Research Note

The Endgame for the Eurozone?

HOWARD FLIGHT

- It is to be hoped – though it looks unlikely – that the measures that President Sarkozy and Chancellor Merkel have been seeking to organise will buy time to address the fundamental, underlying problem of the major decline in competitiveness of the Southern economies compared with Northern Europe, under a common currency. If the EU does not come up with a realistic, long-term solution, a chaotic breakup of the Euro in due course is inevitable.

- Since the introduction of the Euro, the competitiveness of Southern Europe, in comparison with Germany, has declined by 35% and more. As a result, the economies of Southern Europe are "dead in the water" with fiscal deficits likely to rise until they can achieve a substantial devaluation. The German prescription is for these economies to implement internal devaluations by slashing wages and welfare expenditure, as Ireland has done to a certain extent. But an internal devaluation of the extent required is not a practical, political or economic option. It would, moreover, depress their economies yet further, increasing their fiscal deficits. **These economies (and Ireland) need, above all, economic growth to help resolve their deficit and borrowing problems. This they can only achieve by a significant devaluation.**

- The EU has flirted with closer fiscal union as a solution. However, no clear definition of this has yet emerged and it is clear that Germany is not willing to foot the bill. Pan-Eurozone bonds backed either jointly and severally, or pro rata to their size of economies, by Euro area members would relieve the borrowing pressures on Italy and Spain, but they would amount to a substantial underwriting of Southern European government debt by Germany.

- Problems of relative competitiveness within Sovereign States are typically addressed by transfer payments from the more prosperous to the less prosperous areas. In the US these amount to some 30% of Federal tax revenues. In the UK they represent some 12% of total government spending. It is clear that Germany is not willing to finance such massive, regular transfer payments. The transfer payments from West to East Germany following reunification were on a much smaller scale, but depressed German growth for 15 years.

- Nor is Germany willing to allow the ECB to act as the Central Bank to a fiscal union, and lender of last resort – able where necessary to print the money and buy the bonds of those governments having difficulty in raising the necessary funds in the market.

- A fiscal union, including a transfer payments regime, would also have the disadvantages of locking in the uncompetitive countries as failing, dependent economic regions. It would also stir up nationalism: Southern Europe resents being ordered around by Northern Europe and Northern Europe resents footing the bill. Fiscal union would also create a sclerotic Eurozone economy, damaging growth prospects for both the North and the uncompetitive South.

- Within the Eurozone, Germany has come to occupy a position comparable to that of China versus the developed economies. For Germany, the Euro is a cheap currency underpinning her competitiveness in the Eurozone, while the reverse has been the case for Southern Europe.

- The ball is in Germany's court; if it wishes to preserve the Eurozone, they have to pay the price. It is no use calling on China, the US or the IMF to pay up to solve the Eurozone's home-grown problems.

- So it is Germany which needs to come up with a solution which makes economic sense and addresses the underlying problem. **The least painful solution would be a division of the Euro area into two currency zones** – a hard currency for Northern Europe and a weak currency for Southern Europe. While these are not perfect currency zones, they should at least be capable of functioning for some time.

- Economically, France would be much better off joining the weak currency, but *amour-propre* would probably dictate it being in the hard currency block. The initial extent of the Southern European devaluation would probably be of the order of 50% but this should stabilize to around 35% in due course. Either a new Northern Europe DM could be adopted, led by Germany, leaving the Euro as a weak currency for Southern Europe – or the other way round. The former would be easier to manage and cause less financial dislocation.

- Such a bold measure would need to be planned, confidentially, well in advance and implemented over a targeted weekend for business on a Monday morning.

- Measured in the new DM currency, banks, insurance companies, businesses and other institutions in Northern Europe (and elsewhere in the world) would sustain significant one-off losses on Euro denominated financial assets located outside the new DM area, but the extent of the losses would depend upon the terms of the currency re-organisation – e.g. whether the re-denomination of financial assets and liabilities were limited to those issued/located in the new DM countries, or included cross-border assets and liabilities; and also for banks on how their Euro loans are financed.

- The Euro area should then be capable of managing satisfactorily with two currency blocks. Both would float independently, allowing exchange rates to absorb changes in competitiveness.

- As Germany has made clear, it is not willing to foot the bill to preserve the Eurozone. So could this (or something similar) be Germany's Plan B?

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