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Knowledge Leadership

Healing Europe: Recasting the Future for Growth

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> *"Adherence to fiscal discipline is a necessary condition for growth, it is not, however, a sufficient condition."*
>
> *— Mario Monti, Prime Minster of Italy, speech to audience at the London Stock Exchange, January 18, 2012*

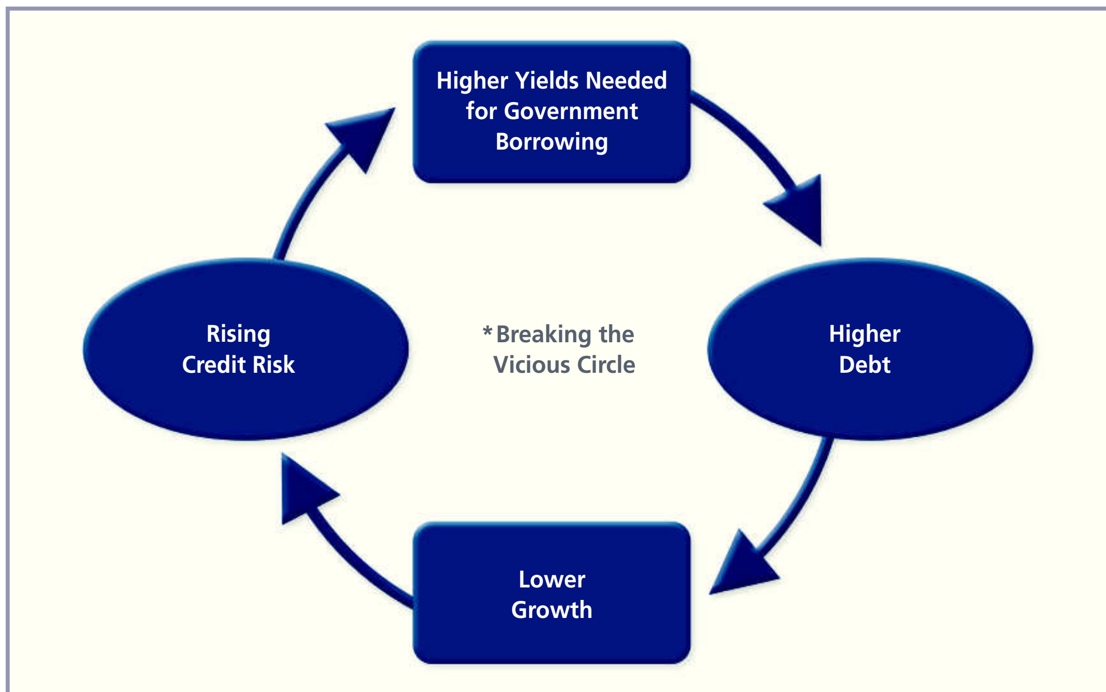
Breaking Euro Zone's Vicious Circle

In the last two years the Euro Zone has been caught in a vicious circle of four interlocking links as illustrated in Chart 1. It begins with high sovereign debts pushing up yields on government bonds in the crisis countries, and with the bond market evaluating risks of Euro Zone economies on a standalone basis instead of seeing them as part of a coherent whole. In the second, higher yields have led to higher debt levels for all the crisis countries, which then necessitated more government spending cuts and credit tightening. The third link is that the economies in crisis countries contract with all the dire consequences. In the fourth and final link, debt levels continue to rise as a result of austerity-induced economic contraction, in absolute terms as well as relative to GDP, which push up bond yields further.

Up until recently, the remedy applied by the troika (European Central Bank, IMF, and the European Commission) had focused on breaking the circle in its second link: reducing bond yields. This requires the imposition of austerity programs on the crisis countries to cut government spending in order to reduce deficits, sometimes very drastically as in the case of Greece and Ireland. The assumption is that in so doing, market panic will recede, and government borrowing costs will accordingly decline. Supposedly this approach also has the added benefit of reigning in the undisciplined governments of the crisis countries whose profligate ways had landed them in crisis in the first place, and return the Euro Zone to a rule-abiding region. Two years on, this orthodoxy of austerity has clearly failed. Market panic has not gone away and instead the crisis has now deepened to the point where the very survival of the Euro Zone itself is in question.

