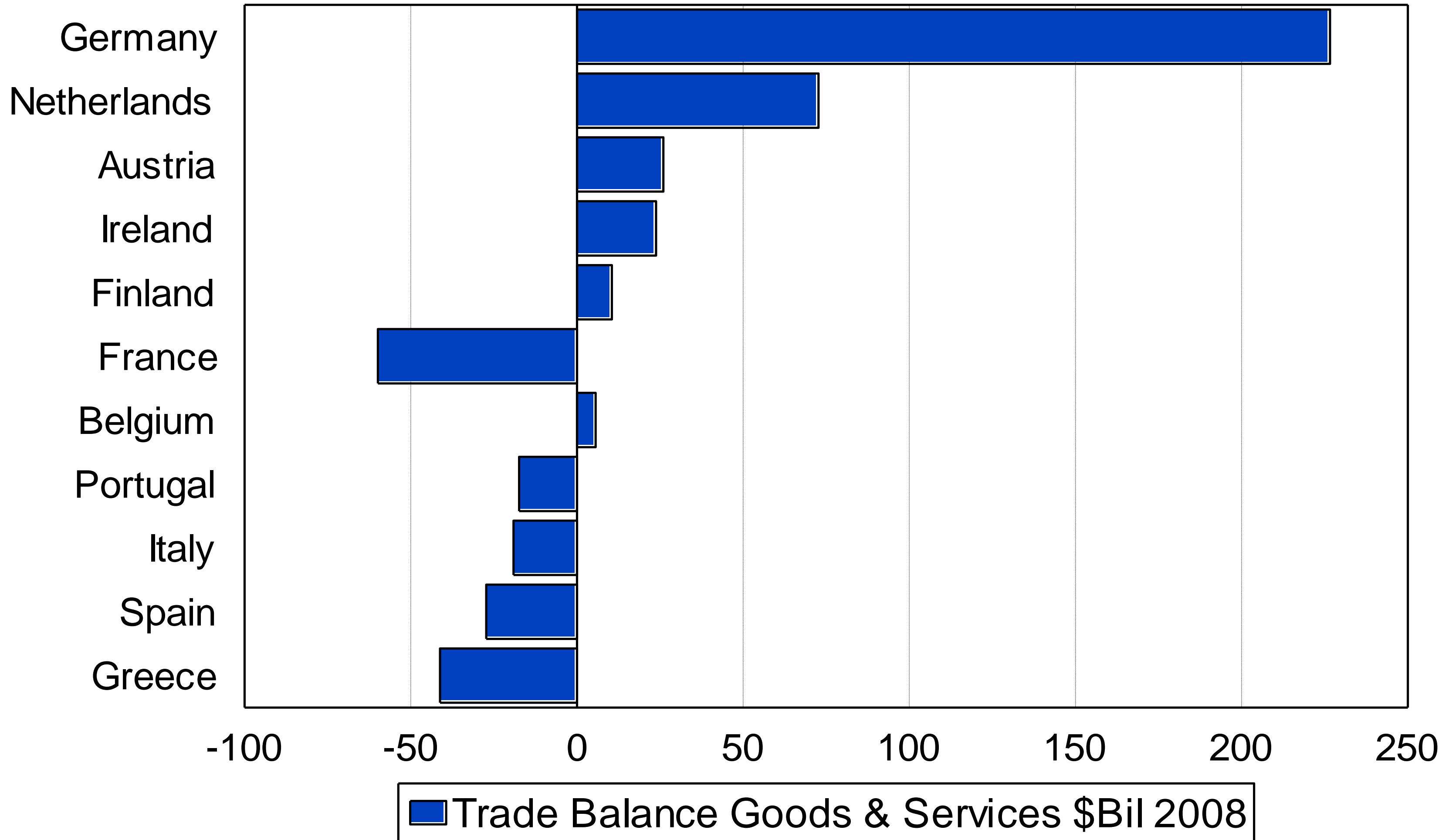
A Common Currency is Sustainable in an Optimal Currency Area

- A common currency without a fiscal union is sustainable when the member countries have roughly similar levels of economic development, productivity and socio-economic structures, what is known as an '**optimal currency area**'
- This condition is not met fully in the case of the EZ
- There is roughly a 30% productivity gap between the North and the South of the EZ
- This is reflected in the trade competitiveness of the two regions and their trade imbalances
- These facts suggest that: as presently constituted, the EZ cannot survive unless radical changes are implemented

