On Campus

Too Late for the Euro?

A decade into its ambitious currency experiment, the Eurozone is in trouble. Business school professor David Beim, a financial-markets expert and former investment banker, says the euro's hour of reckoning is at hand.

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For more than a year we've been reading that the European debt crisis, which began in Greece, has put the survival of the euro in doubt. How likely is the euro to survive 2012?

Not very. It might hit insuperable stress this year. What would crack the euro would be the defection of one or more countries. Greece has elections in April, and the opposition could well turn anti-euro after yet more austerity. Or the opposition in a small northern country — the Netherlands, Austria, Finland — might try to block further “rescue” payments.

In December, the European Union held an emergency summit in Brussels. What did it accomplish?

It produced a declaration of intent. German chancellor Angela Merkel and French president Nicolas Sarkozy agreed to recommend a treaty change that would establish more central control over member states’ budgets. Debts would have to be reduced to below 60 percent of GDP and deficits to below 3 percent of the GDP. These were the original requirements of the Maastricht Treaty, which set up the euro in 1992, but they were never enforced. In fact, Italy never did meet them, nor did Greece, which concealed its figures to pretend it did.

Even Germany doesn’t meet those criteria today.

Only Finland does. A treaty change would require the signatures of all twenty-seven EU members, which is horrifically difficult to achieve. Of the ten EU members that did not adopt the euro from the outset, only two (Sweden and Denmark) meet the Maastricht criteria today.

As you’ve seen in the papers, Britain has already balked. Prime minister David Cameron said he would not sign, because the EU was going to give powers to the European Court of Justice and the European Union bureaucracy in Brussels to enforce budget discipline and put sanctions on countries that fell outside of their agreements. Cameron said, in effect, we’re not going to let a bunch of bureaucrats in Brussels tell us how to do our budget. Even Sarkozy said publicly that the sovereignty of France comes first and anything that impinges on it is out.

My guess is that there will not be a treaty change for the immediate future. Lacking that, states that consent to more central economic control will have to work out an executive agreement with less than all. That would create three unions: twenty-seven in the EU, seventeen in the euro, and some lesser number in the control agreement. It’s messy.

Have you always been a euro skeptic?

No, I've been a euro enthusiast for fifty years. I've lived long enough to remember the beginning, when Europe was first getting organized and Europeans said, we've been ravaged by two horrible world wars, and we're going to be sure that never happens again. I thought, fabulous: this is really important. I applauded Europe for getting its act together. The designers of the European Union began brilliantly by lowering trade barriers in the 1960s and 1970s, aligning product rules in the 1980s, and promoting financial-market integration in the 1990s.

Wasn't the union more than economic?

Absolutely. Its designers wanted to harmonize not just economic relations but also broader social and military policies, so Europe would feel more like a force in the world, a unified set of powers rather than a bunch of people bickering with one another. But there remained confusion about the endgame. Was the ultimate goal a single country, a United States of Europe? Or was it something less, and, if so, what?

The euro was not an end in itself. I get distressed when I hear politicians saying that the euro must be saved at all costs. Really? I would have thought cooperation must be preserved at all costs. If the euro promotes closer cooperation, then it is a good thing. But if the euro becomes divisive, pitting the interests of Northern Europe against those of Southern Europe, then it needs to be rethought.

You've written that a critical flaw of the Eurozone is that it lacks effective governance.

There is no governance structure for the euro. There should be. Any great enterprise deserves a CEO and a leadership structure with full authority to make decisions that bind all those connected to it. Instead, the Eurozone needs to get seventeen separate legislatures to agree to every significant initiative. This precludes the EU from taking decisive actions and causes the crisis to drift unresolved. The Eurozone is a monetary union without a political union.

Isn't the European Central Bank (ECB) part of a governance structure?

The ECB is the manager of the currency. It controls the interest rates on short-term euro deposits, and can increase or decrease the supply of euros — it owns the printing press.

When states give up their separate currencies, they give up having their own monetary policy — they can no longer print money and can no longer devalue their currency. These are important tools for managing an economy, and it is quite serious to lose them. Greece, for example, is now quite dependent on Germany and the other northern countries, and this is uncomfortable on both sides.

This gets to the heart of the euro crisis. Loss of a separate currency is a partial loss of sovereignty. Are the nations of Europe ready for this, or does national identity still trump European identity? The December summit formally raised the idea of a fuller fiscal union. But most European states are less than enthusiastic about such a fiscal union, now that they look at it more closely. The Finns like being Finnish, the Greeks like being Greek.

Is the size of the Eurozone part of the problem?

The Eurozone is too big, and the member countries are too different from one another. A currency union can succeed only if its members are sufficiently alike. In particular, they need to have a common rate of inflation. The currency of a more inflationary country will gradually devalue relative to the currency of a less inflationary country. For example, Greek prices increase about 2 percent a year faster than German prices, and this was true both before and after the euro was introduced. Germany is just more efficient, and its productivity rises faster than Greek productivity. When currencies were separate, the deutsche mark steadily appreciated and the Greek drachma steadily depreciated. In the fifteen years before the euro's launch in financial markets in 1999, the drachma lost three-quarters of its value relative to the mark.

