EMU — IS IT TIME TO DROP THE M?
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The Economic and Monetary Union (EMU) is synonymous with the euro zone, which for the past two years has been inexorably linked to some form of debt crisis. On June 27-28, for the 20th time since the euro crisis began, European leaders held a summit in an attempt to diffuse once again the most pressing problems and establish a long-term plan for economic growth and stability. As in several previous summits, they were clever enough to navigate the political obstacles and craft a set of measures designed to boost market confidence – albeit perhaps for only a short time.

There remains, however, an underlying concern among many market participants and analysts that the single-currency euro system is fundamentally flawed and that the offered prescriptions are either unworkable politically or fall short of dealing with issues of festering debt and competitiveness. This raises the question of whether it is time to abandon the monetary union and euro in favor of a return to multiple exchange rates. The initial costs would undoubtedly be high in terms of transition costs, lost output and the denting of European pride, but ultimately could be less than the mounting price tag from a long parade of emergency stopgaps.

**Summit Leaders Approve Tangible Measures**

Market participants have generally applauded policymakers for exercising common sense in crafting measures to tackle the problem of unsustainable borrowing costs for some member states. The leaders agreed to three key changes:

First, the European Stability Mechanism (ESM), the euro zone’s bailout fund, will be able to recapitalize banks directly, rather than through governments. This circumvents the previous requirement for public authorities to take the loans on their books as higher national debt and, according to the summit statement, will reduce the “vicious circle” between governments and banks.

Second, the ESM will be permitted to intervene in the primary debt market of countries not subject to bailout programs. In theory, these primary market purchases should result in much more “bang for the buck” (or in this case, euro) than would secondary market purchases. It is hoped that by making it easier and cheaper to reduce borrowing costs, countries like Spain and Italy can avoid the need for full-blown sovereign bailouts.

Third, the loans to Spanish banks will no longer be subject to preferred creditor status when they are transferred from the European Financial Stability Facility (EFSF) to the ESM. This will keep private-sector creditors from being pushed down the seniority list behind the lender countries.

However, like many of the previous edicts, the devil is in the details. Direct ESM recapitalization of the banks is a “possibility,” according to the summit statement, but not until “an effective single supervisory mechanism is established, involving the European Central Bank (ECB), for banks in the euro area.” Also, primary debt purchases by the ESM carry the condition that countries respect specific recommendations and other commitments, like the Stability and Growth Pact, which prescribe criteria for fiscal discipline. It is not entirely clear that Spain and Italy could meet such conditions today.
The leaders also signed a growth and jobs pact aimed at pumping 120 billion euros into the region’s moribund economies. Only about half the money can be dispersed quickly, according to senior EU officials. One of the key provisions in the pact increases the capital of the European Investment Bank (EIB) by 10 billion euros.

On the regulatory front, summit participants requested proposals that would help unify banking supervision and enhance the ECB’s powers. They referred to a clause in the EU treaty that allows them to give the ECB prudential oversight of banks and other non-insurance financial institutions. The European Commission, the EU’s regulatory arm, now has a green light to augment its proposals on deposit insurance, capital requirements and the handling of failing banks.

**Markets’ Initial Reaction to Summit Outcome**

With the summit concluding at 4:30 a.m. Brussels time on June 29, European market participants woke up to the pleasant surprise of measures being put into place to ease borrowing pressures in countries like Spain. Rallies ensued across asset classes, with European equities staging their biggest one-day move this year. Bank stocks were the biggest beneficiaries, with some share prices rising at a near double-digit pace. Sovereign bond prices also rallied, with the yield on 10-year Spanish bonds dropping nearly 50 basis points to under 6.5 percent. The euro appreciated roughly 2 percent against the U.S. dollar.

While markets exhibited something akin to euphoria, portfolio managers and analysts were more subdued in their comments. A sampling of reactions included the statement that “the agreement at least brings some clarity and stabilization in the short term.” A less enthusiastic comment came from the head of currency research at a major bank in London, who said, “This is not a game changer.” But perhaps the most penetrating remark was uttered by Bill Gross, the founder of PIMCO, who warned that a “debt trap remains in place.”

**Should We Be So Pessimistic?**

The fact that the euro crisis has dragged on for more than two years does little to instill much optimism. From the outset, a strong contingent, including George Soros, has argued that European officials misdiagnosed the problem as a fiscal one, when it encompasses problems in banking and competitiveness issues. By placing so much attention on fiscal adjustment, not enough consideration was directed to looming banking crises in a number of countries. When the banks’ failing balance sheets began to affect those of local and national governments, creating a vicious circle of rising debt, orthodox policies had little effectiveness.

