

Can the Euro Survive?

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“Europhoria”



- ◆ **Introduced as actual currency - January 2001**
- ◆ **Currently 17 members of Eurozone, Slovakia being most recent**
- ◆ **Prior to 1999, Portugal, Ireland, Greece and Spain (PIGS) all had significant spreads of 10-year bond yields over Bund yields**
- ◆ **2001-09, PIGS' 10-year bonds traded as if as safe as German bonds – spreads often less than 20 basis points**
- ◆ **Expectation of risk-pooling in Eurozone, i.e., European Central Bank (ECB) bailouts**

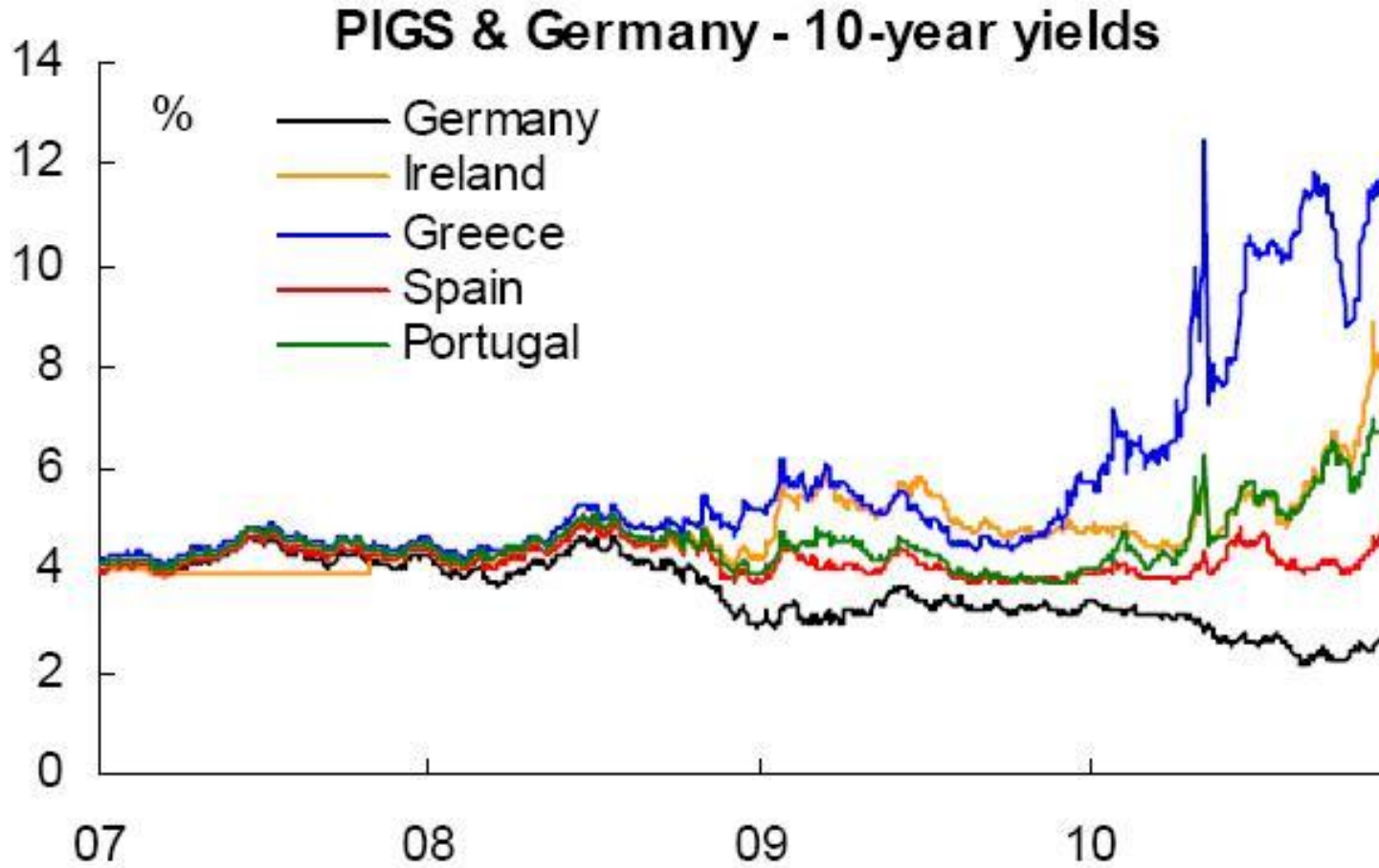
Euro-zone map



Euro crisis: a drama with 4 actors