These value changes played an important economic role: they enabled trade between Germany and Greece to expand without causing balance of payments problems. But look what happens when you lock the two currencies together: now the higher rate of Greek inflation makes Greek goods become more and more expensive to Germans, and makes German goods look ever cheaper to Greeks. As a result, Germany over-exports and Greece over-imports. Cheap northern imports begin to crush Greek businesses, while Germany piles up ever-more cash and IOUs from the south. Germany has now become the China of Europe, and for a similar reason. Currency prices matter a lot.

Yet a border-free Europe seemed to hold a lot of promise.

There is an economic theory called convergence that says that if you globalize — if you open your borders totally so that goods, services, people, capital, ideas, and money move freely across borders — then we will become more like one another.

The hope was that the euro would make Europe converge. But it didn't. Germany exercised wage restraint, liberalized regulations, and opened further to global competition, all of which boosted German productivity. Greece, Portugal, and other southern economies continued to limit competition, supported local monopolies, and left restrictive labor practices in place. Instead, the euro has revealed the lack of real convergence, the huge differences among these countries in corruption, rule of law, regulatory quality, and government effectiveness. Currency union should not have been implemented until such differences among countries had been more substantially erased.

Is the Eurozone too big to fail?

I don't know who would bail it out. It's too big for the International Monetary Fund (IMF). I don't think the United States could spend scarce resources trying to bail out Europe. As for the Chinese, I was teaching a group of about thirty senior Chinese executives who had come to the business school's executive-education program recently. I gave them my little talk on the euro, and they were visibly angered at the thought that the euro might fail. They said, "We want it to succeed; it must succeed." They want to have an alternative to the US dollar. That's their game. But are they going to put money into the euro? I don't think so.

Could the European Financial Stabilisation Mechanism or a unified European bond help?

These are both ways of raising new money that might be lent to the stressed governments of Southern Europe. But because this kind of lending is temporary, its success depends on the theory that the underlying imbalances will quickly self-correct. They are not self-correcting, though. Once you see that the payments imbalances are structural, and are the result of the euro itself, you realize the folly of lending ever-larger amounts to states that already have too much debt. These are called bailout loans, but they are not bailouts at all: they only increase the debt of countries that have too much debt already. They pour more water into the boat, they don't bail it out. If countries have too much debt, there's only one rational solution: reduce their debt.

We had a comparable situation in the 1980s, when almost every government in Latin America was over-borrowed and in default. Everybody thought they'd grow their way out of it, but they didn't, and the crisis only got worse. The interest due was never paid but got rolled up into ever-higher amounts of principal. Those countries were just strangling. In Mexico it was called the lost decade. The crisis was brought to an end in 1989 by Nicholas Brady, the US secretary of the treasury, who told the banks that they had to negotiate major reductions of Latin sovereign debt. And so they did. New "Brady bonds" with secure principal but lower value were exchanged for existing loans. Latin sovereign debt was reduced by 50 to 85 percent, depending on the country. US banks and other big banks took a huge loss, but prosperity quickly returned to Latin America. Southern Europe urgently needs that kind of relief.

How would that work?

It would basically be an offer to all those who hold Greek bonds, for example, to exchange them for a new instrument of greater security but lower value.

Isn't a deal like that being negotiated?

Yes, but it's too little and too late, and it involves only private-sector lenders; that is, it exempts the ECB, IMF, and other state organizations. Also, they are trying to make it voluntary, which is extremely difficult to negotiate. The euro leadership has said they never want to do this again. But they will have to do something, some day.

My thought is to give the stressed Eurozone members true debt relief — comprehensive debt reduction that could let them restart their economies, but on one condition: those that get such relief must leave the euro. That condition gives them a reason not to ask for it; every country would want a debt reduction unless there was a penalty, and this would be the penalty, which would slow down contagion.

I don't think this is an unreasonable condition. Greece should never have been in the euro in the first place. Its businesses are now being crushed under a wave of cheap imports because its currency is overvalued. Re-establishing the drachma would be messy and expensive, but less messy and less expensive than staying in the straitjacket of the euro.

But the Eurozone leadership is not going to want to do this, is it?

No, amazingly, they are locked into a political idea that the euro must be preserved in its present form, no matter what payments imbalances it leads to. I have never seen a project with such strong politics and such weak economics. If some party has too much debt and is being economically crushed, like Greece, something needs to change — a fresh approach is needed. Instead, the leadership steams forward with more of the same, lending ever-larger sums instead of rethinking the fundamentals.

How serious a problem is that?