EZ is not quite an optimal currency area



Competitiveness in Trade Balances: The Divide Between the North and the South



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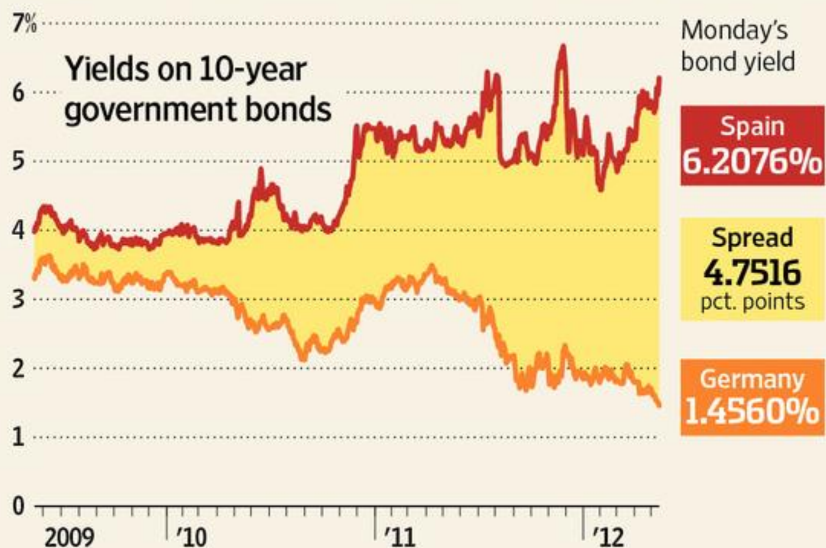
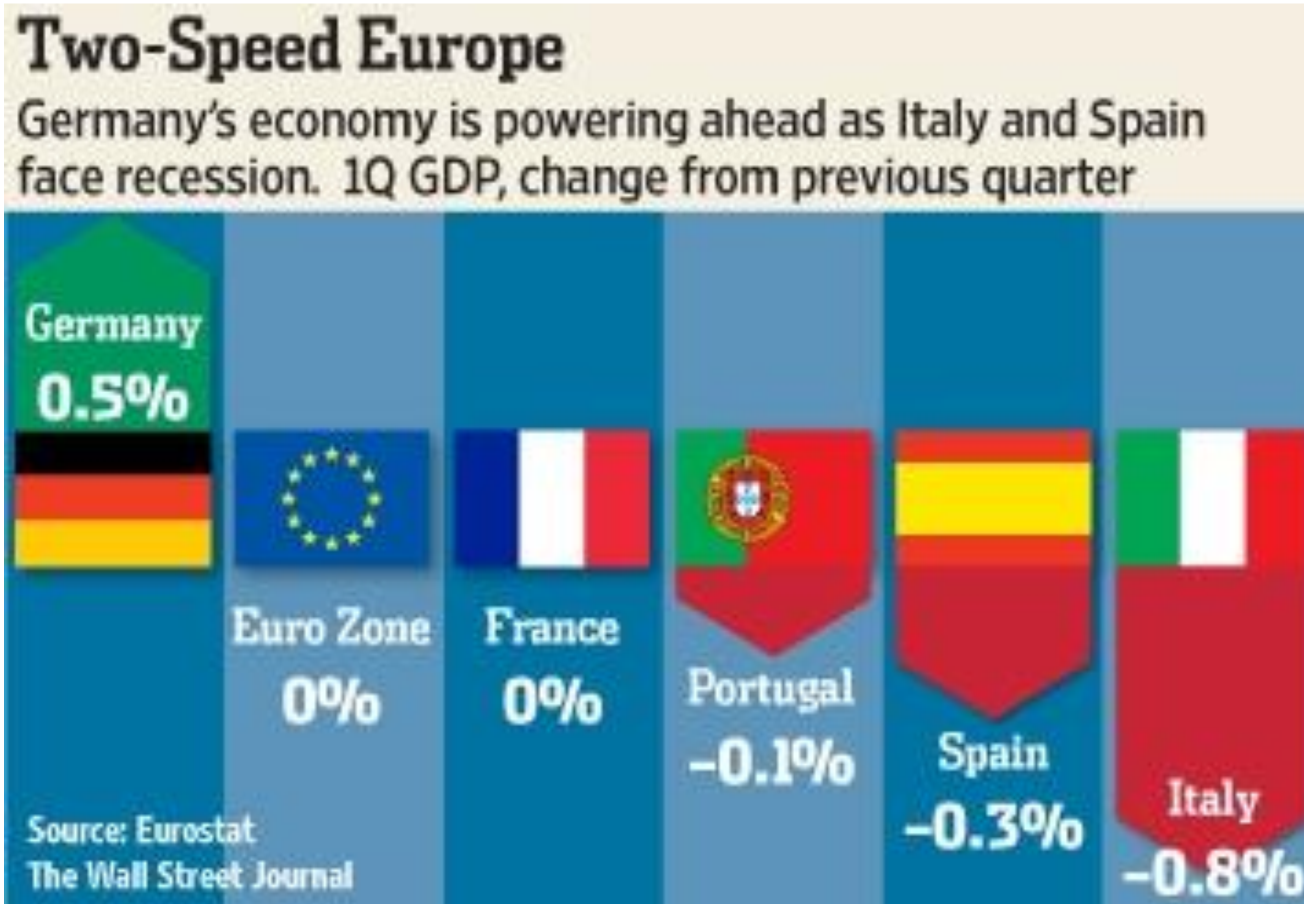
Rising spreads between the Core and the Periphery are tearing the EZ apart:

