



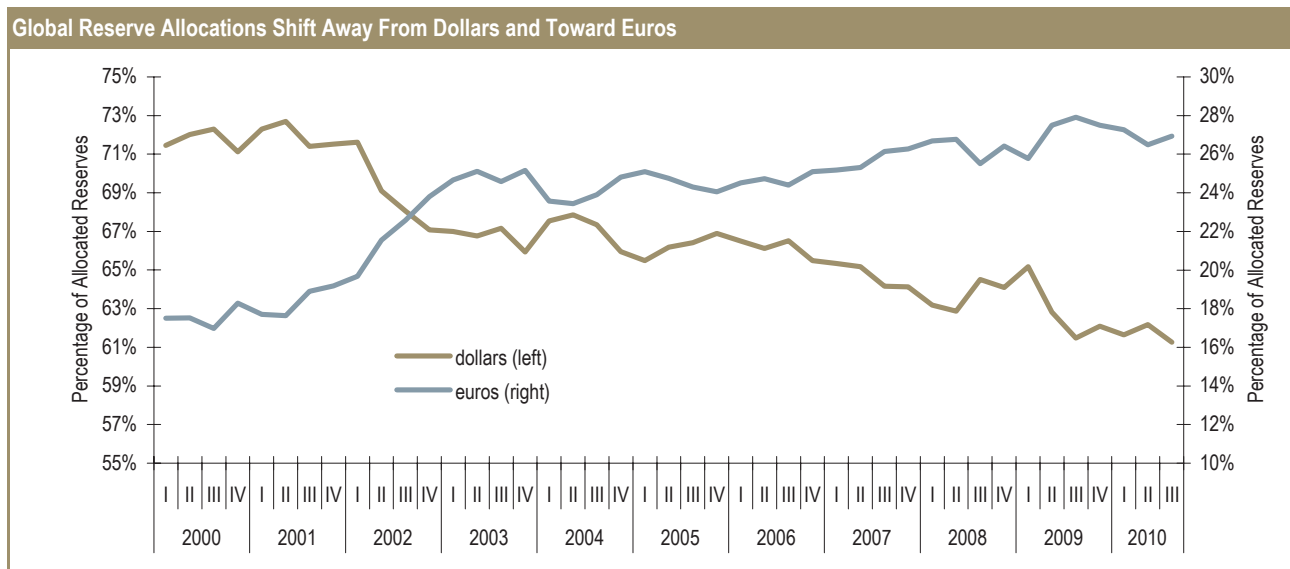
STANDISH



## A European Marriage: For Better or For Worse

*Thomas Higgins, Ph.D.*

Europe will celebrate the 10-year anniversary of the launch of euro currency on January 1, 2012. The common currency has had its ups and downs during its first decade in circulation, but overall it has been a success. The number of countries sharing the euro has grown from eleven to seventeen, intra-European trade has increased more than 40% to €380 billion, and the stock of foreign direct investment in the euro-zone has nearly doubled to €3.5 trillion.<sup>1</sup> At the same time, the euro has risen to international prominence, becoming the second largest reserve currency in the world behind the US dollar.



Source: IMF as of September 30, 2010

Yet, in some quarters, doubts persist about the viability of the common currency. Euro-skeptics contend that sovereign debt woes in Greece, Ireland, Portugal and Spain will force one or more of these peripheral countries out of the common currency. Others insist the stronger economies in the core of Europe, including Germany or France, will abandon the euro rather than bail out their neighbors.

We disagree. It is our opinion that neither the weaker economies in peripheral Europe, nor the stronger economies in core Europe, would benefit from a breakup of the euro-zone. However, we feel the framework for the single currency has been flawed from the very beginning. Though not insurmountable, the problems are large and resolving them is likely to strengthen the economic ties between member countries.

2011©

Standish Mellon Asset Management Company LLC

BNY Mellon Center · 201 Washington Street · Boston, Massachusetts 02108-4408

1-617-248-6000      [www.standish.com](http://www.standish.com)

**For additional copies of this document, please contact [info@standish.com](mailto:info@standish.com).**

# A European Marriage: For Better or For Worse

## Divorce Would Be Messy

Much of the debate about a possible break up of the euro has centered on whether a member could legally exit the euro given that it would violate the Maastricht Treaty. From our perspective, the issue of legality is secondary. Rather, the more important question to ask is would it be in the economic interest of any euro-zone members to abandon the common currency? We believe the answer is no.

