Viewpoint

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Eurozone Partners Likely to Stay in Marriage for Better or for Worse

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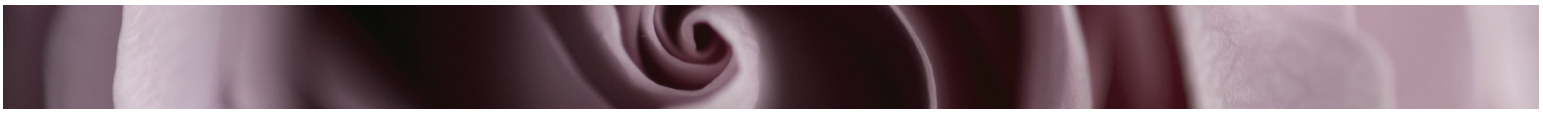

April 2011

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Executive Summary

With persistent European sovereign debt problems casting doubts in some quarters on the future of the eurozone, Standish Global Macro Strategist Tom Higgins does not see a breakdown in the European marriage as a likely scenario. He argues that neither the weaker economies in peripheral Europe nor the stronger core economies would benefit from a divorce. Still, he emphasizes the need for reforming the currency union, especially in terms of adhering to the fiscal discipline envisaged under the Eurozone's Growth and Stability Pact "prenuptial" agreement. In an ironic twist, far from breaking up the union, Europe's sovereign debt crisis may end up drawing members closer together given recent moves toward joint bond issuance and the imposition of a sort of back-door fiscal discipline for those countries borrowing from one of the recently established stabilization facilities.

Next January will mark the 10th anniversary of the euro launch. While the European common currency has had its ups and downs during its first decade in circulation, we believe it has been a success overall. The number of countries sharing the euro has grown from 11 to 17, intra-European trade has increased more than 40% to €380 billion, and the stock of foreign direct investment in the eurozone has nearly doubled to €3.5 trillion.[1] At the same time, the euro has risen to international prominence, becoming the second largest reserve currency in the world behind the U.S. dollar (Exhibit 1 on next page).

Yet amid this progress, some doubts persist about the viability of the common currency. Euroskeptics contend that sovereign debt woes in Greece, Ireland, Portugal and Spain could force one or more of these peripheral countries out of the common currency. Others insist that the stronger economies in the core of Europe, including Germany or France, might abandon the euro rather than rescue their neighbors with more bail-outs.

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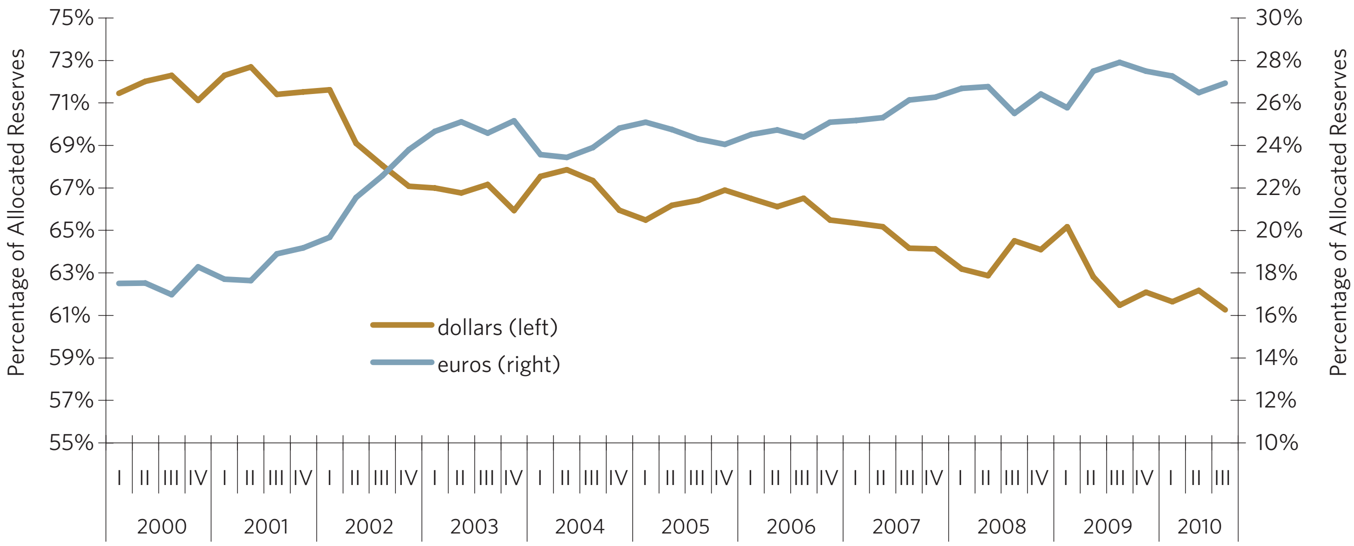
1 International Monetary Fund statistics, as of September 30, 2010.

