Can the Euro Survive?

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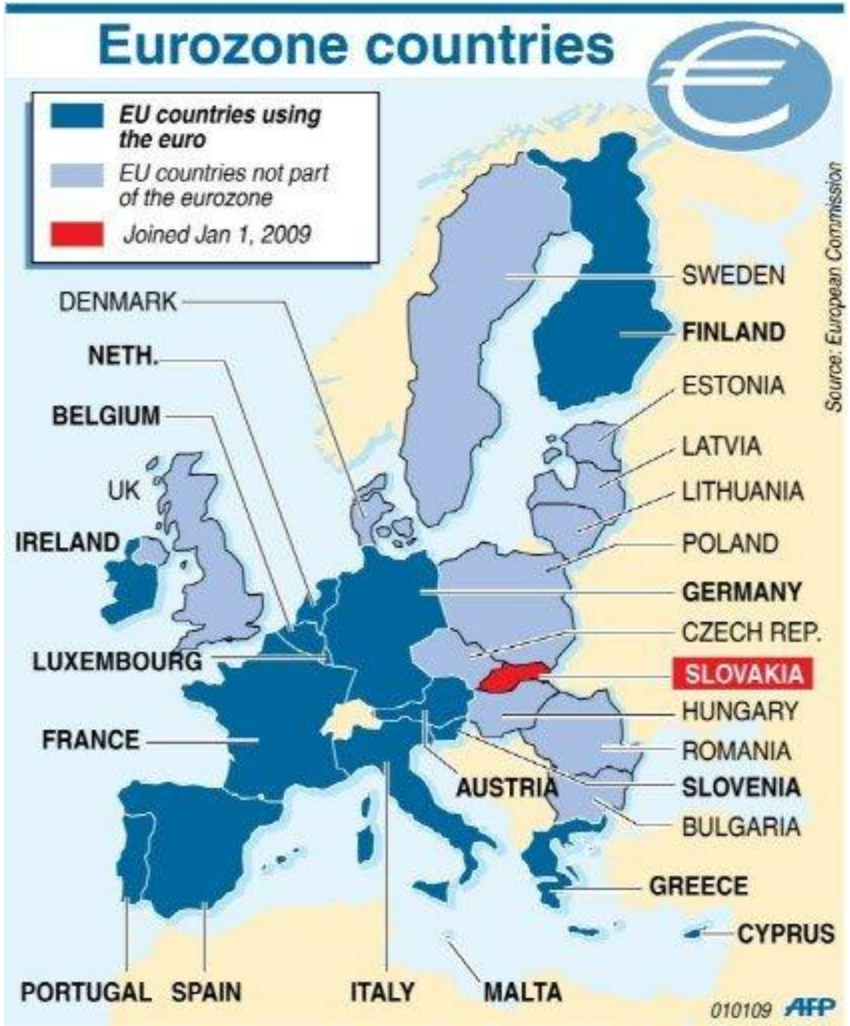
"Europhoria"

