



Perspectives by Ruth Lea

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Options for the Eurozone: fiscal union or reconfiguration

Introduction: the US and the UK

The markets were understandably concerned last week with the political stand-off in the USA over the raising of the debt ceiling from the current level of \$14.3tn. A compromise deal does now seem to have been agreed, just ahead of the 2 August deadline. The political difficulties over the debt ceiling overshadowed the release last Friday of the latest US GDP figures, which were disappointing to say the least. Not merely did the first estimate for 2011Q2 fall below expectations, growth was 1.3% (annualised) compared with expectations of around 1¾%, but the first quarter growth was revised down to 0.4% (annualised) compared with the previous estimate of 1.9%. As we discussed in a recent Perspective, debt ceilings apart, America's "soft patch" should worry us all.¹

Britain's economic recovery also appears to be running out of steam. The first estimate for 2011Q2 showed a quarterly increase of 0.2%, much as expected. The ONS suggested that growth would have been 0.7% in the quarter if there had not been "special factors" such as the Royal Wedding, hot weather and the after effects of the Japanese tsunami, but such implied underlying buoyancy seems hard to justify.²

The Bank of England's Monetary Policy Committee is due to meet this week, with the latest announcement on monetary policy released on Thursday 4 August. We expect the Bank Rate will be maintained at 0.5% and there will be no decision to extend Quantitative Easing – though given the weakening in the economic outlook there may be some indications in a further softening of attitudes towards further QE.

The Eurozone: Greece's second bailout package

America apart, the troubles of the Eurozone continued to worry the markets last week. Since the last Perspective³ the key development was the Eurozone leaders' announcement (21 July) of Greece's second bailout package.

The European Financial Stability Facility (EFSF)-IMF package was worth €109bn, broadly comprising (details are shown in the annex):

- €34bn of “traditional” bailout.
- €20bn to buy back Greek bonds on the open market, which could reduce Greece’s debt by €12.6bn. This is the first measure involving the private sector.
- €35bn to support credit enhancement measures for the agreed programme of bond swaps and bond rollovers, which could reduce Greece’s debt by €13.5bn. This is the second measure involving the private sector, included at Germany’s insistence and conceded by the ECB. Following this *de facto* “selective default”, the ratings agencies have downgraded Greek debt further.⁴
- €20bn to recapitalise Greek banks.
- In addition, interest rates on the EU’s loans were reduced. It was also agreed to support Greece until it is able to return to the market.

There are still several questions hanging over the package, principally:

- The IMF contribution has not yet been finalised. Representatives of leading emerging market countries at the IMF have warned the fund’s management against pouring more large sums of money into another Greek bailout with such uncertain prospects. They are becoming more vocal in their concerns and Paulo Nogueira Batista, Brazil’s representative on the IMF executive board, recently said that it was “not a done deal”.⁵ If the IMF fails to contribute significantly to the package then the burden would almost entirely fall on the EFSF. The UK was not involved in this bailout.
- Crucial decisions have still to be made concerning the investors involved in the bond swaps and bond rollover programme.⁶ It is possible that this “voluntary” private sector haircut will fail to win enough support to go ahead.
- There are doubts the package will enable Greece to get on top of its indebtedness and there is already speculation that the country may need further financial assistance. As already stated, there are potential savings from the buybacks, swaps and rollovers amount to about €26bn compared with Greece’s total debt of €350-360bn and it is widely expected that Greece’s debt-GDP ratio will remain at around 150%, if not higher, in the foreseeable future.⁷ The package, though large, is therefore arguably not large enough and did too little to lighten Greece’s debt burden.
- All in all, the omens are not especially encouraging.

The announcement of 21 July: towards fiscal union?