Exhibit 1 – Global Reserve Allocations Shift Away From Dollars and Toward Euros



Source: IMF as of September 30, 2010

We disagree. In our opinion, neither the weaker economies in peripheral Europe, nor the stronger economies in core Europe, would benefit from a break-up of the eurozone. However, we feel the structural framework for the single currency has been flawed from the very beginning. Though not insurmountable, the problems created by divergent fiscal conditions are significant and resolving them is likely to strengthen the economic ties between member countries.

An exit from the common currency would likely be particularly damaging to the weaker economies in peripheral Europe. For example, if Greece were to abandon the euro, the value of its reintroduced drachma would likely collapse as investors focused on the country's poor economic fundamentals.

Divorce Would Be Messy

Much of the debate about a possible break-up of the eurozone has centered on whether a member could legally exit the currency union, given that it would violate the Maastricht Treaty. From our perspective, the issue of legality is secondary. Rather, the more important question for us is whether it would be in the economic interest of any eurozone members to abandon the common currency? We believe the answer is no.

An exit from the common currency would likely be particularly damaging to the weaker economies in peripheral Europe. For example, if Greece were to abandon the euro, the value of its reintroduced drachma would likely collapse as investors focused on the country's poor economic fundamentals. This, in turn, might likely precipitate a default by the government on its euro-denominated debt.

This situation could be aggravated if investors were to insist on higher interest rates to compensate them for both the *credit risk* of Greek bonds as well as the *currency risk* of the drachma. With Greek 10-year government bonds yields rising as high as 12.5%,[2] the country could be locked out of the capital markets and forced to undergo a draconian fiscal consolidation. There might also be an incentive for Greek citizens anticipating the redenomination of their checking and savings accounts into a devalued drachma to rush out of domestic banks, precipitating a banking collapse. A similar outcome could occur in any of the peripheral eurozone economies. Given these potential risks, it seems unlikely to us that any country would voluntarily leave the euro.

2 "Greek, Spanish Government Bonds Jump on Expanded Bailout Plan," Bloomberg, March 14, 2011.

Not even the stronger economies in the core of Europe, such as Germany or France, would emerge unscathed from a break-up of the common currency. The reintroduction of a domestic currency would be costly and time-consuming. It took three years to get the eurozone up and running. Contracts would need to be redenominated; computer code rewritten; automatic teller machines reprogrammed.[3] Even if a government decreed that all claims in an economy were to be converted into deutsche marks or francs, there could still be the question of what exactly constitutes a German or French debt contract. For instance, foreign multinationals selling corporate bonds in these countries could choose to fight the redenomination of their contracts in court. The new D-mark or French franc would also likely appreciate and whittle away any competitive advantage these countries have in the European market.

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In our opinion, the biggest single obstacle to Germany or France leaving the euro is the exposure of their banking systems to the debt of peripheral eurozone economies. According to the Bank of International Settlements, German bank exposure to the government debt of Greece, Ireland, Portugal and Spain totals $394 billion or more than 15% of its GDP (Exhibit 2). The figures for France are comparable. The risk of default by any or all of these peripheral European economies would almost certainly increase if the common currency were to collapse. Thus, Germany and France could potentially undermine the capitalization of their own banking systems by exiting the euro.

Exhibit 2 – Bank Exposure to Peripheral Europe

(Q2 2010, in US $ Billions)						
	Greece	Ireland	Portugal	Spain	Total	% of GDP
French Banks	53.5	50.1	41.9	162.4	307.9	15.3%
Germany Banks	36.8	138.6	37.2	181.6	394.2	15.1%
Total European Banks	141.6	508.6	205.6	656.6	1512.4	15.9%

Source: Bank of International Settelements as of December 31, 2010

Putting aside these concerns, it is important to recognize there are potential advantages to the common currency. The eurozone is what economists refer to as an "optimal currency area."[4] This implies the euro has improved economic efficiency by allowing greater price transparency across countries and increasing cross-border investment by eliminating exchange rate risk. A recent empirical analysis of the euro effect suggests that the single currency has increased trade by roughly 10% in the eurozone when compared to trade between non-eurozone countries.[5] In addition, direct investment between eurozone nations is estimated to be at least 15% higher as a result of the euro, according to the same report. Several of the peripheral European economies are also net recipients of funds from the European Union budget (Exhibit 3). Were they to leave the eurozone, these funds might be at risk, particularly if the countries were forced from the European Union simultaneously.