The assumption that market panic will recede as a result of so-called austerity programs has clearly failed. The crisis has now deepened to the point where the very survival of the Euro Zone itself is in question.

Chart 1. Recasting Europe's Future to Focus on Growth



There is an alternative to the futility of austerity programs being imposed. A combination of more pragmatic and pro-growth policies can be more effective in calming the market— by allowing crisis-hit economies to gradually improve their rates of growth over time. Historically this nurturing approach is the only proven way for highly-indebted countries to deleverage successfully.

But there is an alternative. Another way of getting out of this vicious circle is by breaking its third link: lower economic growth. As argued in this report, a combination of more pragmatic and pro-growth policies can be more effective in calming the market, allowing the crisis countries to gradually raise their growth rates over time, which is the only proven way historically for highly indebted countries to deleverage successfully. Pragmatism means, however, that the European Central Bank (ECB) will have to act proactively as a lender of the last resort; and the troika will have to selectively tone down austerity, even allowing some increase in government spending in areas that improve the economy's efficiency and competitiveness, and to let the euro exchange rate fall much further. This amounts to recasting the future of the Euro Zone with a focus on growth instead of attempting to preserve the status quo of the monetary union. So these are stark choices: sticking to the dogma of austerity will not keep the Euro Zone intact while risking disorderly fragmentation and prolonged stagnation; focusing on growth with pragmatic and growth-oriented policies will save the Euro Zone from a deep depression which would also improve the chance of the euro's survival.

The Futility of Austerity

Thus far, imposing austerity programs on the crisis countries in the Euro Zone has the net effect of pushing their economies into recession with soaring unemployment and business failures. Governments in the crisis countries today are rendered utterly impotent in terms of macroeconomic management— they cannot deploy the usual policy tools to cope with declining demand: interest rate cuts, exchange rate depreciation, and fiscal spending. Prior to the crisis, by virtue of the single currency, two of these three policy tools had already been neutered. Interest rate determination has been transferred to the ECB, which takes account of the economic conditions of the monetary union as whole and not its individual member countries. The single currency also means that member countries cannot choose to depreciate their currencies against their trading partners, be they inside or outside of the Euro Zone. Now austerity means shutting down the third and last policy tool, fiscal spending, including all the counter-cyclical automatic stabilizers such as a rise in social welfare support and unemployment benefits. Not surprisingly, for Europe's crisis countries austerity has resulted in plunging economic output and rapidly rising unemployment, along with a collapse of tax revenue. A contracting economy with dwindling tax revenue automatically makes government's debt burden worse even if the size of overall debt remains unchanged. Thus, the logic of returning government's fiscal position to sustainability through austerity is peculiar, to say the least, if not outright perverse.

Take for example the case of the Greek economy. The reality today is that government finance in Greece is simply not sustainable without continual injections of subsidized capital. The Greek fiscal system as it currently stands will crash merely from the weight of its sovereign debt; with serious potential risk for the banking sector across the Euro Zone. In the past two years, the Greek government has consistently failed to meet targets of budget deficit reduction set by the troika. This is in spite of the fact that the Greek economy is now in its fifth year of contraction, directly as a result of fiscal spending cuts. The Greek economy has fallen by 6% in 2011, much higher than expected. If the forecast of another 2.5% GDP contraction is realized in 2012 (considered by many to be conservative), then the Greek economy would have shrunk by a disastrous 16% in the 2008 to 2012 period. Unemployment rate has reached the 20% mark. The Greek government has accepted the austerity program mandated by the troika as a condition for providing the cash bailouts, and has actually implemented some of the austerity measures. However the situation is that while the Greek government has not done enough to shrink the deficit to meet the troika's targets, it has done more than enough to shrink its GDP.

