Innealta
CAPITAL

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# ON THE EUROZONE CRISIS

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- Likely not new to regular readers of these pages, we have had a negative outlook on Europe-the Eurozone in particular-for quite some time. We are convinced that causes of the Eurozone crisis can be narrowed to a short list of grand mismatches between a given set of conditions that might support just such a monetary union and the present state of the European continent.
- Monetary union may make sense if the following conditions are satisfied. The Eurozone fails to satisfy any one of them: 1) National economies are open and intertwined to a great degree; 2) The industry structure in member countries is well-diversified and similar across countries; 3) National approaches to adhere to the rules of a monetary union and to deal with economic shocks are similar between countries; 4) Capital and the work force are geographically mobile and prices as well as wage levels are flexible.
- The problem is that once a common currency has been introduced it is very difficult and costly to get rid of it. The question is how the damage resulting from the current crisis can be limited.
- The Innealta portfolios currently underweight all European countries, as we remain skeptical of near-term resolution. Indeed, the 'news' of a deal that cajoled bondholders into accepting a 50% cut to the value of their Greek-debt holdings, along with a massive strengthening of the facilities used to grease European bond markets, left us scratching our heads. So many words and so few details in the message, one wonders how much boot is there to put on the ground. And there's still precious little conversation in regard to the question of how we get out of this mess.
- We could be wrong: there remains a slight chance that politicians will be able to come up with and then successfully execute a workable solution at some point or the market selloff will become so severe that even though grave problems exist in Europe, markets are exaggerating any negative repercussions. Those circumstances might just present opportunity. Meantime, we remain focused on the evolving situation, prepared to take advantage of any such opening were it to arise.

## EUROZONE CRISIS

The Eurozone crisis has highlighted numerous problems that come about if a monetary union is forced upon nations that do not naturally form what we refer to as an "optimal currency area." Although most European politicians and bureaucrats are trying to make us believe that the prevailing problems are matters of fate, few bits of recent global financial and geopolitical evolution have been more foreseeable than the current situation in Europe. We'll give that the timing of the crisis might have been a bit of a surprise, but the fact that it would occur *at some point in the near future* was, in our minds, a given. And we weren't alone, joined by a host of folks more expert in such matters and even some key European political figures (though their voices often were muffled by choice, function or force).

Likely not new to regular readers of these pages, we have had a negative outlook on Europe—the Eurozone in particular—for quite some time. We are convinced that causes of the Eurozone crisis can be narrowed to a short list of grand mismatches between a given set of conditions that might support just such a monetary union and the present state of the European continent. Before we get to that list, we'll offer a brief look at monetary unions in general, their *raison d'être* and the conditions that support their success.

## MONETARY UNIONS

At a very basic level, monetary unions are a balance of costs and benefits. For the purposes of the Eurozone discussion, the costs of a monetary union relate primarily to the loss of localized (national) monetary policy, while benefits accrue in the form of the efficiencies gained via a normalized currency and freer flows of trade. That is, individual members of a monetary union give up monetary sovereignty in order to gain broader market freedom.

Outside of a monetary union, trade flows are governed primarily by exchange rates (when not distorted by tariffs and such), with relative exchange rates being indicative of the relative economic competitiveness of relevant countries. Suppose we have a "strong" country and a "weak" country. For the balance of trade between the two countries to find equilibrium, price levels in the weak country must fall relative to those in the strong country. This shift can happen either because, from the perspective of the weak country, local prices themselves fall or the local currency loses relative value; that is, the exchange rate decreases. Via this mechanism, the products of the weak country become relatively cheaper until they have regained competitiveness and those of the strong country become more expensive. Demand thus shifts to the lower-priced good and in this way trade balances move toward equilibrium.

In a monetary union, however, the balancing mechanism facilitated by currency exchange rate adjustments is eliminated. Hence, other balancing mechanisms have to be invoked. The question is: What are the conditions for such mechanisms to work smoothly?

