The Euro Jens Bastian and Vanessa Rossi

The Euro sculpture in front of the European Central Bank in Frankfurt

'Til Debt Do Us Part

A new year always presents many risks and uncertainties – this is not unusual. However, the challenges that the global economy faces in 2011 include not only the normal threats posed by volatile background conditions, but also the possibility of a major structural break-up that might have far-reaching, possibly devastating, repercussions.

The 'normal' risks that the global economy faces include the challenge posed by global food prices and concerns over the US economy, the dollar and speculative capital. Rising food price inflation is damaging emerging markets' growth prospects: if this escalates, it could pull the rug from under the key driver of global growth. Yet tightening policy to curb increases in food price only works by weakening demand – not only posing a risk to global growth but also failing to address underlying food supply problems.

Improving growth in the United States economy is also important, not just for US jobs and the recovery in the developed economies but to reassure markets about the backing for the dollar and the sustainability of sovereign debt.

Greater certainty about positive global growth prospects would also be the best cure for the waves of speculative capital roving the world – these must be anchored into real investments, enhancing real growth prospects and turning volatile capital into a

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stabilising ballast for the world economy.

In spite of these uncertainties, forecasts for global economic growth generally remain very robust indeed, in the 4-4.5 percent range for 2011, only slightly down from the rebound to almost five percent last year. The outlook for global economy is also relatively insensitive to the 'normal' variations in growth forecasts for Europe. Notably, whether the European Union's gross domestic product (GDP) rises at 0.5 percent or two percent, this seems to have little impact on Asia for example, especially when emerging markets themselves are growing at 6-7 percent per annum. Many therefore conclude that risks within the EU economy have little significance outside the area.

However, in our view, Europe does pose a severe threat, not because of the importance of its GDP growth for the rest of the world under 'normal' conditions and risks but because of the potential for an eruption in the economic and financial system similar to, or perhaps worse than that of September 2008. Certainly the European debt crisis must be treated with the utmost urgency. It is not just an internal EU debate of no relevance to the global economy.

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CRITICAL YEAR

Concerns about the integrity of the Eurozone and its financial sector have never been as widespread or as well founded as they are today. On whatever basis this is examined, the Eurozone debt crisis is still in intensive care. So 2011 will almost certainly be a watershed year for Europe and the euro.

As International Monetary Fund (IMF) chief Dominique Strauss-Kahn has recently highlighted, Europe's debt problems need a full and convincing plan of action, not piecemeal, band-aid solutions for the most debt-burdened countries on a dripfeed basis. This is amply demonstrated by events over the past year: the Greek crisis dragged on through the first half of 2010 until the bailout and birth of the European stabilisation mechanism.

After only a few months of relative calm, rumblings began again over the extent to which the Eurozone would continue to provide assistance and guarantees to member states in financial difficulty beyond the mechanism's current three-year time span. This coincided with news that the Greek economy was falling further into recession (GDP falling 4.2 percent in 2010), implying it may be unable to comply with the fiscal targets agreed agreed with the IMF and the European Central Bank (ECB) . But it was Ireland that brought the simmering Eurozone debt crisis starkly back into focus in November as the bailout of its banks proved too large a fiscal burden for the country to bear unaided.

The Irish problem is therefore quite different to that of Greece and it raises deeper questions. Greece presided over runaway public finances for many years, illustrating the failure of fiscal discipline and enforcement capacity in the Eurozone in spite of the rules and regulations stipulated in the Growth and Stability Pact. Ireland more than met Maastricht rules but has been dramatically sunk by its aspirations to host European-scale banks while the ultimate responsibility remained at the national level. With its banks now struggling to survive or being fully nationalized, this is a responsibility Ireland should — but clearly cannot — bear on its own, given banking-sector liabilities over ten times its GDP.

The key concern going into 2011 rests on the following observation: two countries as economically and fiscally different as Greece and Ireland nevertheless ended up rowing in the same bailout boat. And others could follow. The essential question that follows is how much Eurozone member states are prepared to help?

When the Irish banks were forced to seek assistance for the second time in a year, Ireland had to look for help from the Eurozone and the IMF. The Irish government had already bailed out the banks once in 2010, to the tune of 67.08 billion dollars: no major Irish lender remained independent of the

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state. The facility offered to Ireland was carefully crafted to provide funds at the maximum of what would be credible – the country could not plausibly borrow more. So what happens if the Irish banks need yet more bailouts, for example, because of a rising tide of mortgage defaults by private households and lack of trust within the international banking system, impacting on solvency and liquidity? Efforts to shrink balance sheets are ongoing but may be insufficient: even if they halve, a one trillion euro problem cannot be solved by a country with GDP one-fifth this size. There is no clear answer to this question.

