

MARKET FOCUS

What does the future hold for the Eurozone?

The current debt crisis in the Eurozone appears to be more a symptom, rather than the actual cause, of the difficulties in the Eurozone. The challenge for the Eurozone is twofold — both economic growth and political organisation come into play. The ability of the European countries to curb the debt crisis in the short term is, of course, essential, but in the long term the ability to build actual economic integration will determine the Eurozone's future.

I - The Eurozone debt crisis is the result of holes in the monetary unification project

- The 1992 Maastricht Treaty made provision for the independence of the national central banks, the establishment of convergence criteria in terms of the economy and public finances, and the principle of financial non-solidarity, and therefore the principle of no bail-out, of States with imbalanced public accounts.
- The adoption of the Stability and Growth Pact in 1997 introduced the concepts of multilateral monitoring and an excessive deficit procedure. The first is preventive in nature; the second punishes deviation.
- The fact of the matter is that **multilateral monitoring failed to prevent the slide in public accounts** as the political, and therefore discretionary, nature of the monitoring led the countries to neutralise one another. Furthermore, the convergence process followed by the introduction of the Euro put an end to market discipline: interest rates converged to those of the most plausible country in terms of inflation—Germany—which was the expected outcome, but also did away with any restoring force in the event of a deviation in public accounts.
- In fact, the risk of diverging budgetary policies, though clearly anticipated in the preparations for the Euro, could not be controlled without supranational political control.
- The Euro, thanks to the reduction in financing costs that benefited the so-called peripheral countries (Greece, Spain, Ireland, Italy, Portugal, etc.) in particular, helped to fuel bubbles in the price of some of these countries' assets. The Spanish or Irish economic boom is in part attributable to the sharp fall in interest rates that stimulated investment, particularly in real estate, and, as a consequence, economic activity and tax revenue. Before the crisis, Spain had favorable public accounts with several years in surplus.
- **Differences in competitiveness**, measured using unit labor costs, **worsened between Eurozone countries**, in particular between peripheral and core countries. As a result, current account balances worsened due to the effect of the growth differential. Germany was the main beneficiary as it implemented structural reforms which greatly influenced the cost of labor and therefore reinforced German companies' export competitiveness.

- **Financial integration was incomplete:** although widely achieved in debt markets, equity market integration has been insufficient. An asymmetric shock affecting one or more countries is therefore harder to absorb than in the US, where the losses in one region can be compensated for by gains in another.

II - The vicious circle of mistrust is difficult to break

- The Greek crisis, which began at the end of 2009, has gradually spread to the whole Eurozone. What was a localised problem in a country representing less than 3% of GDP spread like wildfire to all of the Eurozone countries with the exception of Germany, the apparent safe haven.
- **This situation is unlike the ones in the US and the UK where public deficit levels higher than those in the Eurozone are involved (see p. 2).** The choice in these countries, led by the central banks, is to massively reflate the economy by lowering interest rates to a very low level and by buying large quantities of public and private securities. This strategy is based on the idea that the deflationary risks outweigh the inflationary risks due to the excessive debt accumulation on the balance sheets of economic agents.
- **On the other hand, the Eurozone is stuck in a vicious circle:** the inability to stamp out the Greek crisis has planted a seed of doubt about the ability of the States to fully honor their commitments. The decision in July 2011 to restructure Greek debt with private sector losses created a precedent, arousing fears about further restructurings. Risk premiums rose sharply on most sovereign debt, leading to doubts about the financial situation of the banks that traditionally hold public debt due to their assumed security and their liquidity.
- The escalation of market tension over the summer led European banks to shed a very significant part of their exposure to sovereign debt, forcing the ECB to resume its public debt purchases in the summer of 2011 to limit the rise in interest rates (see p. 2).
- **Getting through the crisis will be laborious as unfavorable winds are blowing:** The ECB is afraid to monetise public debt for fear of fueling future inflation. And yet inflation is not an actual concern due to the weakness of credit demand and the reappearance of recession in the Eurozone.
- Investor mistrust keeps risk premiums high (480bps for Italy and 330bps for Spain, for the 10-year rate). In a recession, the level of nominal interest rates is too high to enable stabilisation of the public debt to GDP ratio even with massive budgetary efforts. By way of an example, the Italian 10-year rate is close to 7% whereas it should not exceed 5% to stabilise debt.

- At the same time, the size of Spanish and Italian debt makes it difficult to bring together the resources pooled within the EFSF to enable refinancing in a sustainable way. The requirements for refinancing the national debt (interest + principal) of the two countries are close to €800 billion in total for 2012 and 2013.
- Finally, the recession hitting the peripheral countries is increasing public deficits and forcing additional adjustment efforts at the risk of worsening the downturn in activity.
- **There is little room for manoeuvre in getting out of the Eurozone crisis and several conditions must be met: 1) budgetary efforts that have a long-term, not just short-term, effect with priority given to reducing spending; 2) further relaxing of monetary conditions by the ECB in the form of security purchases; 3) significant progress in terms of governance of economic policy in the Eurozone with increased solidarity dependent on effective monitoring of budgetary policies.**