## CONDITIONS FOR A SUCCESSFUL MONETARY UNION

Again, from a purely economic point of view, a monetary union makes sense if its financial benefits exceed its costs. Benefits include a reduction in transaction costs, such as the costs of converting currencies and hedging currency risk, the elimination of exchange rate risk and more transparent prices across a region with a common currency. The drawbacks of a monetary union include the need to abandon monetary policy on a national level in order to react appropriately to economic shocks facing a country.

Taking these considerations into account, a monetary union may make sense if the following conditions are satisfied:

1) National economies are open and intertwined to a great degree
2) The industry structure in member countries is well-diversified and similar across countries
3) National approaches to adhere to the rules of a monetary union and to deal with economic shocks are similar between countries
4) Capital and the work force are geographically mobile and prices, as well as wage levels, are flexible

Insight likely not lost on readers is that the United States generally, over time and across States, satisfies most of these requirements. But, what about Europe?

### Closed for business

First, not all European economies are open in the sense that they conduct some great measure of business with the rest of the world. This is especially true for the southern part of the Eurozone, which is relatively weak in terms of exports and which has a history of using protectionist measures to support local producers. In contrast, other Eurozone countries, such as Germany, France and the Netherlands, not only have been very much integrated into the world economy, they generally have been competitive on a global level. However, their biggest trade partners often have been large global players, such as the U.S., China and other Asian countries, which are outside the Eurozone.

### Olives anyone?

The Eurozone fails to satisfy the second condition, too. The industry structure of many Eurozone countries is neither well diversified nor similar across countries. While Greece is able to globally compete in little more than shipbuilding, other

Eurozone members have a very different and more diversified productive capacity. France is strong in high tech, aviation and luxury goods; Germany is among the world leaders in manufacturing and engineering.

## The buck stops nowhere

That the Eurozone also lacks common rule necessarily inhibits the potential for a successful monetary union. As we have seen numerous times, the ethics and discipline needed to stick to the rules of a monetary union, or indeed any union, vary greatly across Eurozone countries. Italy, among others, only managed to satisfy the criteria for Eurozone membership by using fiscal and accounting tricks. Greece, as we now know, was able to hide a large proportion of its debt for a long time by using complex financial derivatives. On the other hand, some of the Northern European countries have economic policies that are even stricter and more disciplined than required by EU standards.

Similarly, there are huge differences in the way that different Eurozone members would typically deal with economic shocks. When they still had their own currencies and monetary policy, the first response to an adverse shock to the economy would have been to print more money and thereby hike inflation. Going back to the beginning of the 1980s, Italy, Spain and Portugal used to have inflation rates above 15%, whereas Germany, the Netherlands and several other countries saw rates mostly below 5% due to disciplined monetary policy even during periods of crisis. We could go on, but it's clear the third condition for a monetary union isn't satisfied either.

## Low-flow markets

A mobile work force, if it exists, can lead to an adjustment in real income under fixed exchange rates. Members of the labor force could move from low real-income countries to higher-income countries where the real income would subsequently fall due to a higher supply of labor. This tends to be the case in the United States, where people move from lower-income states to higher-income areas. In Europe, labor force mobility is very limited. Language barriers, differences in qualifications, social ties as well as cultural differences often prevent such people flows.

At the same time wage level flexibility is hampered by strong labor unions and social policies that exist in most Eurozone countries. As a result, price flexibility is also limited as wage costs to produce goods remain high even if national economies lack competitiveness. In fact, even now, average wage levels in Greece and Italy are only marginally lower than in Northern European countries despite huge differences in productivity. That disparity is the primary cause of the higher levels of unemployment we currently observe in Greece (about 16% unemployment), Spain (around 20% unemployment) and some of the other worst-affected Eurozone members, as the level of employment, and in turn the relative price of labor, are the primary throttles via which productivity finds cross-regional equilibrium.