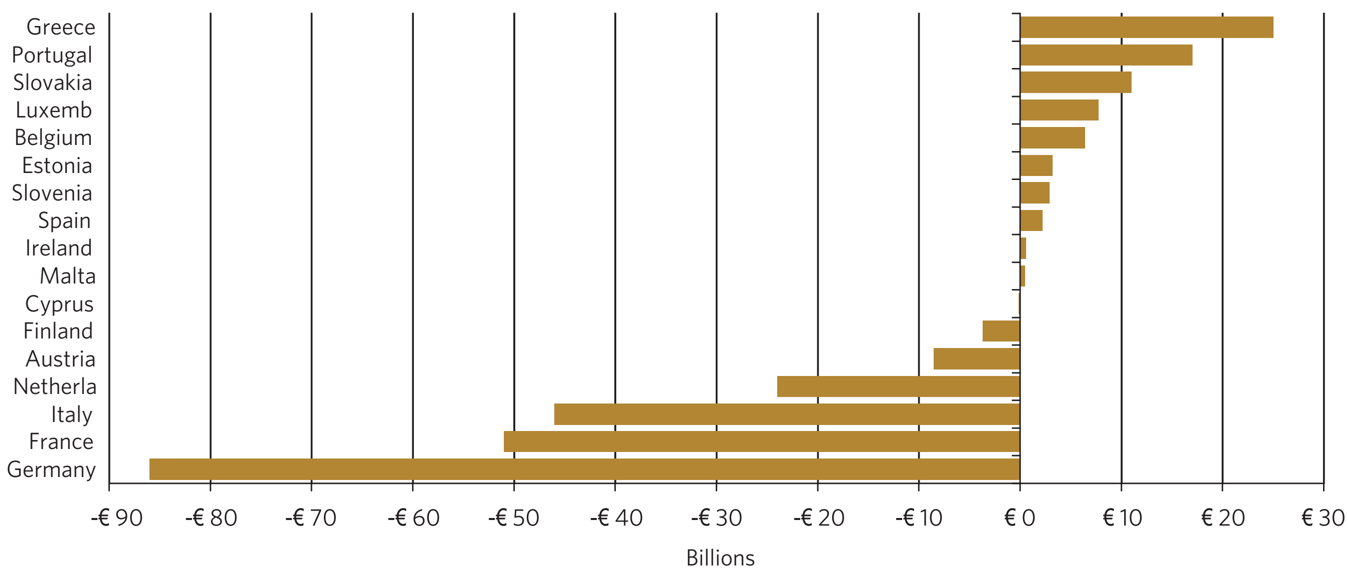
3 Barry Eichengreen, "The Breakup of the Euro Area," University of California, October 2008.

4 See, for example, Robert Mundell, "Optimum Currency Areas," Columbia University, December 1997.

5 Richard Baldwin, Virginia DiNino, Lionel Fontagne , Roberto DeSantis and Daria Taglioni, "Study of the Impact of the Euro on Trade and Foreign Direct Investment," Economic Paper 321, The European Commission, April 2008.

There are seemingly other, less tangible benefits to membership in the eurozone. First, there is greater inflation discipline due to the European Central Bank's (ECB) single mandate of price stability. This aims to protect domestic savers in member countries from seeing the purchasing power of their savings disappear as a result of runaway inflation or currency devaluation. Second, the ECB can act as a lender of last resort in instances where the need of an individual country exceeds the ability of the national central bank to provide liquidity. The ECB played this role in the recent crisis by purchasing the bonds of some of the peripheral European economies as a means of stabilizing sovereign debt markets. And third, the common currency has fostered greater political cooperation in Europe, even though the dialogue has been acrimonious at times.[6] In our opinion, for all of these reasons, the members of the eurozone will have a common motivation to make their marriage work.