In their statement of 21 July the Eurozone leaders also sought to address two other issues overshadowing the Eurozone. The first was the problem of contagion from Greece, Portugal and Ireland to other vulnerable members, principally Spain and Italy, and the second was the poor growth prospects of the peripheral Eurozone economies. Accordingly additional measures were announced in addition the Greece’s bailout:

- The powers of the EFSF bailout fund were extended partly to address the problem of contagion, though the resources of the EFSF were not. The expanded powers were:
 - The provision of “precautionary”, pre-emptive credit lines to countries under pressure in the credit markets, though the borrowers must meet certain “conditions”.
 - The recapitalisation of banks.

- The purchase of bonds of troubled sovereigns in the secondary market in “emergency” circumstances. This had been previously opposed by Germany and German MOF Schäuble has since been at pains to point out the EFSF had not got “carte blanche” to buy the bonds. (But it should be noted that any intensification of market attacks on Spain and Italy may trigger a joint Eurozone guarantee of all Eurozone outstanding debt, with common Eurozone bonds being the next logical step.)
- In addition to cuts in Greek interest rates, there were also interest rate reductions on the EU’s loans to Portugal and Ireland. The UK also agreed to reduce the rate on its bilateral loan to Ireland.
- There was heady talk about a “Marshall Plan” for the weaker economies but, apart from lower interest rates, little by way of a growth package emerged and the term was dropped in the final statement.
- There were also statements to the effect that Greece’s default was in effect a “one off”, ECB president Trichet was especially emphatic on this matter. But this sentiment contains more than an element of wishful thinking. It is quite possible that if/when Portugal and/or Ireland require further support the political need for a Greek-style default will also apply to these countries.

Following the announcement the debate focused on, firstly, the EFSF’s inadequacies and, secondly, the political implications of the extension of the EFSF’s powers.

On the former, it is quite clear that the EFSF does not have the necessary firepower to comprehensively contain contagion involving Spain and, especially, Italy. The EFSF’s current lending capacity is €250bn, with a planned maximum of €440bn. It has been estimated that, given the upper limit of €250bn, Spain could only be partly bailed out. It has also been estimated that, even with the upper limit of €440bn, Italy could not be adequately bailed-out. For the EFSF to be credible it needs to be twice or three times as large as it currently is, yet there are no plans for expanding it. Some estimates suggest it should be as large as €2tn.⁸

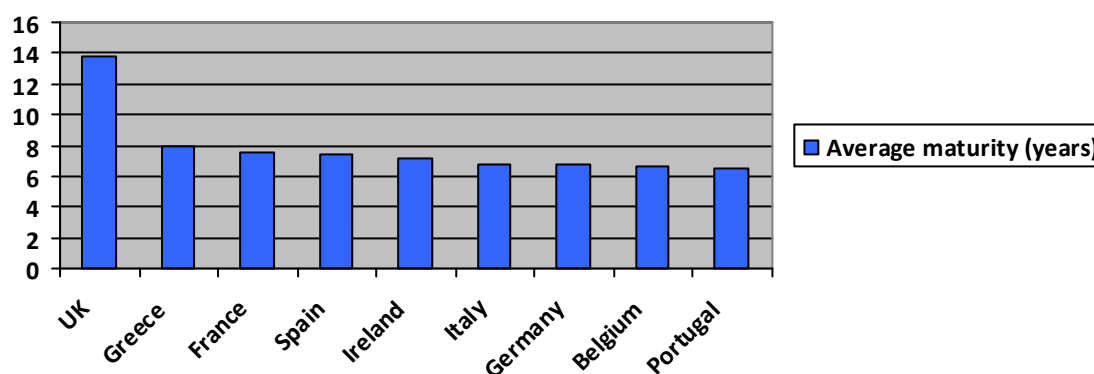
On the latter, the most significant political development in the 21 July statement was the extension of the EFSF’s role, including the power to purchase bonds on the secondary markets which was a major step towards communalising risks within the Eurozone. French President Sarkozy, a keen supporter of fiscal union, announced this development was the birth of a “European Monetary Fund”. Greek PM Papandreou said the measures taken to bolster the EFSF meant that “in an embryonic form, a truly common debt management practice is beginning in the Eurozone.” The decisions undoubtedly suggested movement towards fiscal union.⁹ Fiscal union is discussed further below.