An exit from the common currency would likely be particularly damaging to the weaker economies in peripheral Europe. For example, if Greece were to leave the euro, the value of its newly introduced drachma would likely collapse as investors focused on the country's poor economic fundamentals. This, in turn, would probably precipitate a default by the government on its euro-denominated debt.

This situation may be aggravated as investors insist on higher interest rates to compensate them for both the *credit risk* of Greek bonds as well as the *currency risk* of the drachma. With Greek 10-year government bonds yields already painfully high at 11.5%, the country could be locked out of the capital markets and forced to undergo a draconian fiscal consolidation. There would also be an incentive for Greek citizens anticipating the redenomination of their checking and savings accounts into a devalued drachma to rush out of domestic banks precipitating a banking collapse. A similar outcome could occur in any of the peripheral euro-zone economies. Therefore, it seems unlikely for any country to voluntarily leave the euro.

Not even the stronger economies in the core of Europe, such as Germany or France, would emerge unscathed from a breakup of the common currency. The reintroduction of a domestic currency would be costly and time-consuming. It took three years to get the euro up and running. Contracts must be redenominated; computer code must be rewritten; automatic teller machines must be reprogrammed<sup>2</sup>. Even if a government decreed that all claims in an economy be converted into Deutsche marks or French francs, there could still be the question of what exactly constitutes a German or French debt contract. For instance, foreign multi-nationals sell corporate bonds in these countries and may choose to fight the redenomination of their contracts in court. The new D-mark or franc would also likely appreciate and whittle away any competitive advantage these countries have in the European market.

In our opinion, the biggest single obstacle to Germany or France leaving the euro is the exposure of their banking systems to the debt of peripheral euro-zone economies. According to the Bank of International Settlements, German bank exposure to the government debt of Greece, Ireland, Portugal and Spain totals \$394 billion or more than 15% of its GDP. The figures for France are comparable. The risk of default by any or all of these peripheral European economies would almost certainly increase if the common currency were to collapse. Thus, Germany and France could potentially undermine the capitalization of their own banking systems by exiting the euro.

Bank Exposure to Peripheral Europe (Q2 2010; in US\$ Billions)						
	Greece	Ireland	Portugal	Spain	Total	% of GDP
French Banks	53.5	50.1	41.9	162.4	307.9	15.3%
Germany Banks	36.8	138.6	37.2	181.6	394.2	15.1%
Total European Banks	141.6	508.6	205.6	656.6	1512.4	15.9%

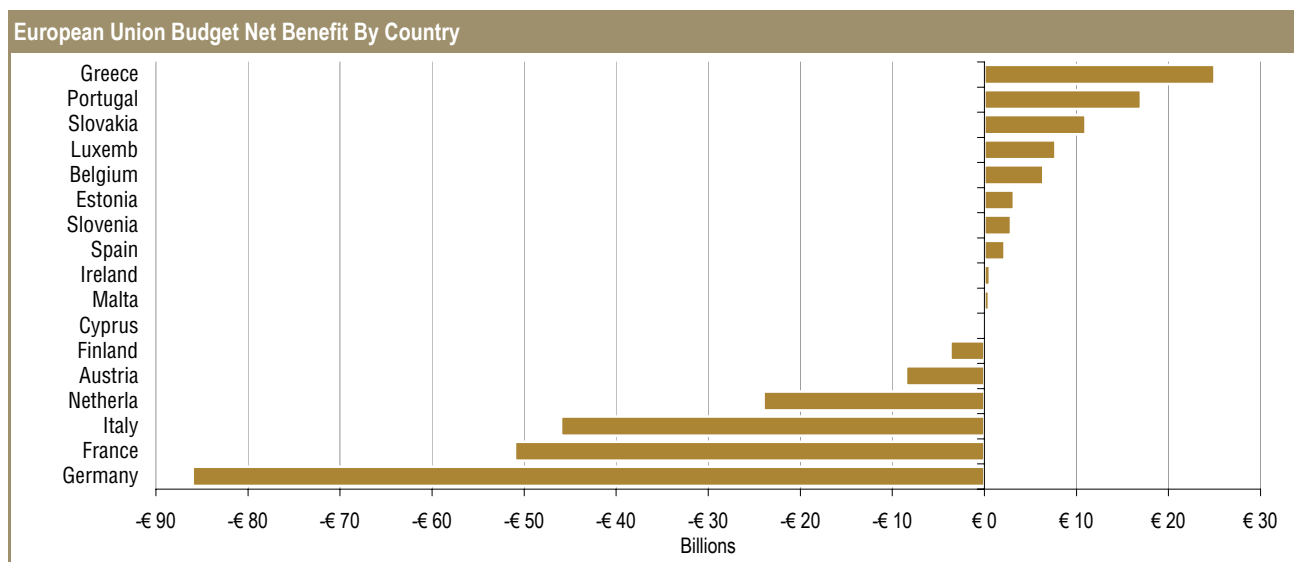
Source: Bank of International Settlements as of December 31, 2010

