

Talking Points

Fallout of the Euro Crisis

David Bartlett
Economic Advisor, RSM International
29 November 2011



Escalation of the Euro Crisis

On 27 October 2011, the 17 Euro countries agreed to new €100 billion bailout package for Greece, which included a 50 percent write down of Greek government bonds held by private European banks. Global financial markets reacted favourably to the accord, raising hopes that the Euro crisis could be contained to Greece and relieving fears of a “double dip” recession.

But ensuing developments quickly dashed these expectations. By the end of November, the cascading Euro crisis had enveloped other financially troubled Southern European countries (Italy, Portugal, Spain) and even fiscally sound Northern European countries like Germany.

- November 1: The Greek government announces a January 2012 public referendum on the austerity programme requisite to enactment of the 27 October agreement.
- November 3: Facing external pressure by the EU and strong internal opposition, Greek Prime Minister George Papandreou abandons the referendum plan.
- November 6: Papandreou resigns and is succeeded by Lucas Papademos. Global financial turbulence mounts amid skepticism over Greece’s capacity to implement austerity measures and concerns about other heavily indebted EU countries.
- November 9: Italian Prime Minister Silvio Berlusconi resigns and is succeeded by Mario Monti. The interim government’s announcement of budget cuts fails to stabilise financial markets, and yields on Italian bonds rise to record highs.

- November 10: The European Commission releases its latest economic forecast for 2012, slashing its previous EU growth projection of 1.6 percent to 0.6 percent.
- November 21: Moody’s issues a warning on France’s AAA sovereign debt rating, citing declining growth prospects and increasing borrowing costs.
- November 23: Germany sells barely half of a government bond auction, signaling waning investor confidence in Euro assets even in financially stable EU countries.
- November 24: Fitch Ratings lowers Portugal’s sovereign rating from BBB- to BB+, reducing Portuguese debt to junk status. Moody’s downgrades Hungarian sovereign debt to a sub-investment grade. Reversing its previous policy of defying the multilateral lending agencies, the government of Prime Minister Viktor Orban requests precautionary financial assistance from the International Monetary Fund.
- November 25: Standard & Poor’s downgrades Belgium from AA+ to AA, voicing concerns over the sustainability of that country’s government debt.

The Euro crisis has reverberated around the world, raising the specter of a global credit squeeze akin to the fallout of the Lehman bankruptcy in the 3rd quarter of 2008. European banks active in Asia (which relies heavily on European financing of infrastructure, syndicated loans and trade finance) have begun deleveraging their Asian balance sheets. Citigroup and other American banks have initiated steps to reduce their exposure to risky Euro assets which approach \$2 trillion.

Future of the Euro: Three Scenarios

Compounding the sense of a crisis spiraling out of control, the European business press reported that leading banks (e.g., Royal Bank of Scotland) were preparing contingency plans for the prospective demise of the Euro zone. On 25 November, Merrill Lynch released a study of the potentially dire consequences of a breakup of the common currency area. Meanwhile, Barclays Capital reported that nearly half of a 1000-strong client survey anticipated that at least one country would leave the Euro.

Three potential scenarios for the Euro have emerged.

Scenario #1: Preservation of the Economic and Monetary Union

In this scenario, the members of the Economic and Monetary Union (EMU) agree to heighten fiscal discipline on improvident Euro countries (the weakness of which is the root source of the financial gap between Northern and Southern Europe) and strengthen the monetary policy capacity of the European Central Bank (which is legally and structurally constrained from acting as a “lender of last resort” à la the U.S. Federal Reserve).

This scenario presupposes (1) the ability of the national governments of the 17 EMU countries to embrace fundamental institutional reforms that would entail amendments of the Treaty for the Functioning of the European Union, and (2) the willingness of German Chancellor, Angela Merkel, to yield on her opposition to expanding the ECB’s policy domain, including underwriting of Eurobonds (“Stability Bonds”) that would supplant government-issued paper.

Scenario #2: Partial Breakup of the Euro Zone

Here, one or more of the financially challenged "PIIGS" (Portugal, Ireland, Italy, Greece, Spain) exits the Euro zone and restores the legacy currency. The solvent economies of the Northern tier keep the Euro and resume their activities in a rump common currency area.