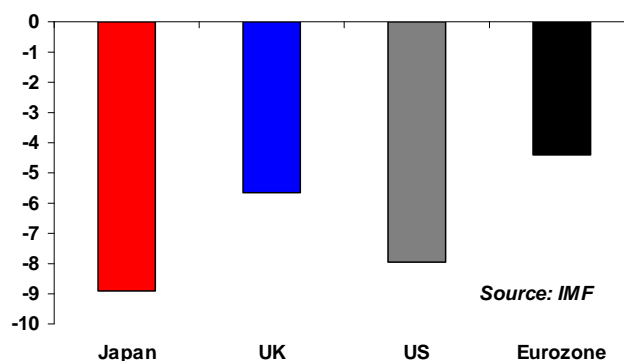
III – The Eurozone will continue to face major political challenges

- Even though dislocation of the Eurozone seems unlikely as its consequences would be dramatic for both Europe and for the global economy, the fact remains that it will have to rethink its growth model and get a better handle on its economic policies.
- **In terms of growth models**, the 2000 Lisbon Treaty, which aimed to make Europe the most competitive region in the world in terms of knowledge economy, has largely gone unheeded.
- Europe is now caught in the crossfire between an American economy that remains the global center of innovation and an emerging world that is now the main driver of global growth.
- Without growth, reduction of excessive national debt is largely illusory as the changes in the Japanese economy over the last 20 years demonstrate.
- **In terms of managing economic policy**, the Eurozone must bear in mind the fact that it is not an optimum monetary zone and that this characteristic should be corrected as much as possible. A monetary zone is only viable if it provides a context-dependent assurance mechanism (e.g., federal budget) and has mobility in the factors of adequate production (capital/labor).
- In fact, there is no short-term system for absorbing the shock in the Eurozone as is the case in the US with a federal budget capable of absorbing up to 40% of the effects of a regional shock thanks to transfer spending (unemployment insurance, public transfers, etc.) funded by the federal government.
- Capitalistic borders remain strong in the Eurozone in some sectors, making the whole zone sensitive to asymmetric economic shocks. Apart from a few exceptions (e.g., EADS), few companies have a truly European dimension in terms of location and production.

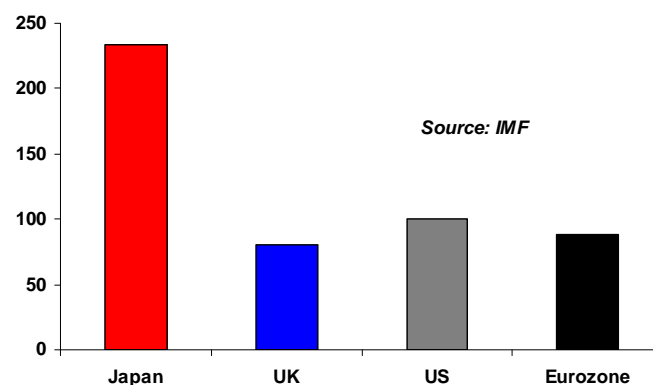
- The lack of economic governance has encouraged fiscal dumping behavior to the detriment of the whole zone's interest. Thus, there has been a downward trend in direct tax rates (income tax, corporate income tax) in the Eurozone in the last 20 years while the level of public spending did not fall, encouraging the emergence of structural deficit.
- There is a risk of the German model imposing itself on the rest of the Eurozone. On the positive side (limited public deficits, high surplus), the German model reflects the demographic characteristics of an ageing country whose population is already falling like in Japan. This model favors saving over investment, export over domestic consumption, a strong currency over a weak currency. It remains to be seen whether all of the European countries are interested in or want to follow this strategy.

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2011 Public Deficit (% of GDP)

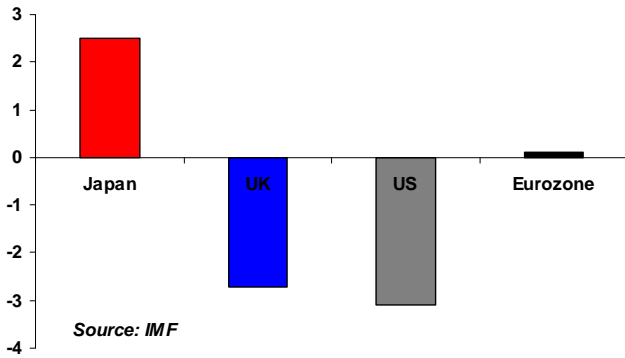


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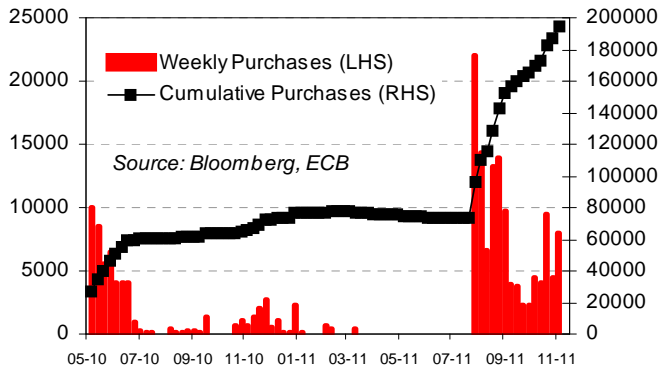


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2011 Current Account Balance (% of GDP)



ECB Securities Purchases (EUR mn)



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