- ❖ **Mismanagement and deception by Greek authorities – October 2009, budget deficit revealed to be 12.7% of GDP *not* 6%**
- ❖ **Having failed to forecast Dubai sovereign debt crisis, ratings agencies focused not only on Greece, but other southern Eurozone countries – downgrading led to increased yield spreads**
- ❖ **Hesitation among Eurozone governments in giving clear signal of support to Greece**
- ❖ **ECB generated uncertainty about willingness to accept Greek bonds as collateral**

PIGS can't fly!



Source: Bloomberg, Scotia Capital Economics



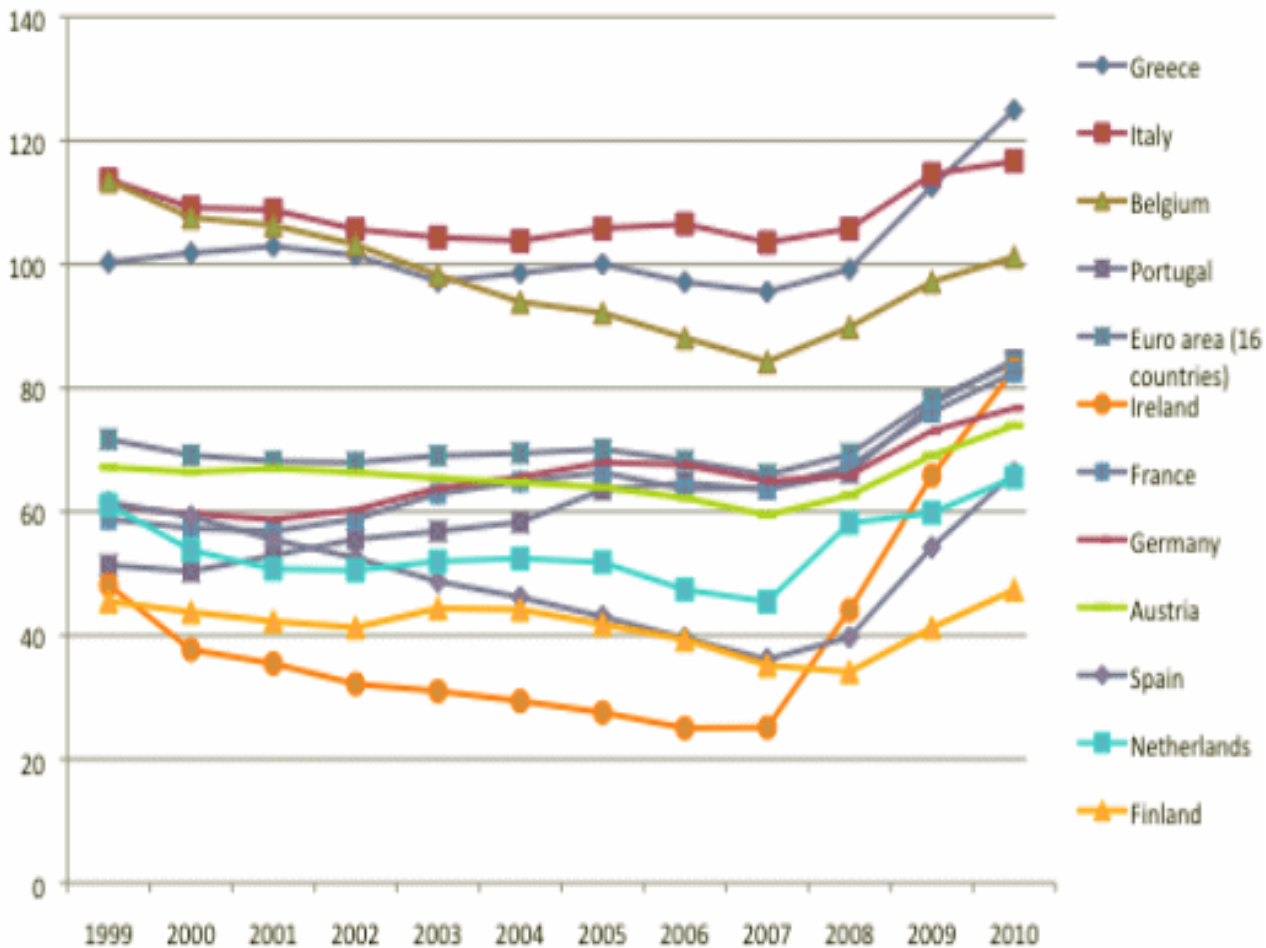
Is it all about public debt?