The ECB recently announced that it will lend unlimited amounts to Eurozone banks on low-rate, three-year terms, creating the impression that Eurozone banks have an unlimited capacity to finance the Eurozone governments. But there is a huge problem: banks also need more equity capital to carry increased assets. The Basel rules require that banks hold sufficient “core tier 1 capital” — essentially, common stock and retained earnings — against various types of risks. These standards have been raised as a result of the 2008–2009 financial crisis, and now European banks do not have enough capital to counterbalance all the assets they currently have, let alone new ones. The European Banking Authority recently estimated the capital shortfall of EU banks at 115 billion euros, though if the actual market prices of sovereign bonds were taken into account, the capital shortfall would come out closer to 300 billion euros.

In other words, unless some nice investors show up willing to buy one or two hundred billion euros of new common stock in the European banks, the banks will have to sell off existing assets and will be in no condition to go on financing the governments of Europe. Deutsche Bank estimates the expected bank downsizing at 1.5 to 2.5 trillion euros. Banks have overdosed on government bonds in the past and must now slim down. This takes out of action the main class of buyers for Eurozone government bonds.

What happens when those bonds mature?

Some day quite soon, a stressed government like Italy or Spain will attempt to sell new bonds to repay maturing bonds, and the market will be unwilling to buy them. Then either it will face default on the maturing bonds or the ECB will have to be the buyer of last resort. The ECB has tried mightily to avoid being in this position, but I think it will face this choice soon. And to avoid a sovereign default, with all its unknown consequences, I think they will succumb.

Why is it so terrible for the ECB to buy government bonds?

Because the ECB can pay for them only by printing money. What we call “money” is the promissory note of a central bank. Look at a dollar bill and you will see the words “Federal Reserve Note” across the top. A central bank, like any company, has assets on one side of its balance sheet and liabilities and capital on the other. If it takes on new assets, it needs to issue new liabilities, i.e., create new money. This is like turning on the printing presses to finance the stressed governments of Europe.

Would that cause massive inflation?

I see no other possible outcome unless the Eurozone dramatically reverses course. This does not mean that prices would immediately start rising in Europe. There is currently a lot of economic slack all over the industrialized world. But the system would shift in a fundamental way, and the flood of new euros, once started, would be very hard to stop.

Furthermore, the quality of the euros would be undermined. The quality of any money depends on the quality of the assets in the central bank that issues it. Ideally, many would like a central bank to hold gold against its issuance of money, but there is not enough gold in the world to do this. The Federal Reserve does the next best thing and holds treasury bonds against its issuance of dollars. This is the closest thing we have to a risk-free asset, so the dollar has retained its popularity. But the ECB’s assets are far from risk-free, and if it becomes the lender of last resort to stressed governments, its asset quality will deteriorate rapidly, and people’s trust in the euro will soon fall. You don’t want your currency to be backed by doubtful assets.

How long could the system go on in that case?

Not very long. I would guess that this scenario would lead fairly soon to the withdrawal of one or more northern countries from the euro. It probably wouldn’t be Germany at first, because they are working so hard to be good citizens in this drama, but it could easily start with the Netherlands or Finland.

Shortly before the December summit, the Organisation for Economic Co-operation and Development (OECD) warned of a worldwide recession if the euro crisis were not resolved.

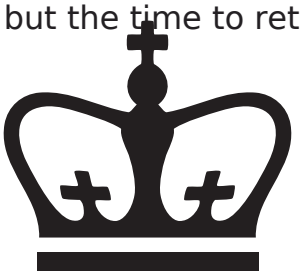
The OECD is right. The flood of government bonds has overwhelmed the Eurozone banks and crowded out bank lending to the private sector, which has fallen precipitously in the past few years. The austerity imposed by the debt crisis further represses the economies. In fact, some economists will soon be saying that the massive printing of euros is desirable to fight recession, a kind of super quantitative easing.

But the real answer, I believe, is to admit that the primary source of these problems is the euro itself. Locking together the currencies of countries as different as Germany and Greece is a mistake, and predictably leads to payments imbalances. The same happened to Argentina, which locked its currency to the dollar in the 1990s and soon fell into a current-account imbalance, rising public deficits, debt escalating without limit, and a bruising economic recession induced by austerity. It ended when the peso was re-established and inflation resumed. That experiment lasted ten years.

The euro turned ten on January 1.

And it is showing the same pattern of current-account imbalance, rising public deficits, debt escalating without limit, and a bruising economic recession induced by austerity. Many intelligent and dedicated people have worked extremely hard to create and defend the euro. But the project is deeply flawed. It includes too many countries too unlike one another. It has no governance system to resolve its many stresses. And the central bank at the center of the system is about to swallow lots of bad assets and pay for them with newly printed money. This would be an ironic end for a currency that was designed to take printing presses away from national governments.

It is painful and difficult to reverse a course that so many governments have so thoroughly committed themselves to. Nevertheless, the question of exit is now being discussed in public for the first time. An orderly exit needs to be planned for, or a disorderly exit will soon occur. Europe should begin this reversal by creating a pathway for exit, beginning with Greece. The euro was a bold and creative project, but the time to rethink it has arrived.



Guide to school abbreviations