Putting aside these concerns, it is important to recognize there are advantages to the common currency. The euro-zone is what economists refer to as an "optimal currency area."<sup>3</sup> This implies the euro has improved economic efficiency by allowing greater price transparency across countries and increasing cross border investment by eliminating exchange rate risk. Most recent empirical analyses of the *euro effect* suggest that the single currency has increased trade by roughly 10% in the euro-zone when compared to trade between non-euro countries.<sup>4</sup>

## A European Marriage: For Better or For Worse

In addition, direct investment between euro-zone nations is estimated to be at least 15% higher as a result of the euro.<sup>4</sup> Several of the peripheral European economies are also net recipients of funds from the European Union budget. Were they to leave the euro, these funds might be at risk, particularly if they were forced from the European Union simultaneously.

There are seemingly other less tangible benefits to membership in the euro-zone. First, there is greater inflation discipline due to the European Central Bank's (ECB) single mandate of price stability. This protects domestic savers in member countries from seeing the purchasing power of their savings disappear as a result of runaway inflation or currency devaluation. Second, the ECB can act as a lender of last resort in instances where the need of an individual country exceeds the ability of the national central bank to provide liquidity. The ECB played this role in the recent crisis by purchasing the bonds of some of the peripheral European economies as a means of stabilizing sovereign debt markets. And third, the common currency has fostered greater political cooperation in Europe even though the dialogue has been acrimonious at times.<sup>5</sup> In our opinion, for all of these reasons, the members of the euro-zone would be better off making their marriage work.



