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From the Desk of...

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The troubles in Europe today represent the greatest threat to the global economy since the 2008-2009 financial debacle: Dr Robert Madsen, highly respected for his penetrating analysis of geopolitics, economics and finance, lays out four core scenarios for the future of the euro zone.

From the inception of the common currency a decade ago, governments and market participants chose to ignore the flaws in the foundation of the euro and the resulting, relentless rise in indebtedness. That is clearly no longer possible. Over the last several months people have made some progress by belatedly acknowledging that the Greek problem is not one of illiquidity but of insolvency and by admitting that the continent's banks are in jeopardy. The truth, however, is that the diagnosis is still incomplete and the prognosis too optimistic. Put simply, none of the policy measures presently under consideration are adequate to save the euro zone in its present form. The purpose of this memorandum is to identify the full range of structural dangers presented by the common currency, offer a rough calculation of their financial magnitude, ask whether the European leaders can meet that burden, and outline the consequences should they fail.

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Original Sin

There are four prerequisites for what economists term an "optimal currency area," meaning a group of territories that can safely share a single currency. First, the business cycles of the member countries must be synchronous—they must all expand and contract at the same time—so that a single monetary policy meets everyone's needs reasonably well. Otherwise the central bank will set interest rates at a level that exacerbates at least some regions' particular economic problems. Second, there must be a high degree of labour mobility so that when a natural disaster or other shock strikes one area, workers can relocate to places with more plentiful job opportunities. The third prerequisite is a fiscal transfer union, meaning a centralized system of taxation and spending that automatically channels wealth from prosperous countries to those that fall into temporary localized recessions. But the most important characteristic is a commitment, shared by all the members of the common currency, to their joint endeavor. Such a consensus is the only way to guarantee that everyone will make the short-term sacrifices required to keep the system afloat. If that political agreement is lacking, rich economies will refuse to accept migration from, or to proffer financial assistance to, their less fortunate neighbours. Those poor econo-

mies must then choose between the pain of extended slowdowns and abandoning the common currency so they can devalue their own exchange rates to stimulate recovery.

Comparing the modern euro zone to the Germany of the 1990s shows how weak today's Europe really is. When East and West Germany merged after the fall of the Berlin Wall, they established an internal exchange rate that overvalued the former communist state's savings and labour, rendering that territory uncompetitive and condemning it to commercial stagnation or even contraction. This might have destroyed the currency union—and indeed the new nation--but the German people and their elected representatives were determined to avoid that fate. So the West accepted the migration of large numbers of unemployed Ossies and provided approximately 5% of GDP in fiscal subsidies every year for well over a decade in order to ameliorate the human cost imposed on the East by the misaligned exchange rate. Without that generosity, national unification may well have failed. Measured by the German standard, however, today's euro zone is a fragile construct. Most fundamentally, the members of the common currency do not have a single business cycle. A cluster of "core" countries shares the dominant German dynamics, but the "peripheral" economies exhibit very different characteristics. Because the European Central Bank sets interest rates according to Berlin's preferences, this divergence in economic structure means monetary policy is normally too tight, and the exchange rate too strong, for the weaker countries. This flaw might have been manageable if the euro zone enjoyed the other prerequisites for an optimal currency area—significant labour mobility and a transfer union—but it does not. Unwilling to surrender fiscal sovereignty to a supranational government, the European states never bound themselves together as tightly as West and East Germany had done. Thus there is no system in place to prevent peripheral countries from stumbling into recessions and depressions that sap popular support and lead to their departures from the euro zone.

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Eat, Drink and Be Merry

Given that the euro zone predisposed Greece, Ireland, Portugal, Spain and Italy and to a lesser degree even France to frequent and protracted recessions, the question is not why the currency union has recently come under strain but rather how it managed to thrive as long as it did. The answer is "convergence." When the founders of the euro zone refused to cede fiscal authority to a central government, they came up with a new theory for why a transfer union was in fact not essential. According to their reasoning, over time the peripheral economies would evolve into extensions of Germany that went through the same business cycle and therefore never needed subsidies. That, of course, did not happen. The only convergence that really occurred was a fall in peripheral borrowing rates as banks decided to treat all members of the euro zone as if they were all as creditworthy as Berlin. This was ultimately very important, for it enabled the weaker countries to expand their borrowing to finance greater government spending, real estate investment, and consumption. In short, they compensated for the excessively tight monetary policy and the lack of a European fiscal union by turning the continent's banks into de facto subsidy mechanisms. The result was

a decade of prosperity based in part on the accumulation of debts that have now assumed unsustainable proportions and that threaten the European and global financial systems. Markets' belated recognition of that unpleasant fact explains the turmoil of the last 18 months if not the failure of the EC, the ECB, the European governments and the IMF to address the danger adequately.

