Handicapping European End Game Scenarios

The European financial crisis is of historic proportions and it remains unresolved as the year draws to a close. The resolution remains elusive, but there seems to be a finite number of ways that the situation will ultimately be resolved. Let's consider them.

Scenario I: Country Leaving Monetary Union (3%)

Many observers suggest that the only solution of the debt crisis is for a troubled country to leave the union and introduce a new, devalued currency. We would attribute a very slight chance of this taking place. A robust cost/benefit analysis would reveal the high costs and uncertain benefits of such a course. Sovereign and bank debt would still be denominated in euros. This would force a default. Whatever competitive advantage is gained by currency depreciation would be offset by substantially higher inflation. Interest rates would rise dramatically, contributing further to a severe economic contraction. The political and economic elite would be discredited.

It is not immediately clear whether such a country would be allowed to remain in the European Community (EC) after leaving the monetary union and defaulting. If it were to leave the EC, lost sovereignty may be regained, but it could only by a pyrrhic victory as the monetary policy and the business cycle of the EC members would limit the degrees of policy freedom. To the extent that sovereignty is recouped, the departing member may find it is increasingly marginalized in Europe and in the world.

Some observers suggest that rather than a debtor leaving, perhaps Germany would. German tax payers, we are told, no longer want to pay for their Greek neighbors to retire early, or for their Irish neighbors to have an incredibly low corporate tax, or for other neighbor's to have ill-thought out policies (which produced a housing market bubble in Spain) or lack of competitiveness as is the case in Portugal (where private sector debt has grown to nearly 3-times GDP).

These suggestions that Germany should (or may) leave monetary union misunderstand the raison d'etre of EMU in the first place. It was not really about maximizing economic outcomes. At its modern conception, it was an economic solution to a political problem. That political problem was under what conditions could Europe allow Germany to be reunited after the Berlin Wall fell. Germany had to be Europeanized—the uber Deutschemark would have to be shared with Europe. The Bundesbank's anti-inflation credibility (and low interest rates) would also be shared with Europe.

Many observers under-estimate the political will for the EMU to be sustained. It embodies the trans-generational vision of a united Europe. The political spectrum may be significantly wider in Europe than the US, but the political elites seem in agreement that there simply is no alternative. What Benjamin Franklin told 13 colonies more than 230 years ago applies to the 16 countries in EMU today: Hang together or hang separately.

Scenario II: Substantially Faster Growth (2%)
One way to lighten the debt burden is for the highly indebted countries to grow substantially faster. This seems to be the American answer, but it does not resonate in Europe. The European answer is to tighten fiscal policy. This coupled with an over-valued currency (around 7% by the OECD's measure and its 10-year moving average and 23% by the Big Mac comparisons) and the withdrawal of ECB's liquidity provisions makes for poor prospects for growth.

Underneath the debt problems lies a competitive problem for most euro-zone countries. Germany has been the major beneficiary of the EMU and after a painful restructuring of its economy, it has done a remarkable job keeping unit labor costs nearly flat over the past decade. Few countries (outside the United States) have come close to matching Germany's feat.

Scenario III: Internal Devaluation/Deflation (7%)
Traditionally the weaker countries in Europe, including France, regain competitiveness by devaluing their currencies against the German mark. European monetary union effectively blocks this route. With external devaluation not an option, countries may regain competitiveness through what some economists call an internal devaluation. This is to cut prices for goods, services and labor.

This is indeed a very painful process. It is politically and socially an expensive path as well. There is a limit on peoples' willingness to sacrifice to service debt, especially if it is largely in the hands of foreign investors, as is the case for countries like Greece and Portugal, for example. Even if one does not accept Keynes' insights regarding the benefits of counter-cyclical fiscal policy, surely we can recognize his terribly relevant insight in his critique of the Treaty of Versailles that ended World War I.

Keynes argued in the Economic Consequences of Peace that the harsh treatment of Germany—"the bleeding of Germany" –would not produce the kind of results the victors hoped for. In fact, the reparation of 269bln gold marks (roughly the equivalent of 100,000 tons of gold) and interest was finally paid off two months ago, according to the BBC.

The elites in the periphery of Europe, with relatively weak governments, are mostly reluctant to take this path. Prices in most peripheral countries should fall relative to Germany. Yet even with a monetary policy setting that arguably is too easy for Germany, its inflation is less than the periphery except Ireland.

To be sure, this is not to imply that the relative change in consumer prices is the best or only measure of changes in relative competitiveness. It is simply meant to be suggestive of a difficulty with the domestic deflation scenario. Overall, the political will and support to enact the painful course is weak.