Source: Open Europe 2007

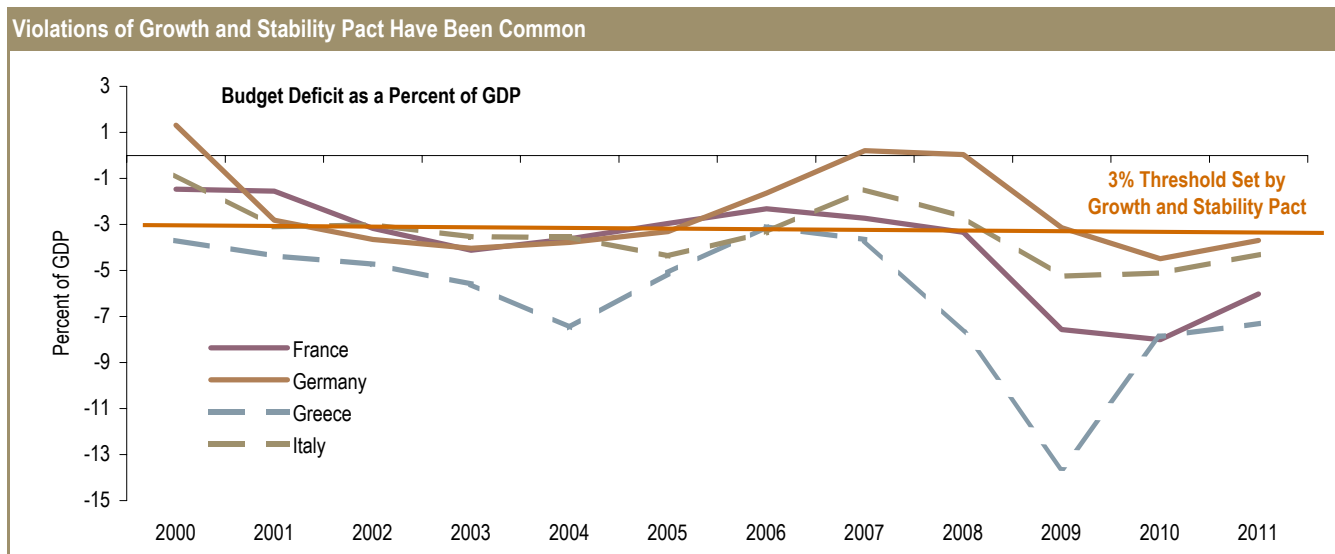
### Reconcilable Differences

Despite our conviction that the benefits of staying together far outweigh the costs of breaking up, we also recognize the framework for the common currency was flawed from the very beginning. Under the Maastricht Treaty, the region adopted a single currency and monetary policy, yet fiscal policy is divided among its 17 member governments. Typically, a country with its own currency would see that currency decline and its interest rates rise if it sold large amounts of debt to global investors. But, because euro-zone countries share a currency, there is no market mechanism to warn when a country's deficit is becoming unsustainable. Indeed, just before the crisis, Greek bonds were regarded as a close substitute for German bonds even though Greek government debt was close to 100% of GDP, which is well in excess of the 60% of GDP threshold set by the Growth and Stability Pact.<sup>1</sup>

One solution to this problem could be for the euro-zone to take steps toward a greater fiscal union, similar to the United States. Almost all of the individual states in America have balanced budget amendments, which prevents them from running deficits for operating purposes. The Growth and Stability Pact was supposed to serve a similar purpose by limiting the budget deficits of euro-zone members to 3% of GDP or less. However, it was generally not enforced. For instance, Greece was in violation of the 3%-deficit ceiling from the first day it joined the

## A European Marriage: For Better or For Worse

euro. Part of the problem was the larger member countries, including Germany and France, ignored the rule and rejected calls for sanctions against themselves. Leaders in these countries contended the rule had to allow a degree of flexibility for deficit spending in recessions. Yet, both countries seemed to run deficits that exceeded the 3%-ceiling in both good times and bad. In fact, Germany and France were each in breach of the Growth and Stability Pact during six of the last 10 years.<sup>1</sup> In the United States, the federal government is charged with providing a buffer in periods of cyclical divergence between the states through transfer payments, such as unemployment insurance or food stamps. This automatic stabilizer lessens the need for deficit spending by the states. However, euro-zone members do not appear ready to sacrifice their fiscal sovereignty to some supra-national body such as the European Commission.



Source: IMF as of October 31, 2010

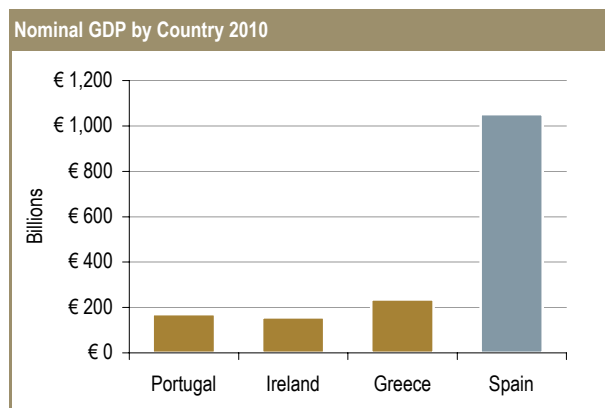
Instead, Europe has taken an alternative approach and set up the European Financial Stabilization Fund (EFSF), which can issue bonds or other debt instruments to raise the funds needed to provide loans to euro-zone countries in financial trouble, recapitalize banks, or buy sovereign debt. The EFSF does not directly impose fiscal discipline on euro-zone members, but because the loans must be approved by all member governments, they have come with strings attached. For instance, the Irish government had to adopt a four-year €15 billion austerity program in order to obtain its €85 billion joint loan from the EFSF and the International Monetary Fund. The EFSF issued its inaugural €5 billion five-year bond at an implied borrowing cost of 2.89% on January 25, 2011. The deal received a AAA-credit rating from both Standard & Poor's and Moody's and investor appetite for the bond issue was strong with orders about nine times the supply.<sup>6</sup>

While the EFSF appeared to address many of the flaws in the Maastricht Treaty, the program only offers temporary solace because it is scheduled to close in June 2013. European leaders began to realize they needed a more permanent solution as the crisis spread from Greece to Ireland and began to threaten Portugal and Spain. This prompted the creation of the European Stabilization Mechanism (ESM) in late 2010. The ESM will function in a similar manner to the EFSF, but it will be instituted along with collective action clauses (CACs) for newly issued bonds when the EFSF expires in mid-2013.