Counting the Cost

The European political class has still not admitted the scale of the challenges facing the common currency. The debate has progressed from a discussion of liquidity shortages to solvency but stops short of discussing the full geographic scope of the dysfunction and the need, even after the debt problem is resolved, to establish the regularized system of fiscal transfers whose absence necessitated the binge borrowing in the first place. While it is difficult to say exactly how expensive resolution of these two flaws would be, one may hazard an informed guess. The initial step in this process is lowering the weaker countries' public and private debts to sustainable levels, which would cost substantially more than a year's German GDP. But that would still leave the euro zone needing a mechanism to channel money from the rich countries to those peripheral economies that cannot survive in a currency union dominated by Berlin without permanent fiscal support. There are various ways of calculating the present value of those payments, but it could easily prove more than twice as great, bringing the total cost of preserving the euro zone to over three year's German economic output. Even if one discounts this surmise to compensate for the imprecision in its calculation, the figures remain daunting—several times larger, for instance, than the price of unifying a Germany whose people were absolutely determined to overcome the territorial division wrought by World War Two. The critical issue is consequently whether any of the major powers would be willing to bear such an onerous burden for countries about which they feel ambivalent. If the answer is negative, the euro zone cannot survive in its present form.

Judgment

At a high level of abstraction there are four ways in which the present difficulties could resolve.

I: Pre-emptive Eurozone Dissolution.

In this scenario the major economies expel Greece and perhaps Ireland and Portugal from the currency union in the hope that the expulsions forestall contagion to other vulnerable countries. But the probability of this solution's adoption must be reckoned low, for no political leader—particularly in France or Germany—wants to be remembered as the person who destroyed the currency union that is the fruit of six decades of European diplomacy.

II: Europe's Present Strategy.

The European leaders assert that a combination of austerity in the overly indebted countries and marginal debt forgiveness will suffice to save the unified exchange rate. This seems unrealistic on both counts. First, the weak economies are already in deep recession and fiscal retrenchment may in some instances be making the budget deficits worse. Second, marginal debt forgiveness would do nothing to address the prospective need for a fiscal union and hence would still leave the peripheral countries in prolonged, and politically unacceptable, recessions.

III: Comprehensive Restructuring.

The idea here would be to forgive the excess debt, either through direct transfers or through monetization by the European

Central Bank, and then construct a true transfer mechanism to enable the periphery to grow within the euro zone without relying on increases in borrowing. But the financial cost of this strategy to rich countries is prohibitively high, and in any case few nations would be willing to surrender their fiscal autonomy--and political sovereignty--to a predominant continental authority. As was true a decade ago, national pride precludes the requisite centralization.

IV: Delayed Eurozone Dissolution.

This scenario assumes that Europe is unwilling either to pay the price of sustaining the common currency or to admit that the project has failed. Rather than deconstructing the system in a timely and controlled fashion, therefore, the euro zone continues along its present path: reacting to each crisis with a new, slightly larger bailout scheme. Over time, however, markets grow frustrated with this endless series of ad hoc solutions and the risks of a systemic crisis rise. Eventually the political leadership fails to respond to a challenge quickly and forcefully enough, and market forces tear the currency union apart.

Unfortunately, given the scale of the economic threat relative to the resources and resolve of the European governments, the "delayed dissolution" scenario appears most likely of the economic threat relative to the resources and resolve of the European governments. This is probably the worst of the four outcomes because the persistence of depression in the periphery and popular exasperation in the core does further damage to political and social institutions on both the national and continental levels. The governments left to deal with the aftermath of the partial or complete collapse of the euro zone will thus be weaker than today and the probability of suboptimal policy responses somewhat higher.

Purgatory

In the short term the delayed dissolution scenario will have moderately negative implications for the global economy. While Europe moves from one rescue package to another, the international tides of capital will ebb and flow; but on the margin funds will continue to seek safe havens and the dollar and the yen will likely evince further strength relative to the euro. With European demand constrained, growth in net exports from Japan, China, the US and other comparatively healthy economies should remain muted, GDP growth restrained, and the need for additional fiscal and monetary stimulus increasingly obvious. This will be a period of only tenuous recovery.

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The medium term—meaning the months or years immediately after the euro zone contracts—will then bring more profound risks. Big sovereign defaults will render several banking systems in Europe insolvent, destroy significant volumes of accumulated wealth in both the periphery and the Germano-centric core, and impair European and global macroeconomic activity. Although impossible to state with confidence, such a development could conceivably prove as harmful to the world as what happened in 2008-2009.

Once that crisis has passed, though, the long-term outlook will in some ways have improved. A new and smaller euro zone—effectively a greater deutschmark zone—will prove much stronger and better governed, and its currency will trade at

a substantially higher level, eliciting more exports from Japan, the United States, and the poorer European countries. The new currency will also be a promising reserve asset, an alternative to the dollar as the destination for the surpluses of high-saving economies. In this sense the euro zone's contraction will help reduce the global financial imbalances that have played such a significant role in the asset bubbles of the last two decades. At least one source of volatility will have diminished. But, sadly, one has to strain mightily to perceive that silver lining on the clouds that are breaking over today's Europe.

About Robert Madsen and The Insight Bureau

Dr Madsen is a Senior Fellow at the Center for International Studies, Massachusetts Institute of Technology (MIT) and is a highly respected commentator on world geopolitics, economics and finance. He is sought after for his clear, logical analysis of many complex issues, for his willingness to challenge consensus and to ask the difficult questions and indeed for answering many of them and taking a position. His insights assist strategic thinking in boardrooms across the USA and Europe and in senior management meetings. With his deep understanding of East Asia, he is regularly invited to participate in conferences and business forums around the world. **www.insightbureau.com/RobertMadsen.html**

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