- 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

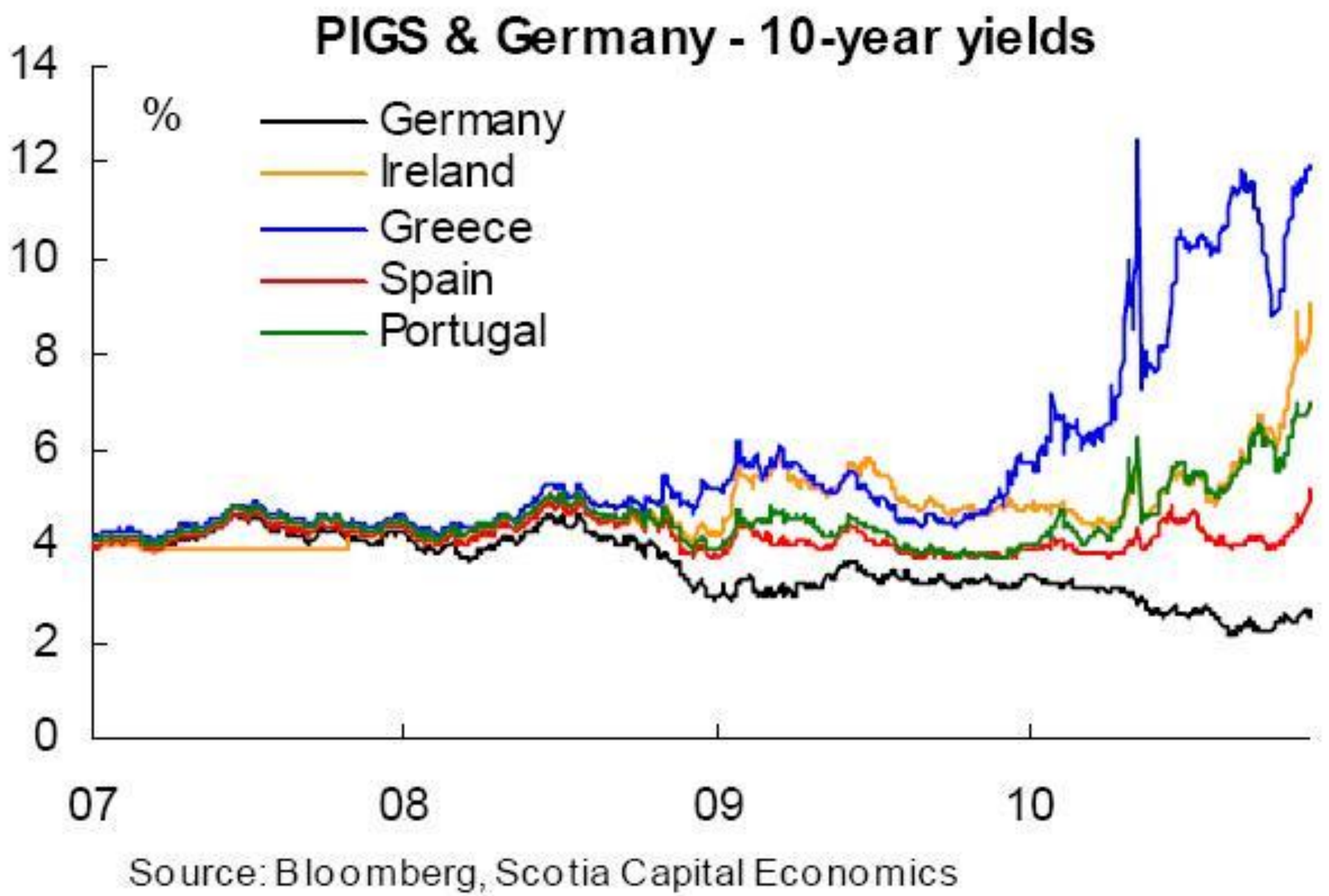
Euro-zone map



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!

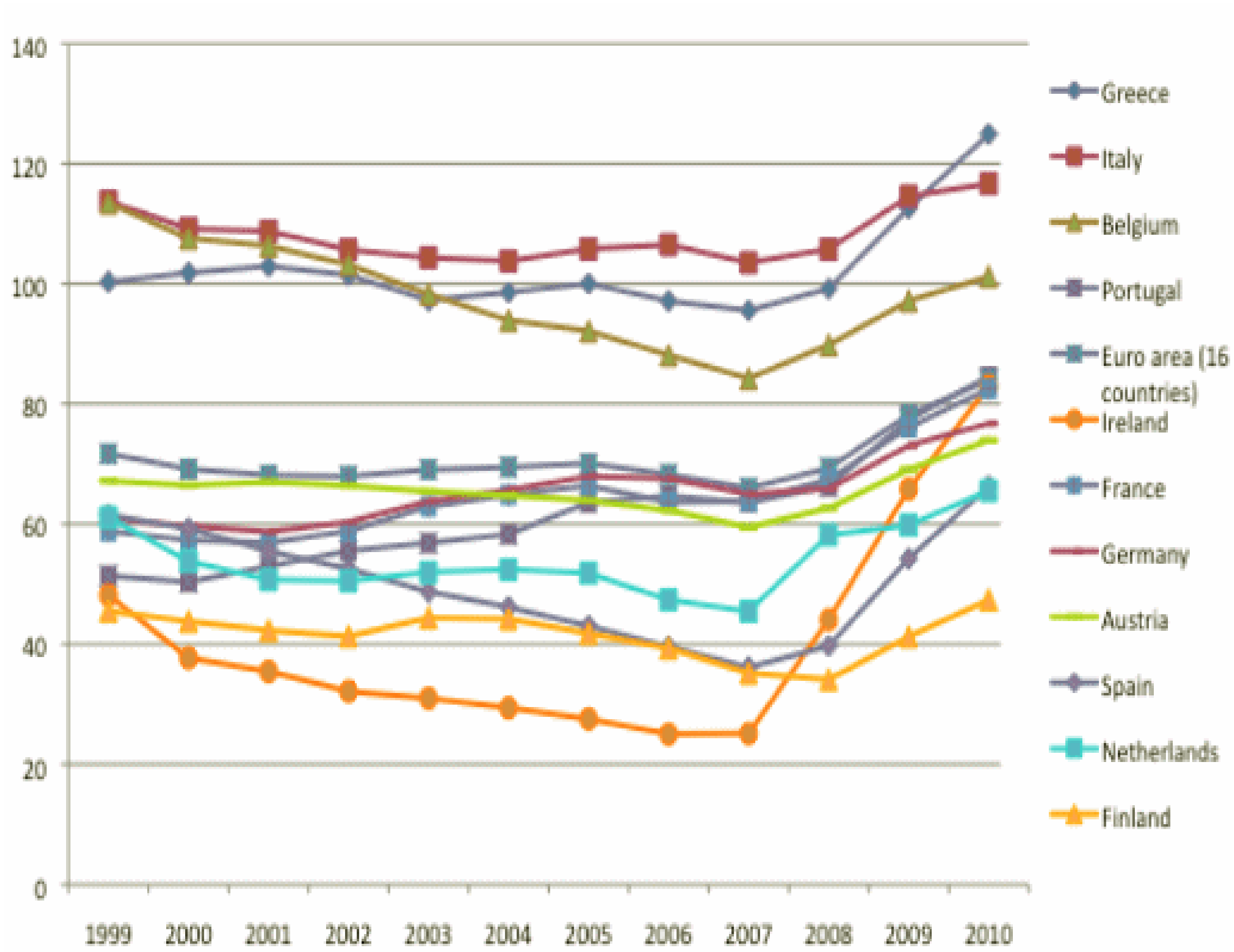


Is it all about public debt?