A Euro form of Cannibalism



Austerity measures have driven the EZ into recession, with the worse to come



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The only way to make the EMU sustainable is to create a Fiscal Union

- Productivity and competitiveness gaps are as big and greater within federal unions like Canada and the United States
- Despite such gaps these countries function effectively because they have fiscal unions
- When a fiscal union is combined with a common currency, payments imbalances no longer matter within the economic union
- When debts are commonly held, no part of a country can suffer the type of ‘sovereign’ debt and banking crisis that the EZ is currently facing
- Structural reforms can make the South more competitive, but structural reforms take time to implement and bear fruit and presently the EZ cannot afford to wait

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What does a Fiscal Union mean?

- Fiscal Union means that member countries **pool** together or **mutualize** their sovereign debts to create a single EZ debt financed by issuing new EZ-bonds and creating a single EZ bond market
- Each country transfers the power to borrow money to a supra-national authority, an EZ-Treasury, that raises money on behalf of its members to finance budget deficits
- New EZ or Euro Bonds are **jointly and severally** backed by all member governments together
- Governments coordinate budgets and fiscal policy closely and agree to operate with common set of budgetary rules

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Is a Fiscal Union feasible in the EZ?

- As Joseph Stiglitz famously said: “You cannot unscramble a scrambled egg”
- The Euro is ‘**too big to fail**’
- The amount of **political capital** that has been invested in the Euro project is immense
- The collateral damage to the global economy is immense. The US, UK, China and Russia will apply the pressure necessary to avoid a euro meltdown because the **consequences** are simply incalculable and **too catastrophic** for the world economy
- The benefits from forming a single European government bond (EGB) market are simply too great to pass on

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What are the benefits from a unified, single EGB market and the Euro Bond?

- EU bond markets will no longer be segmented along national lines
- A single, unified EGB market emerges
- An EGB market of $10 trillion, a size, depth, breadth and liquidity to match the $13 US market for treasuries
- Yields on euro bonds fall below pre-crisis levels and allow EU governments to share in seigniorage or 'exorbitant benefit' of US dollar
- Underpins strength of Euro transforming it from reserve currency to world money, similar to US dollar
- Puts an end to uncertainty, boosts confidence in the EZ and puts an end to the Euro sovereign debt and banking crisis
- Re-ignites economic growth on the European continent