Other recent developments in the Eurozone

Even though the markets initially reacted favourably to the announcement of the second Greek rescue package, later sentiment has been negative. The Greek bailout has clearly not relieved market concerns over Spain and other vulnerable sovereigns. On the contrary, the Greek bailout has made things worse. The Greek rescue package has set a precedent for private sector participation in future sovereign debt restructurings and, in the words of Moody’s, “signalled a clear shift in risk for bondholders of countries with high debt burdens or large budget deficits”.¹⁰

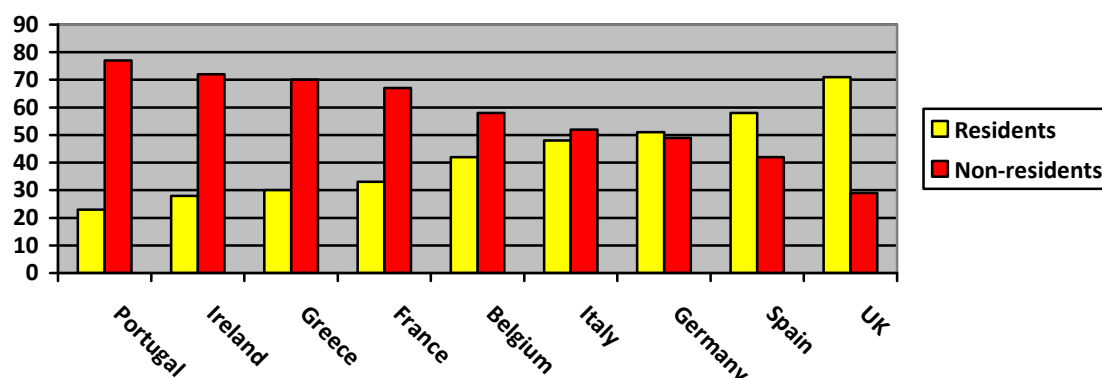
Moody's have accordingly threatened Spain with a ratings downgrade. Spain is "on review for possible downgrade". The country continues to struggle with unacceptably high unemployment, sclerotic labour markets and political uncertainty. Italy, hampered by €1.8tn of sovereign debt, remains especially vulnerable to higher rates on government bonds.¹¹ This is despite the fact that the average maturity for its debt is a perfectly respectable 6.8 years and nearly half of its government debt is held by residents, as shown in charts 1 and 2.

Chart 1 Average maturity (years) of Government debt, December 2010



Source, IMF, Fiscal Monitor, April 2011: *Shifting Gears - Tackling Challenges on the Road to Fiscal Adjustment*, chapter 2, table 2.3 reconstructed.

Chart 2 Government debt holding by residence, 2010 (% total)



Source: IMF, Fiscal Monitor, November 2010: *Fiscal Exit: From Strategy to Implementation*, chapter 2, figure 26 reconstructed.

The situation in Cyprus has rapidly deteriorated recently there is rising concern that it will need a bailout package. Standard and Poor's recently downgraded Cyprus's credit rating to BBB+ (3 notches above junk). Cyprus has recently been hit by a triple whammy:

- Cyprus's banks are disproportionately affected by losses on Greek sovereign debt owing to high exposure to the debt.
- The economy has been undermined by the destruction of a power plant in early July when a cache of Iranian weapons seized *en route* to Syria exploded.
- Political turmoil.

But Cyprus is a very small economy, not to say one of the EU's micro economies. It represents just 0.2% of the Eurozone's GDP and 0.15% of the EU27's GDP (see charts 1 and 2 in the annex). It is "manageable". By comparison, Italy and Spain represent 17% and 11½% of Eurozone GDP respectively. (Note that Greece, Portugal and Ireland are small economies representing 2.5%, 1.9% and 1.7% of Eurozone GDP respectively.)

