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

Eurozone countries

- EU countries using the euro
- EU countries not part of the eurozone
- Joined Jan 1, 2009

Source: European Commission

DENMARK
FINLAND
SWEDEN
ESTONIA
LATVIA
LITHUANIA
POLAND
GERMANY
CZECH REP.
SLOVAKIA
SLOVENIA
BULGARIA
HUNGARY
ROMANIA
Greece
PORTUGAL
SPAIN
ITALY
MALTA
IRELAND
BELGIUM
NETH.
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!

PIGS & Germany - 10-year yields

%  
14 12 10 8 6 4 2 0

Germany  
Ireland  
Greece  
Spain  
Portugal  

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
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**

Gross government debt (% of GDP)

- **Source:** European Commission, Ameco

**Figure 2:**

10-year government bond rates Spain and UK

- **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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