Although capital within Europe is relatively mobile, investors have no incentive to invest in lower-productivity countries as wage levels tend to be similar to higher-productivity areas. Local price levels tend to be high as well since exchange rate adjustments are eliminated with a single currency.

## THE TRANSFER UNION

This leaves only one option to maintain the common currency: capital transfers from stronger to weaker economies on a grand scale. Taxpayers in stronger and more disciplined economies have to continually sustain weaker economies. And worse, weaker or less disciplined countries have no incentive to improve their discipline because they know that other monetary union members have to bail them out to sustain the common currency (definition: moral hazard). Cue another round of capital support. This is exactly the situation we see in Europe right now.

## FORGETTING HISTORY

Each time a system of fixed exchange rates had been introduced in the past the experiment ended in disaster. The conclusion: a simple change in the system (that is, artificially retaining fixed exchange rates) does not result in more stability as long as countries have no incentive to be more disciplined and follow common economic policies. Rather than learning from these earlier experiences, though, European politicians started working towards the grand goal of a common currency as early as the late 1970s.

These efforts finally resulted in the Euro. Political reasons were usually put forth as rationale, their primary source the still-too-fresh memories of World War II. Several countries, France in particular, did not want Germany to again become too powerful and thereby present a potential threat to the rest of Europe. At the same time Germany was keen to avoid the isolation that sparked the war. Economic concerns were secondary or non-existent – the current crisis in Europe is a result of this neglect!

## NOW WHAT?

The common currency in the Eurozone was introduced purely for political reasons. There is very little economic rationale for it given that, as illustrated above, Europe isn't an optimal common currency area. The problem is that once a common currency has been introduced it is very difficult and costly to get rid of it even if the political will exists (which clearly isn't the case in Europe yet).

Given that the common currency is a reality, the question is how the damage resulting from the current crisis can be limited. While a comprehensive discussion of the different options that politicians have right now would be beyond the scope of this commentary, the one option (most viable in a friction-free world) would be to have a much smaller Eurozone among countries that satisfy the above-mentioned optimal currency area criteria. In geographic terms this would broadly mean that all the Southern European countries would have to exit the Eurozone, which would then be confined to Central and Northern Europe. Ireland would potentially be an exception to this rule. Since its disastrous debt collapse, Ireland made relatively good progress on its path to normality as disciplined reforms have been put in place, well in contrast to the rare progress to date in Greece and Italy.

A smaller Eurozone would help both stronger (new Eurozone) as well as weaker (non-Eurozone) countries in the long term. Stronger countries would not have to bailout weaker ones and they would be able to adopt common monetary policies that are more suited to their particular economic situations. Similarly, the weaker, mostly Southern European countries, by having their own currencies again would be able to devalue these currencies and thereby regain competitiveness in the global economy. Note, however, that we are talking about the long term here. In the short and medium term those weaker economies may suffer greatly from falling out of the Eurozone. No pain…

## THE BOTTOM LINE

The Innealta portfolios currently underweight all European countries and particularly the Eurozone members due to the severe structural problems and the lack of political sanity and fortitude that has prevailed in Europe for quite some time. Although European politicians are working feverishly on solutions to the crisis, experience has told us that any potential solutions that arise only address the symptoms rather than the underlying causes of the problems. We thus remain skeptical of near-term resolution. Indeed, the 'news' of a deal that cajoled bondholders into accepting a 50% cut to the value of their Greek-debt holdings, along with a massive strengthening of the facilities used to grease European bond markets, left us scratching our heads. So many words and so few details in the message, one wonders how much boot is there to put on the ground. And there's still precious little conversation in regard to the question of how we get out of this mess rather than just contain it.

We could be wrong: there remains a slight chance that politicians will be able to come up with *and then successfully execute* a workable solution at some point or the market selloff will become so severe that even though grave problems exist in Europe, markets are exaggerating any negative repercussions. Those circumstances might just present opportunity. Meantime, we remain focused on the evolving situation, prepared to take advantage of any such opening were it to arise.

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