Exhibit 3 – European Union Budget Net Benefit by Country



Source: Open Europe 2007

Despite our conviction that the benefits of staying together far outweigh the costs of breaking up, we also recognize the framework for the common currency was flawed from the very beginning.

Reconcilable Differences

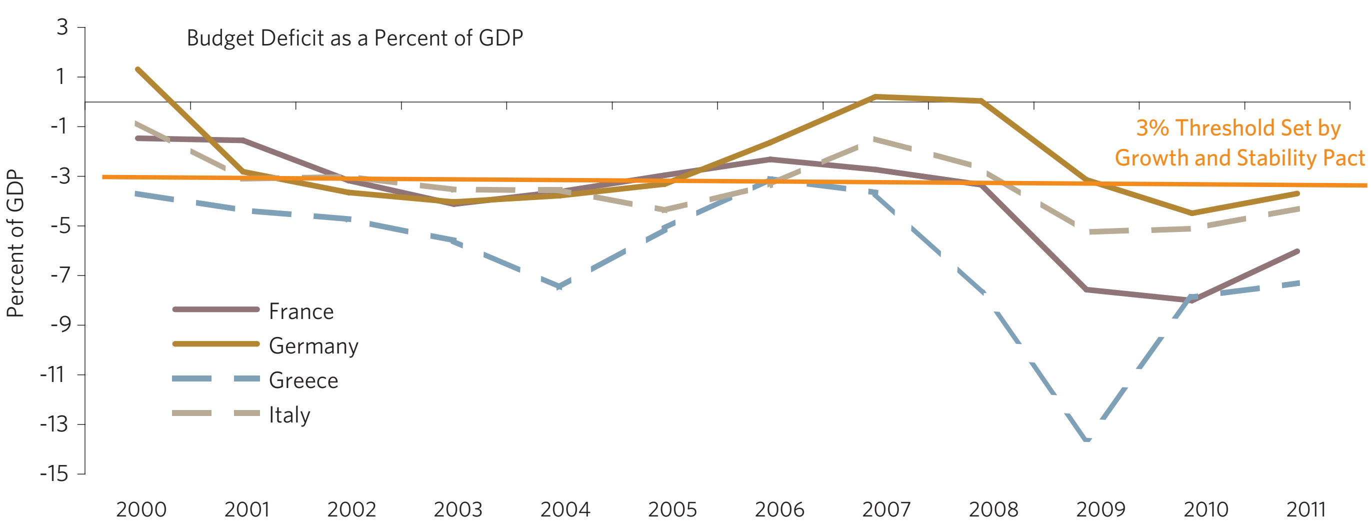
Despite our conviction that the benefits of staying together far outweigh the costs of breaking up, we also recognize the framework for the common currency was flawed from the very beginning. Under the Maastricht Treaty, the region adopted a single currency and monetary policy, yet fiscal policy is divided among its 17 member governments. Typically, a country with its own currency would see that currency decline and its interest rates rise if it sold large amounts of debt to global investors. But, because eurozone countries share a currency, there is no market mechanism to warn when a country's deficit is becoming unsustainable. Indeed, just before the crisis, Greek bonds were regarded as a close substitute for German bunds even though Greek government debt was close to 100% of GDP, which is well in excess of the 60% of GDP threshold set by the Growth and Stability Pact.

6 Martin Feldstein, "Optimal Currency Areas," The National Bureau of Economic Research," November 2008.

Europe has ... set up the European Financial Stabilization Fund (EFSF), which can issue bonds or other debt instruments to raise the funds needed to provide loans to eurozone countries in financial trouble, recapitalize banks, or buy sovereign debt.

One solution to this problem could be for the eurozone to take steps toward a greater fiscal union, similar to the United States. Almost all of the individual states in the U.S. have balanced budget amendments, which prevent them from running deficits for operating purposes. The Growth and Stability Pact was supposed to serve a similar purpose by limiting the budget deficits of eurozone members to 3% of GDP or less. However, it was generally not enforced. For instance, Greece was in violation of the 3%-deficit ceiling from the first day it joined the euro. Part of the problem was that the larger member countries, including Germany and France, ignored the rule and rejected calls for sanctions against themselves. Leaders in these countries contended the rule had to allow a degree of flexibility for deficit spending in recessions. Yet, both countries seemed to run deficits that exceeded the 3%-ceiling in both good times and bad. In fact, Germany and France were each in breech of the Growth and Stability Pact during six of the last 10 years (Exhibit 4). In the United States, the federal government is charged with providing a buffer in periods of cyclical divergence between the states through transfer payments, such as unemployment insurance or food stamps. This automatic stabilizer lessens the need for deficit spending by the states. However, eurozone members do not appear ready to sacrifice their fiscal sovereignty to a supranational body such as the European Commission.