The fact of the matter is that on average, a one percentage point contraction in the Euro Zone economy today will lead to a decline of 0.75% in consumption, which in turn reduces

overall growth further by about 0.62% within two years, as described in Chart 2. This is an unsustainable downward spiral. Austerity imposed in the crisis countries in the Euro Zone today is increasing the risk of a dangerous, debt-deflation spiral first described by Irving Fisher in the 1930s. And we all know, the debt-deflation spiral in the 1930s did not end well.

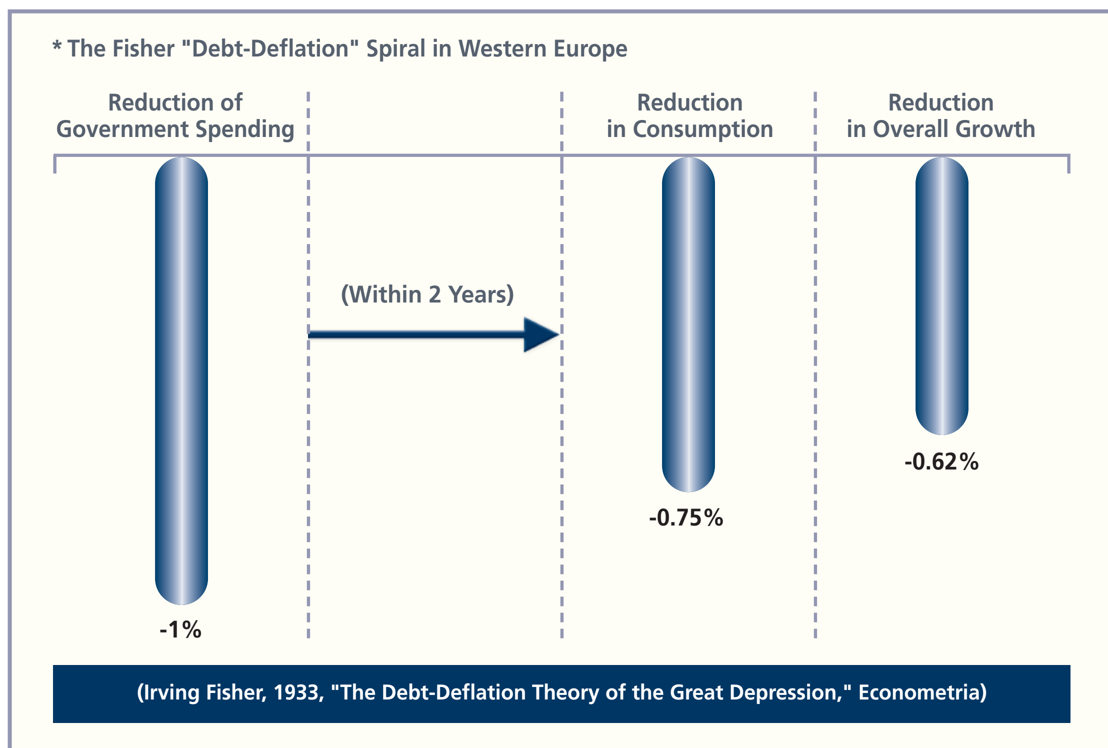
Rising Risks of a Banking Sector Crisis

Deteriorating conditions in the real economy in turn heightens the contagion risk via the banking sector. Banks in the Euro Zone have very high exposure to sovereign debts not only in the crisis countries, but also in Eastern Europe where economic growth is faltering. As a whole, the loan to deposit ratio of Euro Zone banks is estimated at around 145%, which means they cannot lend a single euro more without raising new capital.[1] When banks are reluctant to lend, the resultant shortage of liquidity affects businesses, even if they are well run and profitable. For example, the Greek central bank's figures show that bank credit to households and private firms fell by about 2.5% in 2011. But these official lending figures do not reflect the drying up of other sorts of credit. There is an informal system in Greece of firms using post-dated checks for paying supplies, which the suppliers in turn use as collateral to take out short term loans from banks to fund their operations. This system is no longer working because banks are reluctant to accept the post-dated checks as collateral, thereby choking off an important source of business financing. Making matters worse, few foreign firms will supply Greek customers on the basis of a credit guarantee from a Greek bank. So Greek importers, however solid, now have to come up with cash to pay upfront. For many weaker businesses, these adverse developments could be the last straw that pushes them into insolvency.