Finally, it should be noted the France is not immune to criticism. The IMF warned France last week that it would miss its target of cutting its budget deficit to 3% by 2013 unless it carries out more spending cuts. The IMF also noted that French banks were "significantly exposed" to peripheral countries and remained less well-capitalised than their European peers.

The future of the Eurozone: fiscal union or reconfiguration

We reported above that the extension to the ESFS's powers represented another step towards fiscal union. But it is only a transitional step. Arguably, the time has come to address the underlying design flaw of the Eurozone. It is a single currency with many different states, profoundly disparate economies that are diverging not converging, a seemingly unbridgeable competitiveness gap between the northern and the southern economies, different economic policies and worryingly variable approaches to fiscal stringency and integrity. Given these profound internal conflicts there really are only two "solutions" to the Eurozone: fiscal union or reconfiguration.

There is little question that a fully-fledged fiscal union could economically hold the Eurozone together but this would involve:

- The issuance of joint "Eurobonds" (i.e. common Eurozone bonds), backed by the most creditworthy Eurozone states, and a common debt agency. One criticism of such mutualised debt is that it would encourage moral hazard, where the profligate would get a free ride on the virtuous, but it should be noted that the current system of bailouts positively drips with moral hazard. Any move towards Eurobonds would surely have to be accompanied by much tighter economic controls over the weaker states. Note, too, that joint Eurobonds could result in higher borrowing costs for Germany and the other northern states.
- A common "economic government" and a finance ministry, which would oversee if not determine general economic policies affecting competitiveness (for example labour markets policies) as well as policies over taxation and public spending. Specifically there would need to be credible enforcement mechanisms to ensure member states honoured the agreed fiscal rules. The financial sector would also need close common supervision. The Commission has made proposals for EU economic governance, but they are nowhere nearly as integrationist as in a genuine fiscal union.^{12,13}
- A "transfer union" with a federal budget comprising a significant proportion, say 5-10%, of Eurozone GDP.¹⁴ The budget would be used for sizeable transfers from the richer northern member states to the poorer, less competitive southern states. These transfers would principally be subsidies, not loans with the expectation of repayment.

There have to be very large doubts that such a cast-iron fiscal union is a “starter” for political reasons. It is quite clear that the current system of bailouts is leading to increased tensions in the Eurozone and there is every chance that creditor and debtor states could yet revolt. The former against the prospect that they will not be repaid, the latter against the onerous conditions attached to the loans. The Governments in the creditor nations have yet to convince their sceptical citizens that massive bailouts are a good use of their taxes.

By extension any notion of massive subsidies from north to south could quite simply be politically totally unacceptable. Such a degree of European integration would almost certainly fail to get a democratic mandate and would therefore fail to have democratic legitimacy. Taxpayers in the contributing nations would resent their taxes being transferred to other states, whilst the electorates in the recipient states would resent their loss of sovereignty.

A genuine fiscal union could therefore offer a solution to the Eurozone’s root problems, but is almost certainly a political non-starter. The alternative is the reconfiguration of the Eurozone, preferably in an orderly and controlled way, even though it would be a major blow to the European Project of “the ever closer union of the peoples of Europe”. Such a task would call for utmost secrecy and, who knows, the EU’s authorities may be developing such a blueprint at the moment. They would be wise to do so. One option would be for the Eurozone to be divided into a northern zone centred on Germany, which would adopt the new deutschmark, and a southern zone, which would keep the euro. The euro would then depreciate against the new deutschmark, injecting some much needed competitiveness into the southern economies and hopefully kick-starting growth. The alternative to an orderly and controlled reconfiguration would be a disorderly and apocalyptic break-up, with various countries splintering off.

The Eurozone therefore faces fiscal union or reconfiguration. In the absence of either of these approaches, the currency union will continue to muddle through. But muddling through does not address the root problem and cannot last indefinitely.