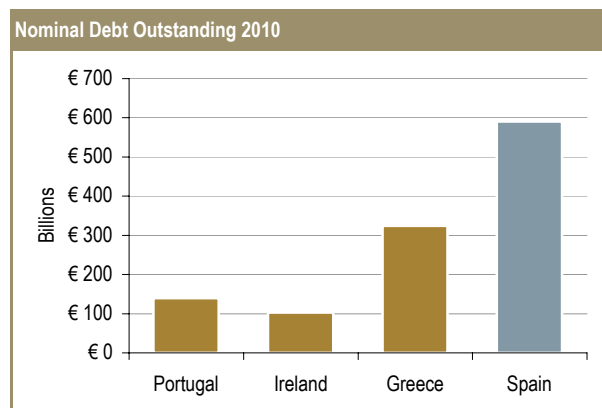
CACs allow a supermajority of bondholders to agree to a debt restructuring that is legally binding on all holders of the bond, including those who vote against the restructuring. Bonds issued through the ESM will be senior to all debt outstanding except IMF loans. This is the so-called "bailing-in" of the private sector. Unfortunately, while the ESM may be part of a long-term solution, euro-zone members still disagree on key details of the program.

## A European Marriage: For Better or For Worse

For example, German policy makers oppose using ESM funds for government bond purchases or for making loans to governments to buy back their own debt. Although this sounds reasonable, it will create problems for countries who are in need of bridge financing to provide liquidity as they seek to restructure their debt. Addressing this issue is critical if the ESM is to serve its purpose as a stabilizing force in the euro-zone.



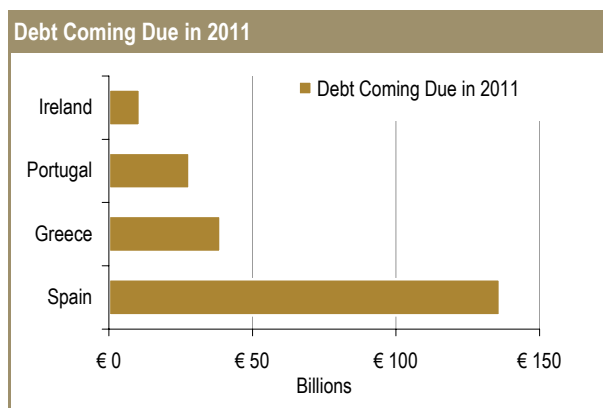
Source: National Statistics Offices as of December 31, 2010



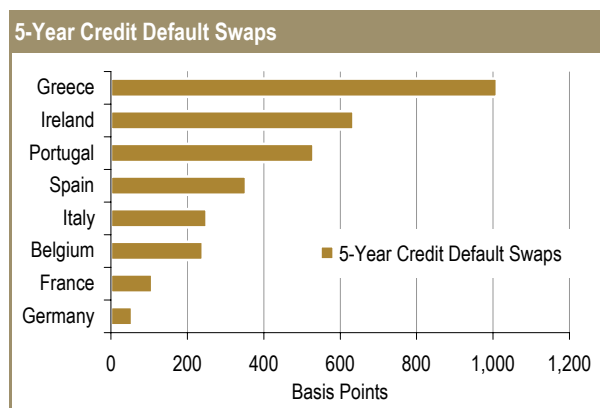
Source: Bloomberg as of December 31, 2010

Moreover, even with the ability to borrow at lower rates through these facilities, it is our view that Greece will likely be forced into some sort of debt restructuring in the future. The International Monetary Fund estimates that its gross debt-to-GDP will stabilize at 144% in 2013.<sup>7</sup> It will be extremely difficult for the economy to grow its way out of this level of indebtedness. The risk of restructuring is lower in Ireland and Portugal where gross debt-to-GDP levels are only expected to reach 100%. But, a fragile banking sector in Ireland and large current account deficits in Portugal have led investors to price in a higher probability of default.