As the performance of the business sector worsens, which is more likely in contracting economies, the quality of the asset side of banks' balance sheet deteriorates. Under these condi-

Austerity imposed in crisis-hit countries in the Euro Zone today increases the risk of a dangerous debt-deflation spiral that was first described by Irving Fisher in the 1930s. As we all know well, the debt-deflation spiral in the 1930s did not end well.

Chart 2. Austerity Does Not Work, Growth is the Answer



tions, banks' imperative is to husband their liquidity, leading to drying up of credit overall, making conditions in the business sector even more dire, and creating a downward spiral. There is therefore a serious risk to the banking sector in Europe from rising loan defaults and delinquencies in the corporate sector, quite independently from all the problems associated with sovereign debts. This is a sector-wide risk that is not limited to the crisis countries. As Chart 3 shows, private sector corporate debts are very high across the board in Europe, both inside and outside of the Euro Zone. In the crisis countries of Spain and Portugal, they are estimated to be 193% and 153% of GDP respectively in 2011. In non-crisis countries like France and Sweden, they are equally high at 155% and 196% of GDP respectively. So there is a rising risk that further deterioration of conditions in the business sector could trigger a banking sector crisis across Europe and beyond.

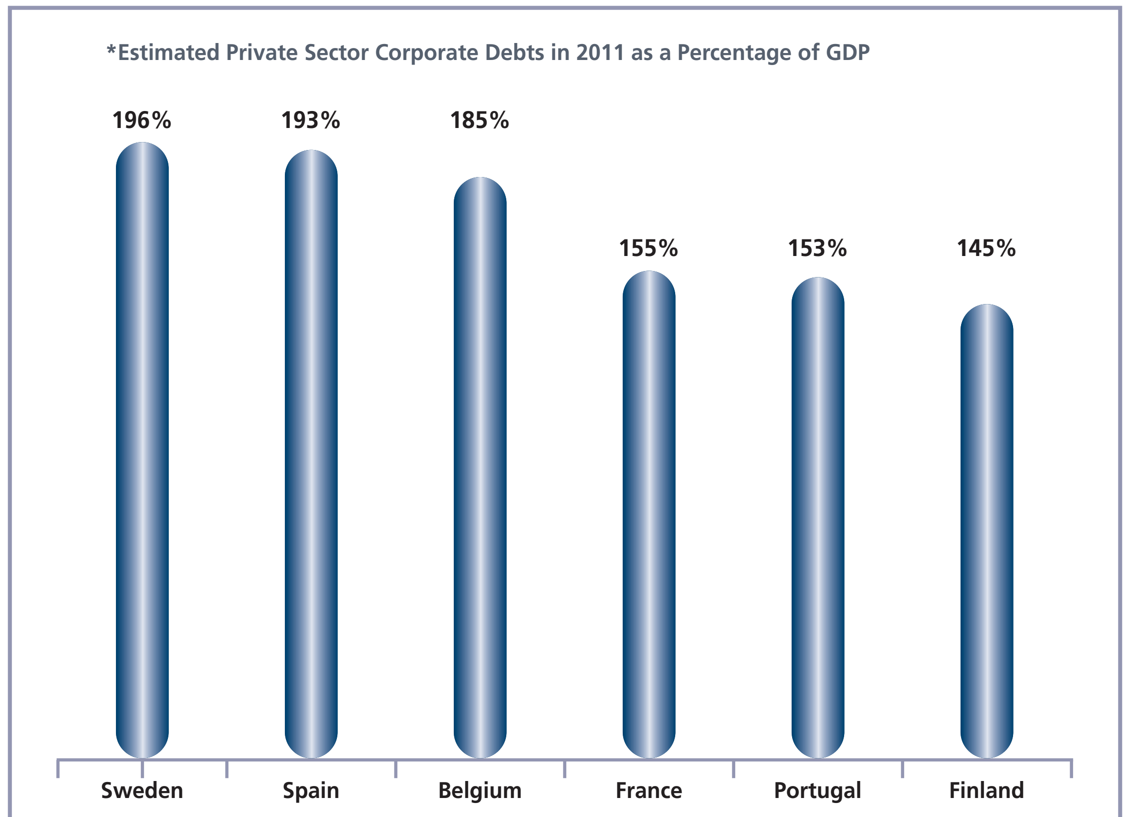
In December 2011, the average unemployment rate in the Euro Zone was 10.4%.
However, in crisis countries average unemployment rates have reached as high as 22.9%. These rates are fueling backlashes against austerity.