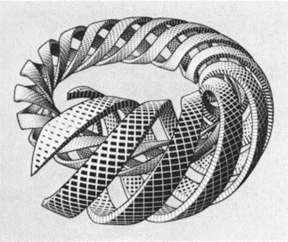
- Other than Greece, root cause of debt problem was unsustainable accumulation of private compared to public debt
- Triggered debt-deflation dynamic, forcing governments to take over private debt
- Prior to 2008, debt/GDP ratios of all Eurozone countries, bar Germany and Portugal, were actually declining – 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

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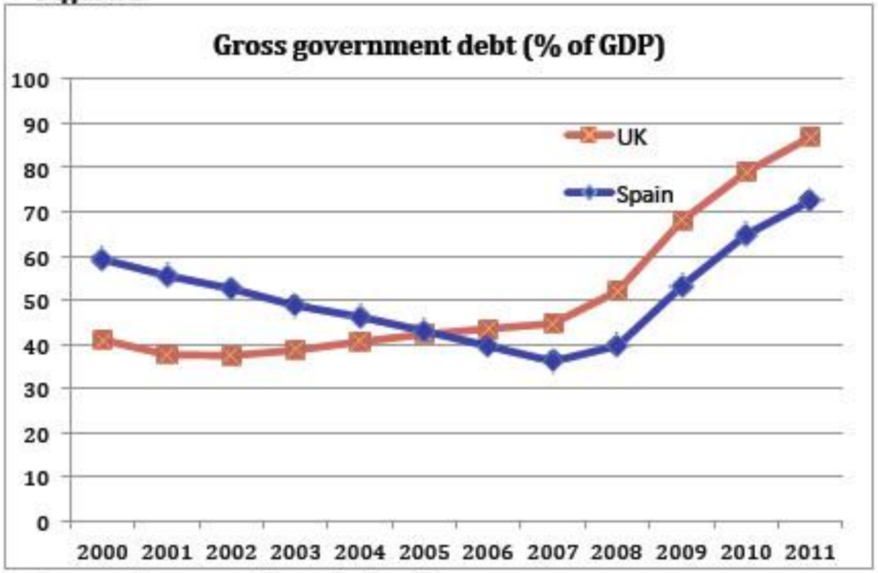
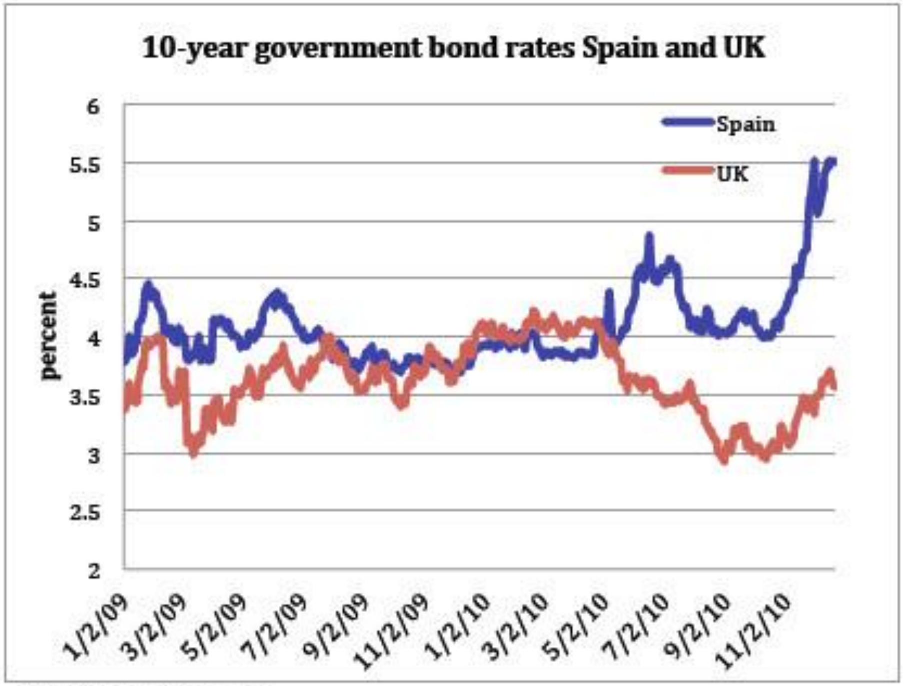
Spain vs. UK

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

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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**

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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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