Exhibit 4 – Violations of Growth and Stability Pact Have Been Common



Source: IMF as of October 31, 2010

Instead, Europe has taken an alternative approach and set up the European Financial Stabilization Fund (EFSF), which can issue bonds or other debt instruments to raise the funds needed to provide loans to eurozone countries in financial trouble, recapitalize banks, or buy sovereign debt. The EFSF does not directly impose fiscal discipline on eurozone members, but because the loans must be approved by all member governments, they have come with strings attached. For instance, the Irish government had to adopt a four-year €15 billion austerity program in order to obtain its €85 billion joint loan from the EFSF and the International Monetary Fund. The EFSF issued its inaugural €5 billion five-year bond at an implied borrowing cost of 2.89% on January 25, 2011. The deal received a AAA-credit rating from both Standard & Poor's and Moody's and investor appetite for the bond issue was strong with orders about nine times the supply.[7]

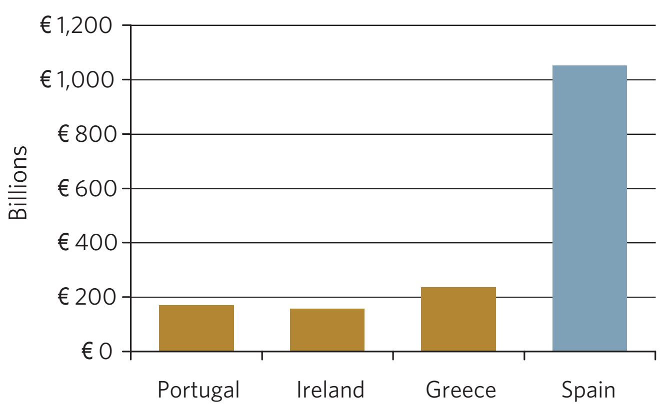
7 European Financial Stability Facility press release, January 25, 2011.

While the ESFS appeared to address many of the flaws in the Maastricht Treaty, the program only offers temporary solace because it is scheduled to close in June 2013. European leaders began to realize they needed a more permanent solution as the crisis spread from Greece to Ireland and began to threaten Portugal and Spain. This prompted the creation of the European Stabilization Mechanism (ESM) in late 2010. The ESM will function in a similar manner to the ESFS, but it will be instituted along with collective action clauses (CACs) for newly issued bonds when the EFSF expires in mid-2013.

German policy makers oppose using ESM funds for government bond purchases or for making loans to governments to buy back their own debt.

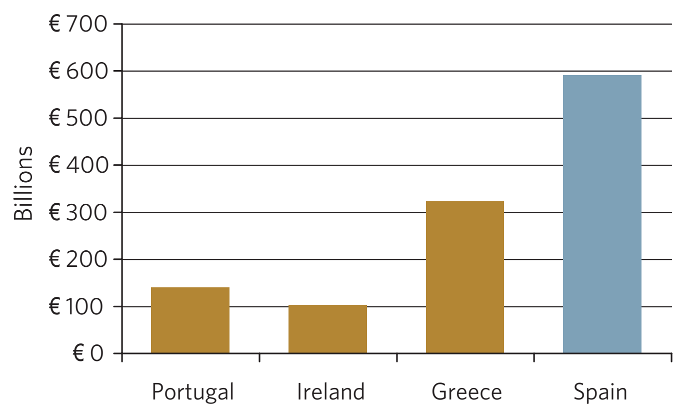
CACs allow a supermajority of bondholders to agree to a debt restructuring that is legally binding on all holders of the bond, including those who vote against the restructuring. Bonds issued through the ESM will be senior to all debt outstanding except IMF loans. This is the so-called "bailing-in" of the private sector. Unfortunately, while the ESM may be part of a long-term solution, eurozone members still disagree on key details of the program. For example, German policy makers oppose using ESM funds for government bond purchases or for making loans to governments to buy back their own debt. Although this sounds reasonable, it may create problems for countries in need of bridge financing to provide liquidity as they seek to restructure their debt (Exhibit 5). Addressing this issue is critical if the ESM is to serve its purpose as a stabilizing force in the euro-zone.