Rising Risks of Political Backlash against Austerity

Political backlash from austerity is becoming more evident, fueled by rising unemployment. In December 2011, the average unemployment rate in the Euro Zone reached 10.4%, which translates into some 23.8 million people without a job. But this average, as high as it is, hides more dangerous developments. Today, unemployment rates in the crisis countries are so high that they are causing political and social backlash against austerity in the crisis countries. Unemployment rates in Spain and Greece are 22.9% and 19.4% respectively, in sharp contrast with 4.1% in Austria and 4.9% in Netherlands. Unemployment actually felled in last December in Germany to 6.7%, the lowest level since reunification in 1991.[2]

Even more worrying than overall unemployment is youth unemployment, defined as those in the age group of 15 to 24, looking for work but

Chart 3. Austerity induced Recession Will Put More Stress on the Banking Sector



Source: Eurostat

unemployed. As shown in table 1, youth unemployment has reached a frightening 48.7% in Spain and 47.2% in Greece. In other words, in these countries, practically one in two youths is unemployed. In Portugal and Italy, it is roughly one in three youths is unemployed. For the Euro Zone as a whole, about one in five youths is unemployed. High youth unemployment tends to have more volatile social and political consequences; and in the crisis countries today the impact of austerity on rising youth unemployment is like pouring gasoline on fire.

Thus, there is a rising risk of a disorderly breakup of the Euro Zone due to increasingly volatile local politics. Voters in the crisis countries at some point will want to escape the seemingly endless cycle of spending cuts, tax hikes, high unemployment, and rolling back of social benefits; all imposed from the outside. Voters in northern Europe, on the other hand, could also become increasingly incensed by the spectacle of their tax money being used to rescue the crisis countries from what appears to be their self-inflicted problems of fiscal profligacy, unproductive workers, and an uncompetitive economy.

Germany's position on fiscal discipline as one of the necessary conditions to bring the Euro Zone back to a functioning monetary union is not wrong. It is right in principle, but disastrously wrong in timing. There is no question that over the long term, the Euro Zone a whole has to become more efficient and competitive, not just Germany. However, for austerity to work, growth has to come first.

Even more worrying is youth unemployment—those looking for work in the age group of 15 to 24 but unemployed.

With a frightening 48.7% level of unemployed young people in Spain and 47.2% in Greece, implementation of austerity programs may result in volatile social and political consequences.

Table 1. Average Unemployment Rate and Youth Unemployment, December 2011

	Average Unemployment Rate	Youth Unemployment Rate
Euro Zone	10.4%	21.3%
Greece	21.0%	47.2%
Portugal	13.6%	30.8%
Spain	22.9%	48.7%
Ireland	14.5%	29.0%
Italy	8.9%	31.0%
France	9.9%	23.8%
Germany	5.5%	7.8%
Austria	4.1%	8.2%
Netherlands	4.9%	8.6%