However, European banks are also heavily involved, and the risk from contagion is much greater than for Greece. These banks hold more than 590 billion dollars in Irish assets, with heavy commercial real estate loan exposure, in particular from Germany, Britain and France. In order to protect their sovereign bond holdings in Greece, Deutsche Bank and Commerzbank as well as Société Générale and Crédit Agricole successfully lobbied their governments in Berlin and Paris to establish the Greek bailout fund in May 2010. They did the same again in Ireland (joined by the British banks), albeit mainly because of their commercial loan portfolio. So perhaps the ECB will provide liquidity if needed, continuing its purchase programme of bonds from Greece, Portugal and Ireland and further polarising sovereign debt holdings. Nevertheless, over time, these balance sheet issues at the ECB have to be addressed.

WIDESPREAD BURDEN

The political and financial-sector tremors in Dublin rippled across the continent — resonating not just in Portugal, Spain and Italy but even in France, where attempts to bring public-sector expenditure and debt under control have run into strong headwinds and may have to be postponed until after the 2012 presidential election. In fact, in spite of its modest budget deficits and a big rebound in growth in 2010, Germany's sovereign debt has also climbed steeply to around seventy-five percent of GDP and could go higher if the banks need further bailouts. It will require several years of tight fiscal policy to bring this debt down towards the sixty percent Maastricht safety limit.

These excessive debt levels limit the scope for providing assistance to the troubled Eurozone periphery, creating doubts about the sustainability of bailouts.

The 16-member euro zone must confront the risks posed by escalating sovereign debt and the politics of implementing austerity budgets. This spells trouble: austerity will not be popular even over a short time span, yet to bring the Eurozone's debt back in line with the sixty percent rule will require many years of fiscal stringency. Political capital will be consumed by this long grind and, with little scope for new initiatives, economic energy will also be sapped.

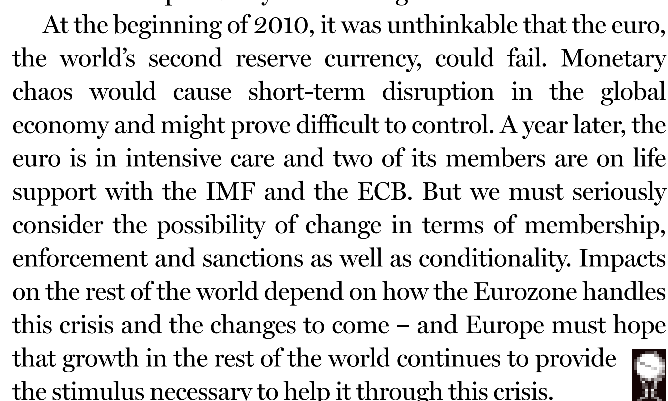
However, if countries ignore the sixty percent limit and continue with high debt levels, this may lead to a permanent European sovereign debt crisis and prolonged recession, which would also enfeeble the economy over the long run. Faced with unpleasant choices, and with no easy solutions, member states may fail to agree on a coordinated strategy, never mind on measures to enforce it. In this respect, 2010 did not represent a bumper year for successful crisis management capacity among Eurozone member states.

UNITED IN EURO

This is truly a fight for survival for the Eurozone, and by extension the EU — and note the repeated mantra of German Chancellor Angela Merkel: that if the euro fails, Europe fails. There will have to be significant structural change, possibly involving the extremes of either the break-up of the euro or a radical move towards greater financial union and accompanying treaty change. At present, the situation can best be described as a short-term fix while the Eurozone debates whether the stabilisation fund will end in extended agreements over debt management, E-bond issuance, a permanent crisis mechanism or what might be called a 'debt divorce'.

Given the scale of the debt built up in the major economies, and voter concerns in the more viable economies over the impossibility of taking on any burden but their own, there may be little option but to move to a debt divorce – effectively returning to the original Maastricht rule of 'no bailouts'. Continuing confidence, bad debt and liquidity problems in the banking sector may also force countries to make tough decisions over whether and under what conditions to back their banks. The restructuring of banks and sovereign debt in the weakest member states would be painful and could call into question their commitment to the euro. Some exits cannot be ruled out and might be facilitated by polarisation in holdings of debt if investors have already fled. We should also not forget that, back in spring of 2010, a political taboo was broken at the height of the Greek crisis when Chancellor Merkel and her Finance Minister Wolfgang Schäuble publicly advocated the possibility of excluding a Eurozone member.

At the beginning of 2010, it was unthinkable that the euro, the world's second reserve currency, could fail. Monetary chaos would cause short-term disruption in the global economy and might prove difficult to control. A year later, the euro is in intensive care and two of its members are on life support with the IMF and the ECB. But we must seriously consider the possibility of change in terms of membership, enforcement and sanctions as well as conditionality. Impacts on the rest of the world depend on how the Eurozone handles this crisis and the changes to come – and Europe must hope that growth in the rest of the world continues to provide the stimulus necessary to help it through this crisis.



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