A new Irish government may be in place by the end of Q1 11. If it continues to accept domestic deflation, it probably will bolster the speed of the Irish economic recovery. Ireland could very well prove to be attractive to longer-term investors when confidence grows after the crisis has turned. Nevertheless, the debt burden is sufficiently large, and with interest rates sufficiently above growth rates, it will surely be difficult to stabilize the debt to GDP ratio in the near-term.

Euro-zone Inflation	November CPI (y/y)
Ireland	0.6%
Germany	1.5%
Italy	1.7%
Spain	2.3%
Portugal	2.3%
Belgium	2.9%
Greece	4.6%

Source: Bloomberg

Scenario IV: Fiscal Union (9%)

One of the criticisms of European Economic and Monetary Union is that it lacks the ability for fiscal transfers. It is enshrined in treaties and is regarded as non-negotiable by Germany (not just the government but the Constitutional Court). Fiscal union in the current context could include what has been dubbed an E-bond, or a collective European bond market. It could also include some entity—some have suggested the ECB, others that the EFSF "federalize" the states debt.

Indeed, the historical precedent is the United States, which the individual colonies debt was "assumed" by the new federal government. Of course, those colonies did not accumulate much debt during the War for Independence because of how they financed their war contribution or had only limited damage, at first balked at the idea of "bailing out" their neighbors and compatriots.

A greater compromise was later worked out, with one of the lasting ramifications being the capitol's location on the Potomac. German Finance Minister Schauble has made many provocative comments, but even he recognizes that "in this crisis Europe will find steps toward further unification." While this does seem likely in the longer-term, it is an unlikely or at best, a partial solution to the current debt dynamics. It will not make the peripheral economies more competitive.

Nor will it will help transfer the German's fiscal culture (which some deem to think necessary) even though this is impractical and fraught with dangers. Part of the reason Germany is able to export nearly 40% of its GDP and why German exports look to have surpassed US exports yet again (although the US economy is four-times bigger) is that many other countries live beyond their means.

Scenario V: Debt Restructuring (79%)

The high costs, ineffectiveness and/or lack of political will are fatal flaws of these strategies. If sovereigns cannot devalue, grow, inflate or be forgiven, the only other way to reduce the debt burden and get to the other side of the crisis is to restructure the debt.

The markets have plenty of experience dealing with debt restructuring in both the private and public sectors. Some reduction in debt servicing costs via lower interest rates is often the first line of defense. This is an incrementalist solution that does not address the stock of debt burden. It seems like the current German government sees a lower interest rate on the aid packages as a form of subsidy. Even though some calculations show it could be a relatively modest subsidy, the issue for Germany is a sacrosanct principle, not affordability.

Historically, the end game entails selective and partial defaulting and lengthening maturities. Officials will want to push the latter, but the experience of emerging market debt crises suggests that the former may ultimately be necessary. European officials seem to want to keep the paper chase going until after 2013 and the European Stabilization Mechanism and the collective action clauses are imbedded in most bonds. This will make it significantly easier to implement debt restructuring and private sector participation, as is also traditionally the case in other debt crises.

However, as IMF President Strauss-Kahn candidly recognized, European officials appear "much behind the curve compared to the markets" and institutional thinking is still too local. The cost of Europe trying to wait three years to restructure the debt may be that other countries will need to tap into the EFSF and IMF funding.

The high interest rates and conditionality risks fueling the very crisis it seeks to resolve. The EU-IMF package for Greece has not stabilized its situation. Its 2-year and 10-year yields have risen 239bp over the past six months to 10.9% and 11.72% respectively. The 10-year premium over Germany is near 885bp compared with 762bp at the end of July. And this is despite ECB purchases. It also continues to face the risk of credit downgrades. In essence, peripheral countries in general have not been rewarded for their fiscal austerity by lower market rates or renewed investor confidence. But quite the opposite.

The first two acts of the European drama unfolded in 2010. The key question is whether it can be a three act play or need it be more in 2011. The current facilities are adequate for Portugal and maybe even Belgium, which saw the second largest rise in 10-year bond yields among euro-zone members in the last three months.

Yet the key issue remains Spain. Overall, Spain's economy is bigger than Greece, Ireland, Portugal and Belgium combined and more specially nor does there appear to be current funds/guarantees available for it. Although existing facilities could increase, such an intensification of the crisis, would likely increase speculation of a collapse of EMU and spark greater institutional response in Europe.

Marc Chandler
Global Head of Currency Strategy

For more information, please contact our Currency Strategy Team:
Marc Chandler, Global Head of Currency Strategy, 1.212.723.8800, marc.chandler@bbh.com
Win Thin, Global Head of Emerging Markets Strategy, 1.212.723.8867, win.thin@bbh.com
Mark McCormick, Currency Strategist, 1.212.493.8744, mark.mccormick@bbh.com