References

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2. ONS, "Gross domestic product preliminary estimate, 2011Q2", 26 July 2011.
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5. Dow Jones newswires, 27 July 2011.
6. FT, "Investors grapple with Greek rescue plan", 26 July 2011.
7. FT, "Default threat remains despite deal", 28 July 2011, reported that Barclays Capital calculated that debt/GDP ratio would probably remain at 150% for the next 20 years.
8. *Economist*, "Bazooka or peashooter?", 30 July 2011.
9. *Economist*, "How much closer a union?", 30 July 2011.
10. *Daily Telegraph*, "Spain downgrade threat adds to debt woes", 30 July 2011.
11. FT, "Italian woes knock the euro", 29 July 2011, reported that the average yield on a recent sale of €2.7bn of 10-year bonds was 5.77% compared with the previous outturn of 4.94%.
12. European Commission, "A new EU economic governance – a comprehensive Commission package of proposals", 29 September 2010.
13. Ruth Lea, "Eurozone pain will continue: a lesson from Black Wednesday", Arbuthnot Banking Group, 4 October 2010.
14. See the European Commission's *Report of the study group on the role of public finance* (chairman Sir Donald MacDougall), 1977. The report concluded that the EEC should be spending 2-2.5% of member states' total GDP in a pre-federal stage; 5-7% in a federal small-public-sector stage; and up to 25% in a federal large-public-sector stage. By contrast the EU currently spends some 1.2% of the aggregate GDP of its members.

Annex

Greece's second bailout package: details

The EFSF-IMF bailout of €109bn from 2011-2014 comprises:

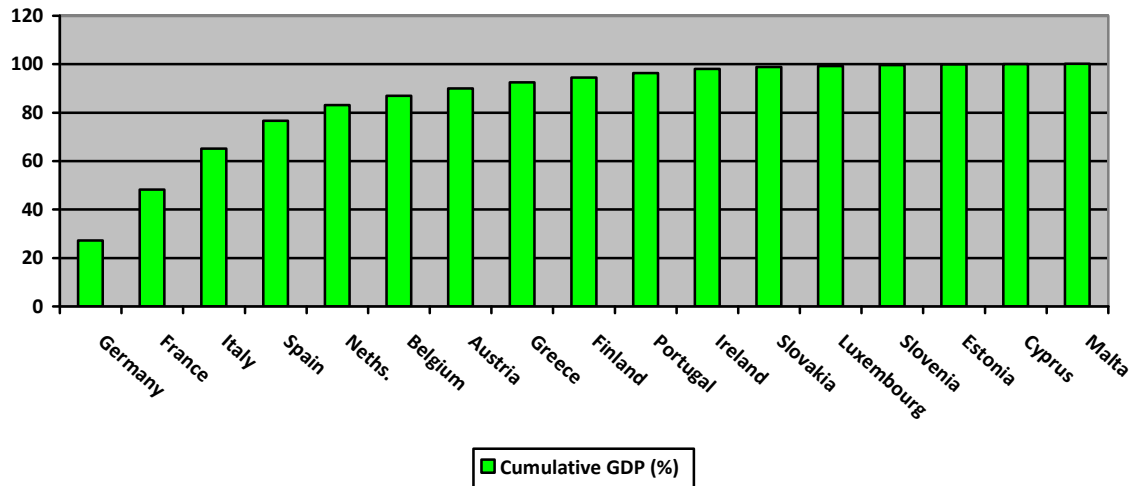
- €34bn to cover the residual financing needs of Greece up to 2014, expected after the anticipated contribution from private bondholders, in other words the “traditional” bailout.
- The private sector is involved in the next two components.
- €20bn to buy back Greek bonds on the open market (debt buyback schemes), which will enable Greece to cut €12.6bn (estimated) from its stock of debt. The buybacks will capture a market discount of 40% for the benefit of taxpayers.
- €35bn to support credit enhancement measures for the agreed programme of bond swaps and bond rollovers. The Institute of International Finance (IIF) has said that, assuming 90% participation, private sector investors would contribute €54bn of financing by mid-2014 and €135bn by 2020 under this scheme, while the average maturity of the debt would rise from 6 to 11 years. The losses to investors would be about 21% of the NPV of their Greek debt holdings. The plan is voluntary to avoid a “credit event”. The €35bn will be used as “credit enhancements” or guarantees and the delay in interest payments has been estimated to reduce Greece’s debt by €13.5bn. Under the proposal, devised under the IIF, bondholders are given the following menu of options:
 - A par bond exchange into a 30-year bond.
 - A par bond offer involving rolling over maturing Greek government bonds into 30-year bonds.
 - A discount bond exchange into a 30-year bond.
 - A discount bond exchange into a 15-year bond.
- €20bn to repair the damage of buybacks, swaps and rollovers, by recapitalising the Greek banks. This has been criticised as “hasty”. Greek banks are very exposed to Greek government debt.