Exhibit 5 – Nominal GDP by Country 2010



Source: National Statistics Offices as of December 31, 2010

Nominal Debt Outstanding 2010



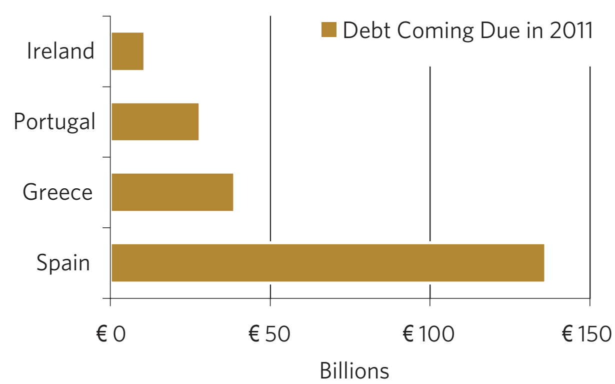
Source: Bloomberg as of December 31, 2010

Moreover, even with the ability to borrow at lower rates through these facilities, it is our view that Greece will likely be forced into some sort of debt restructuring in the future. The International Monetary Fund estimates that its gross debt-to-GDP will stabilize at 144% in 2013.[8] It will be extremely difficult for the economy to grow its way out of this level of indebtedness. The risk of restructuring is lower in Ireland and Portugal, where gross debt-to-GDP levels are "only" expected to reach 100%. But a fragile banking sector in Ireland and large current account deficits in Portugal have led investors to price in a higher probability of default.

8 "Recovery, Risk and Rebalancing," World Economic Outlook, International Monetary Fund, October 2010.

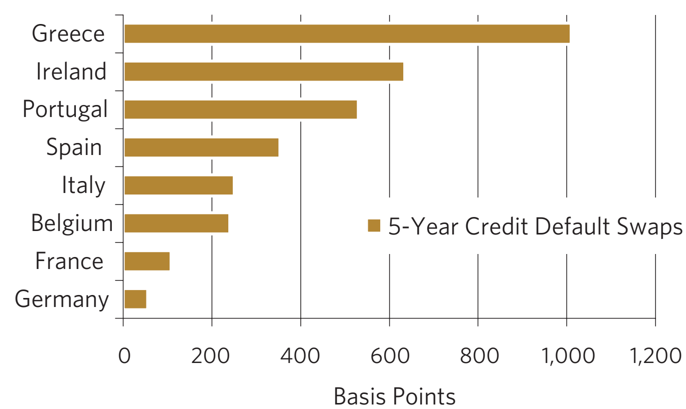
Unlike the others, Spain faces a liquidity issue rather than a solvency issue. Spanish gross debt-to-GDP levels are expected to peak at around 82%, but the country must roll over the 23% of its debt outstanding (€123 billion) in 2011(Exhibit 6). This should be manageable as long as interest rates do not continue to rise. The eurozone could digest a restructuring of Greek debt without too much trouble. Greece only accounts for about 2.3% of regional GDP. However, the same is not true for Spain whose economy is larger than Greece, Ireland and Portugal combined.

Exhibit 6 – Debt Coming Due in 2011



Source: Bloomberg as of December 31, 2010

5-Year Credit Default Swaps



Source: Bloomberg as of December 31, 2010

We believe further bouts of volatility in Europe's debt and foreign exchange markets will remain a risk until the European Commission begins to speak with one voice on policy issues.

Looking ahead, the establishment of the ESFS and the ESM appears to have put the euro on better footing than it was before the crisis. These programs: 1) provide a means for emergency lending to member countries that are in need; 2) impose some degree of fiscal discipline on those that borrow from them; and 3) add a restructuring mechanism for members whose government debts are unsustainable. Ironically, rather than causing the common currency to break up, the crisis may actually draw Europe closer together given the moves toward joint bond issuance and the imposition of a sort of back-door fiscal discipline for those countries that borrow from one of the facilities. Nevertheless, we believe further bouts of volatility in Europe's debt and foreign exchange markets will remain a risk until the European Commission begins to speak with one voice on policy issues. Specifically, European leaders must come to some resolution about using ESM funds for government bond purchases or propose some alternative form of bridge financing for eurozone members who face debt restructuring.

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