- ❖ **Other than Greece, root cause of debt problem was unsustainable accumulation of private compared to public debt**
- ❖ **Triggered debt-deflation dynamic, forcing governments to take over private debt**
- ❖ **Prior to 2008, debt/GDP ratios of all Eurozone countries, bar Germany and Portugal, were actually declining – notably Ireland and Spain**
- ❖ **As austerity measures have been implemented, deleveraging of private sector has become harder, with potential for further deflation**

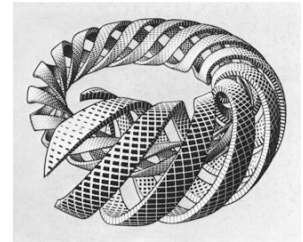
Eurozone debt



Government Debt in Eurozone Countries (% of GDP)



Source: European Commission



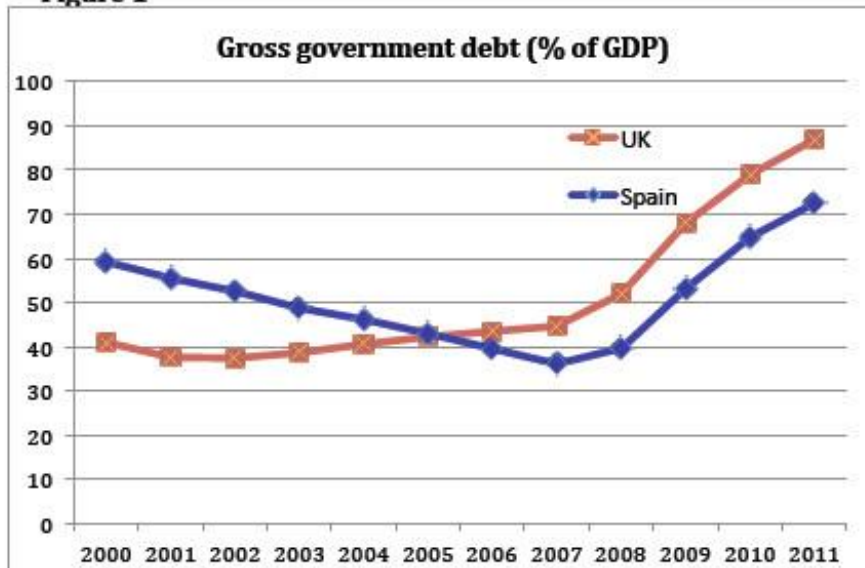
A paradox

- ◇ **Since start of financial crisis, government debt ratio in UK has increased by more than in Spain, i.e., 89% vs. 72% of GDP**
- ◇ **Yet yield on Spanish bonds has increased strongly relative to UK bonds**
- ◇ **Why such difference in evaluation of sovereign default risks between Spain and UK?**
- ◇ **“Achilles heel” of monetary union such as Eurozone: Spain has no control over currency in which it issues its debt**