Unlike the others, Spain faces a liquidity issue rather than a solvency issue. Spanish gross debt-to-GDP levels are expected to peak at around 82%, but the country must rollover the 23% of its debt outstanding (€123 billion) in 2011.<sup>6</sup> This should be manageable as long as interest rates do not continue to rise. The euro-zone could digest a restructuring of Greek debt without too much trouble. Greece only accounts for about 2.3% of regional GDP. However, the same is not true for Spain whose economy is larger than Greece, Ireland and Portugal combined.



Source: Bloomberg as of December 31, 2010



Source: Bloomberg as of December 31, 2010

---

## A European Marriage: For Better or For Worse

---

Looking ahead, the establishment of the EFSF and the ESM appears to have put the euro on better footing than it was ahead of the crisis. These programs: 1) provide a means for emergency lending to member countries that are in need; 2) impose some degree of fiscal discipline on those that borrow from them; and 3) add a restructuring mechanism for members whose government debts are unsustainable. Ironically, rather than causing the common currency to break up, the crisis may actually draw Europe closer together given the moves toward joint bond issuance and the imposition of a sort of back door fiscal discipline for those countries who borrow from one of the facilities. Nevertheless, we believe further bouts of volatility in Europe's debt and foreign exchange markets will remain a risk until the European Commission begins to speak with one voice on policy issues. Specifically, European leaders must come to some resolution about using ESM funds for government bond purchases or propose some alternative form of bridge financing for euro-zone members who face debt restructuring. Until this issue is addressed, we believe it is premature to establish any long-term positions in peripheral European debt markets of the euro. Instead, we look to play the region tactically with an eye towards periods when valuations are stretched.

### Thomas Higgins, Ph.D.

Tom is the Global Macro Strategist for Standish. He is responsible for developing views on the global economy and making relative value recommendations among global bond markets, currencies, and sectors. Before joining Standish in 2010, Tom was employed as the Chief Economist for Payden & Rygel Investment Management in Los Angeles and served as International Economist at The Conference Board. He is a member of both the American Economics Association and the National Association of Business Economics (NABE). Tom was President of the Los Angeles Chapter of the NABE from 2006-2007. Higgins is a past board member of the Los Angeles Economic Development Corporation and the California Council on Economic Education. In 2010, he was the Recipient of the Robert T. Parry Award for Exemplary Contributions in the Field of Economics. Tom received his Ph.D. and M.A. degrees in Economics from Fordham University and holds a B.A. in Economics from Drew University. Tom has eighteen years of experience analyzing financial markets.

<sup>1</sup> *The International Monetary Fund.*

<sup>2</sup> *Eichengreen, Barry. "The Breakup of the Euro Area." University of California. October 2008.*

<sup>3</sup> *Mundell, Robert. "Optimum Currency Areas." Columbia University. December 1997.*

<sup>4</sup> *Baldwin, Richard and DiNino, Virginia and Fontagné, Lionel and De Santis, Roberto A. and Taglioni, Daria. "Study of the Impact of the Euro on Trade and Foreign Direct Investment." Economic Paper 321. The European Commission. April 2008.*

<sup>5</sup> *Feldstein, Martin. "Optimal Currency Areas." The National Bureau of Economic Research. November 2008.*

<sup>6</sup> *Bloomberg.*

<sup>7</sup> *World Economic Outlook. "Recovery, Risk and Rebalancing." The International Monetary Fund. October 2010.*



BNY Mellon Center · 201 Washington Street · Boston, Massachusetts 02108-4408

For additional copies of this document, please contact [info@standish.com](mailto:info@standish.com).

*This information is not provided as a sales or advertising communication. It does not constitute investment advice. It is not an offer to sell or a solicitation of an offer to buy any security. Past performance is not an indication of future performance. This information is not intended to provide specific advice, recommendations or projected returns of any particular product offered by Standish Mellon Asset Management Company LLC ("Standish"). Some information contained herein has been obtained from third party sources and has not been verified by Standish. Standish makes no representations as to the accuracy or the completeness of any information herein.*

*Views expressed are subject to change rapidly as market and economic conditions dictate. Portfolio composition is also subject to change.*

*BNY Mellon Asset Management is the umbrella organization for The Bank of New York Mellon Corporation's affiliated investment management firms and global distribution companies.*