However one might judge the merits of this argument, it is clear that usual bank funding mechanisms, such as the interbank and wholesale funding markets, have basically stopped functioning. This has led to deposit imbalances with central banks in different countries. Risk has been repatriated, with banks in countries like Italy and Spain acquiring an outsized share of their government’s debt. The ECB’s longer-term refinancing operation (LTRO), launched in 2011, helped restart the flow of funds, but this has left more bank assets tied up with the ECB as collateral for loans. As more bank assets have the potential to
become encumbered this way, senior unsecured debt holders would become increasingly subordinated to secured debt holders, resulting in reduced participation by private lenders and a further fragmentation of the capital markets.

The decision of summit leaders to forgo preferred creditor status for the ESM is an effort to dial down the seniority issue. However, there is a concern that while policymakers are willing to offer pari passu status to private creditors, this could change. Investors remember that in Greece, official creditors took unilateral action to assume super-senior status, forcing bondholders to take additional losses on their debt.

While the latest measures have temporarily managed to diffuse market pressures over access to funding, a comprehensive solution to the euro crisis remains elusive. The idea of more integration has near-universal support among Europe’s leaders, but the sequencing and degree of integration have sparked intense debate. Germany favors integration that involves supranational oversight of fiscal policies along with a single financial regulatory authority and system-wide deposit insurance. This would allow for the common issuance of Eurobonds with joint liability, or debt mutualization.

Although most countries in the euro zone would like to move forward quickly with system-wide deposit insurance, debt mutualization and the issuance of Eurobonds, there are significant reservations about the need for supranational oversight. The French, in particular, have been ardent supporters of intragovernmental solutions, rather than the German approach. Both German Chancellor Angela Merkel and the head of the Bundesbank, Jens Weidmann, have been outspoken on the subject, with Merkel commenting that the predominate focus of other member countries on joint liability issues first is “wrong and counterproductive.”

But sequencing or more concerted fiscal integration aside, the more important issue is whether or not a monetary union is viable in Europe. With the median level of debt across households, governments and businesses in the euro zone standing at 500 percent of GDP, it is hard to see any combination of debt mutualization, Eurobond issuance and internal devaluation moving debt dynamics to a manageable path. Medium-term economic growth prospects looking anemic, the dollar/euro rate remains elevated, and market interest rates in troubled countries stand at crushing levels.

The ability of those countries with competitiveness issues to bring about internal devaluation is problematic at best. Despite unemployment rates of more than 20 percent in Greece and Spain, the downward pressure on real wages has been minimal. Until political leaders are able to revive their economies, their ability to attract sufficient private sector financing is likely to remain in doubt, necessitating reliance on funding from the ESM and other official sources which in all probability will prove to be inadequate.

The repeated calls to save the euro seem to be ringing increasingly hollow with the German electorate and other northern Europeans. There is a growing suspicion of the motives of the EU bureaucracy, along with a belief that it is bloated, overpaid and at times incompetent. The notion that the welfare system at its core is about the transfer and sharing of benefits, but not the costs, appears to be gaining traction.
According to Stern magazine, 62 percent of the German public supports Chancellor Merkel on the need for wayward European countries to implement austerity measures. A separate survey found that 55 percent of Germans want the return of the deutschemark, up 9 percentage points from the previous month.

**New Game Plan**

It may be time for European leaders to give up on the idea of having a more integrated EMU. The obstacles and pitfalls to operating a monetary union have been made painfully obvious by the debt crisis over the past two years. While turning back the clock might not at first glance seem the best solution, it could prove to be the least costly, in terms of avoiding social upheaval, limiting the distortion of capital markets and inhibiting the full realization of potential economic output.

There has already been a high-profile call from Kenneth Griffin of Chicago-based Citadel LLC, and Anil Kashyap of the University of Chicago for Germany to leave the euro and reintroduce the deutschemark. There is sound reasoning behind their opinion piece in the New York Times on June 26, but it probably does not go far enough in addressing the diversity of the euro zone economies. Although a presumptive case can be made that the other countries of the euro zone meet the generally accepted criteria for an optimum currency area, a closer inspection of the revealed preferences of the countries involved would suggest otherwise.

A decision to abandon the euro must take into account such questions as how long it would take to introduce a new currency, how much would it cost and what steps would be necessary to implement the decision. Obviously, there are no simple answers, and the change would involve appreciable costs in terms of forgone output and wages, abrogated contracts and defaulted debt. Yet it is safe to say that many of them are already being considered by governments, businesses and individuals. A key to minimizing the costs is for politicians throughout the Europe Union to agree quickly and to act in unison – in other words, to do just the opposite of what they have done up until now.

**Conclusion**

To most Europhiles and probably a fair number of economists, the idea of dropping the euro is nothing short of radical. Nevertheless, the history of currency union breakups does not support the doomsday scenarios that have dominated the media. Indeed, most currency breakups have confounded pundits and led to renewed prosperity. The same could happen with the euro zone. The likely devaluation of currencies following the death of the euro could provide not only a favorable tailwind for structural reforms but also an environment conducive to real money investors. Instead of looking for safe-haven investments in U.S. and German government bonds, investors would once again feel safe in investing in European private enterprise.