Spain vs. UK

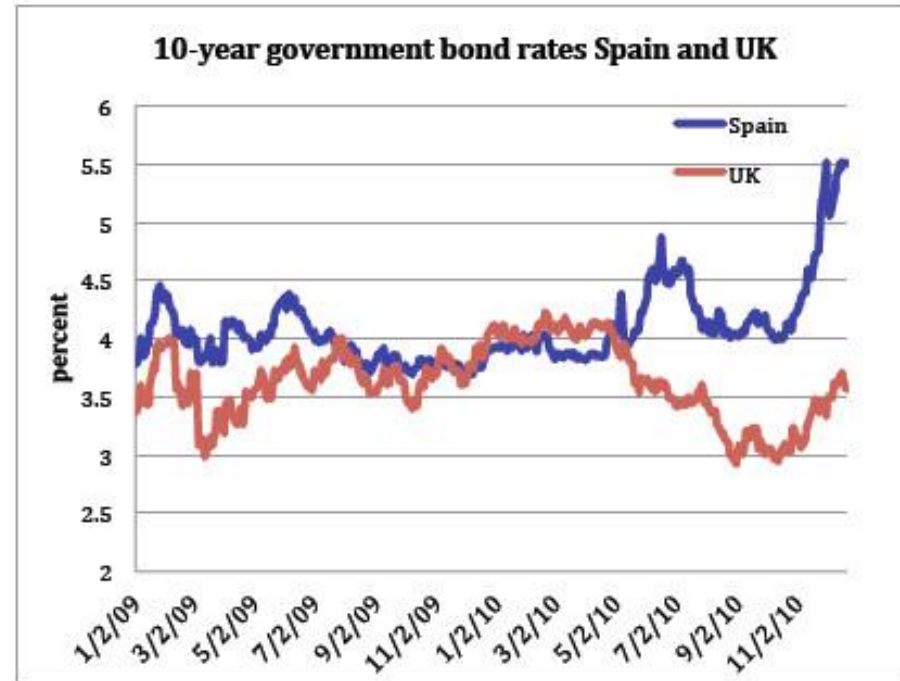


Figure 1



Source: European Commission, Ameco

Figure 2:



Source: Datastream

“Pain and misery...”



- ❖ **If investors have concerns over default in Spain, interest rates rise as bonds are sold**
- ❖ **Euros leave Spanish banking system, and liquidity crisis occurs as cost of rolling over Spanish debt increases – “sudden stop”**
- ❖ **Also, Spanish economy cannot get boost from currency depreciation**
- ❖ **Fear of default in Spain becomes self-fulfilling prophecy as liquidity crisis turns into solvency crisis - risk of contagion elsewhere**

Where are we now.....?



How to save Euro?



- ❖ **Draw line between Greece (insolvent), and Italy and Spain (solvent but illiquid)**
- ❖ **European banks who need to recapitalize are hugely exposed to risk of sovereign default - ECB should commit to providing liquidity**
- ❖ **Fiscal contraction in Eurozone is self-defeating – key issue is credibility, i.e., ECB should stand behind sovereign debt of solvent countries**
- ❖ **Strengthen European Financial Stability Facility (EFSF) – at present it could not support Italy**

What if Euro collapses?



- ◆ **UBS have estimated costs of collapse:**
 - *peripheral* country (Greece) first year at **40-50% of GDP, 15%/annum thereafter**
 - *core* country (Germany): first-year at **20-25% of GDP, 11%/annum thereafter**
- ◆ **Costs of a rescue seem a bargain by comparison – but German taxpayers would prefer to punish “spendthrift” Italians and Portuguese**
- ◆ **However, breakup of Eurozone, and possibly European Union, would be much worse**

Can the Euro survive?



- ❖ **Concern in Northern Europe is to not provide incentive for more irresponsible behavior by “Club-Med” countries**
- ❖ **This view treats crisis as series of *individual* problems as opposed to a *systemic* problem**
- ❖ **Illiquidity of single country becomes problem for whole Eurozone – especially with financial market integration**
- ❖ **Reluctance of ECB to be lender of last resort in sovereign bond market has probably been key reason for contagion not being stopped**

Thank you

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