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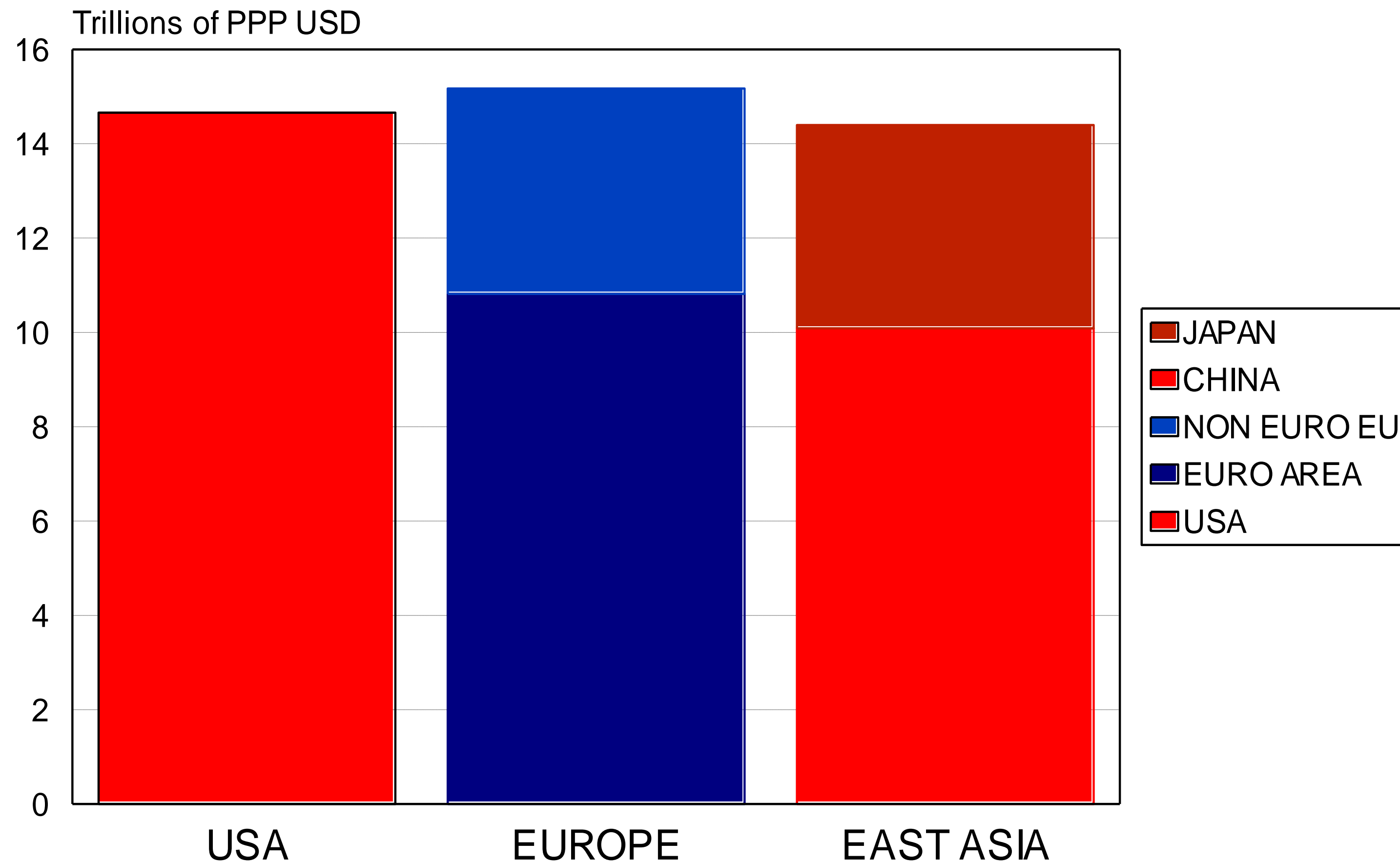
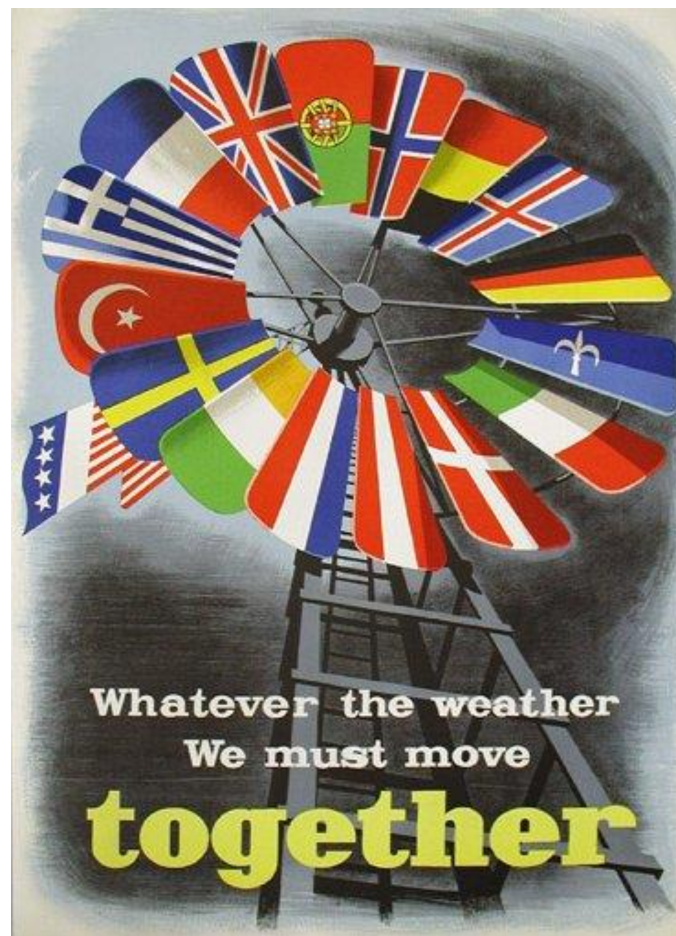
If Fiscal Union does not take off the runway, there is always the 'nuclear' option

- What if the Euro leaders fail to come up with a fiscal union in time to prevent a break-up of the euro?
- Then, there is the 'nuclear' option:
- The ECB will be forced to buy huge amounts of EZ government bonds by printing money, a Euro Area **quantitative easing** (QE2) to backstop the euro and restore growth momentum
- US Federal reserve has done QE1, QE2 and now contemplating QE3;
- UK has done numerous QE injections as has the BOJ
- Failure is not an option, **The ECB will be forced to act !**

The Euro is too important to be allowed to fail, The World Depends on it



"Whatever the weather, We must move together"



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Thank you!

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- **Read: Matziorinis (2012) "Is the Euro Bond the Answer to the European Debt Crisis?", Journal of Wealth Management**
- **http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1999518**