Greece's second bailout package: main numbers (€bn)

		Debt reduction
Loans	€34bn	
Private sector involvement (PSI):		
Bond buybacks	€20bn	€12.6bn
Credit enhancement measures	€35bn	€13.5bn
Bank recapitalisation	€20bn	
Total	€109bn	€26.1bn

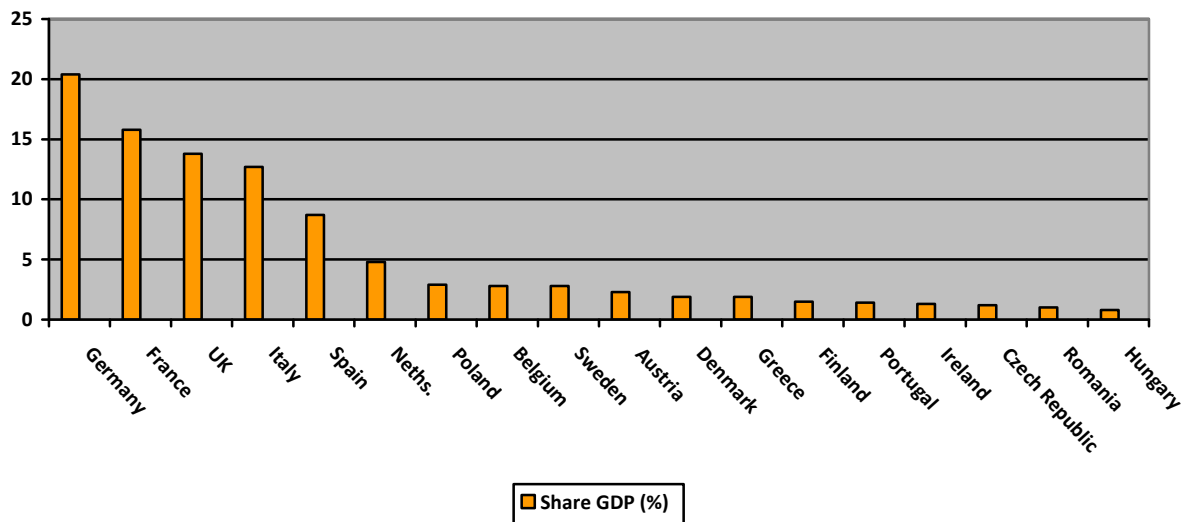
Sources: (i) *FT*, “Plan presents a cost paradox”, 23 July 2011, amended. (The original *FT* article contained the figure of €14bn for the expected debt reduction from “credit enhancement” measures); (ii) *FT*, “Greek rollover”, 26 July 2011; (iii) *FT*, “Investors grapple with Greek rescue plan”, 26 July 2011.

Chart 1 Eurozone (EU17), cumulative share of GDP (%), 2010



Source: ECB, *Statistics Pocket Book*, July 2011.

Chart 2 EU27, share of total GDP (%), 2010



Source: ECB, *Statistics Pocket Book*, July 2011, excluding: Slovakia (0.55%), Luxembourg (0.35%), Slovenia (0.3%), Bulgaria (0.3%), Lithuania (0.2%), Latvia (0.15%), Cyprus (0.15%), Estonia (0.1%), Malta (0.05%).

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