The partial breakup scenario offers a potential upside for both Northern and Southern tier countries. Weak economies like Greece would be freed from the macroeconomic straitjacket of the Euro, permitting a return to their now devalued national currencies to stimulate export-led GDP growth. Strong economies like Germany and Netherlands would be relieved of the need to subsidise financially profligate countries in Southern Europe. A truncated Euro zone would survive, clustered around responsibly managed Northern European economies aligned with the original vision of the Economic and Monetary Union.

But a partial breakup of the Euro zone also presents significant downside risks. The steep devaluations that would likely result from a restoration of national currencies in Southern Europe (Greek drachma, Italian lira, Portuguese escudo, Spanish peseta) might ignite domestic price inflation, further antagonising local populations already pressed to the limit by EU-mandated austerity.

Such currency devaluations would also imperil the ability of exiting countries to settle outstanding Euro-denominated liabilities. On 5 November, the European press reported that German tour operator, TUI, was already renegotiating contracts with Greek hotels to hedge for the possible replacement of the Euro with a devalued drachma. It is reasonable to assume that other Western companies active in Greece will follow suit.

"Redenomination risks" would be much greater in larger Southern tier countries like Italy and Spain, generating adverse domino effects throughout Europe and other regions.

Scenario #3: Full Collapse of the Euro

In this scenario, the complex web of interconnected contracts and currency settlements in Europe prevents the EMU from successfully executing a partial breakup of the Euro. Investor anxieties over Euro-denominated liabilities in the peripheral Southern countries spill over to the core Northern countries, precipitating a global flight from the Euro that fatally undermines the integrity of the common currency zone.

The full collapse scenario would likely fulfill the grim prognostications of pessimistic economists (including New York University's Nouriel Roubini, who famously predicted the 2008 crisis) of a Lehman-type financial crash and another global recession. The legal/institutional mechanisms for a dissolution of the EMU (membership in which is treaty-bound and theoretically irrevocable) do not presently exist, so it is unclear how a total Euro breakup would be managed or what its consequences would be.

Conclusion: "Not Less Europe, But More"

Reflecting a growing realisation that a full Euro collapse is plausible, German Chancellor Merkel issued the following statement: "The Euro must not fail, and it will not fail. The Euro is much, much more than a currency. It is the guarantor of a united Europe." Accordingly to Merkel, what Europe needs is not "less Europe, but more."

Merkel's solution (tougher enforcement of Euro zone rules and convergence toward a fiscal union) will be a central topic of discussion at the European Council summit on 9 December. The European Commission has

publicly endorsed the expansion of Brussels' surveillance over the national budgets of Euro members. Former ECB President, Jean-Claude Trichet, has called for the creation of an EU Ministry of Finance with taxation power and borrowing authority. French President Nicolas Sarkozy has voiced broad support of Merkel's push for increased fiscal integration, while urging a more active role in the present crisis by the European Central Bank (whose interventions have been limited to modest purchases on the secondary bond market).

The fiscal union proposal represents a much deeper level of politico-economic integration than the original Economic and Monetary Union, which set macroeconomic thresholds for Euro membership (the four Maastricht criteria) while leaving fiscal policy in the hands of popularly elected national authorities.

This institutional arrangement proved wholly inadequate to the challenges of the 2000s, when the combination of easy credit and poor national governance led to unsustainable sovereign debts in a number of Euro countries. The resultant Euro crisis presents a critical (and perhaps decisive) test of the political will of the EMU member governments to move toward a greater degree of transnational cooperation.

About David Bartlett

David Bartlett, Economic Consultant, has over ten years' experience of consulting, researching and teaching on international corporate strategy. He specialises in international growth, global manufacturing, foreign sourcing and distribution and corporate risk management.

David is Adjunct Professor of Strategic Management and Organization at the Carlson School of Management, University of Minnesota. He has also held faculty appointments at Vanderbilt University (USA), Yerevan State University (Armenia), and the University of World Economy and Diplomacy (Uzbekistan).

David has received a Fulbright Senior Scholarship, Salzburg Seminar Fellowship and other scholarly awards. He holds a PhD and BA from the University of California and an MA from the University of Chicago.

E: david.bartlett@rsmi.com

About RSM International

RSM International is a worldwide member organisation of independent accounting and consulting firms. RSM International is represented in 90 countries and brings together the talents of over 32,500 individuals worldwide. The organisation's total fee income of US\$3.8bn places it amongst the top ten international accounting organisations worldwide. Member firms are driven by a common vision of providing high quality professional services, both in their domestic markets and in serving the international professional service needs of their client base.

www.rsmi.com