Source: Eurostat

Lessons from History

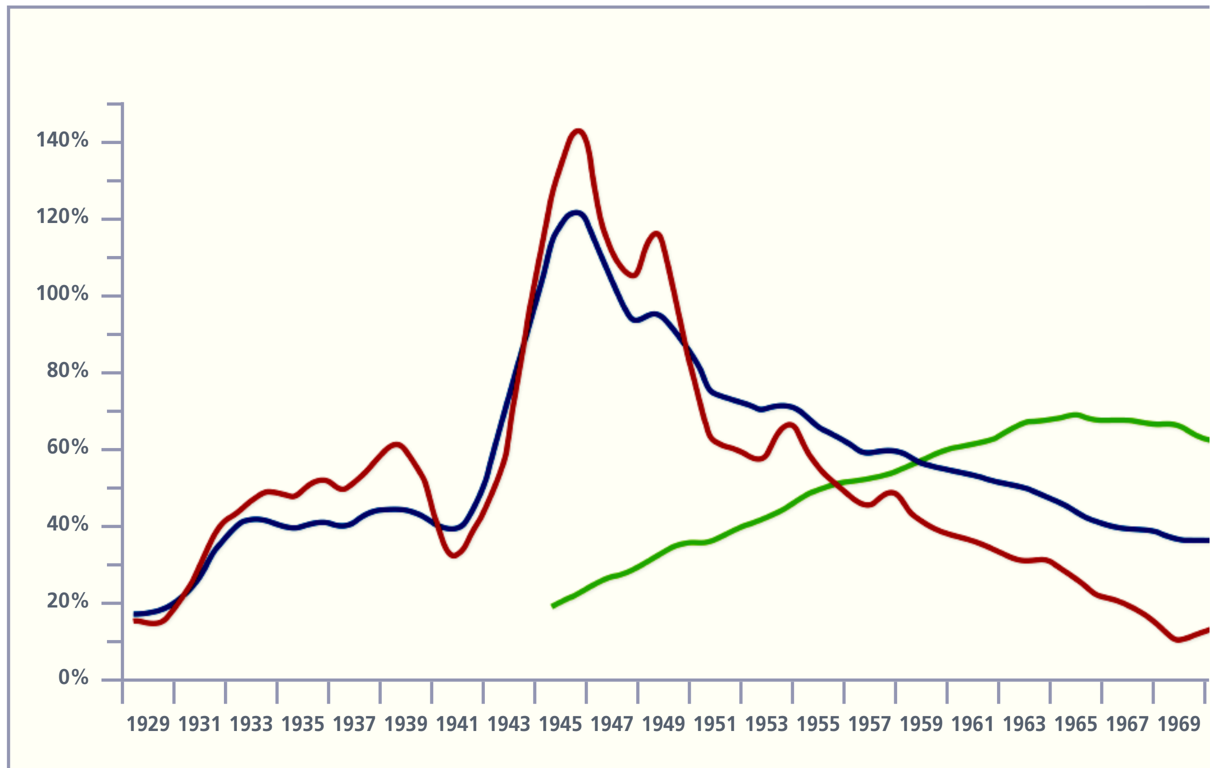
By the time the Second World War was won by the allies in 1945, public sector debt as a percentage of GDP and as a percentage of tax revenue in the US was at a record high, more so than any of the crisis countries in the Euro Zone today. However, as illustrated in Chart 4, US public sector debt, represented by the blue curve, dropped quickly in the 1950s. But it is the steeper decline of the red curve, representing the debt to tax revenue ratio; that is significant. As long as the red curve declines faster than the blue curve, it means that tax revenue, on the back of strong economic growth, is rising faster than debt, thus bringing down the debt to tax revenue ratio; and thereby the risk associated with debt. Accordingly, costs of debt would also fall.

A review of the data shows that the US government actively paid off its debts only between the years of 1946 and 1948. From then on, the decline of debt as a percentage of GDP was achieved almost exclusively by GDP growth, with some help from rising inflation in the late 1950s. Because of strong economic growth, the US government was able to refinance the maturing War Bonds with cheaper Treasuries, and allow the debts to slowly shrink over time as a percentage of GDP. The US in the 1950s was clearly not in the same situation as the Euro Zone crisis countries are today. The major demographic trend in the US in the 1950s, for example, was that of the baby boom; millions of demobilized war veterans returning to civilian lives to get married and have children. Whereas population growth in Europe is low, if at all, and population aging is the major demographic trend. Nevertheless, the lessons learned from the way the US government debt declined in the 1950s are still valid: economic growth is the best way to get out of debt.

There are recent examples in Europe that illustrate very much the same principle at work of growth solving a debt crisis. In the early 1990s,

In the US after World War II, public sector debt as a percentage of GDP and as a percentage of tax revenue was at a record high. The US government actively paid off its debts only between the years of 1946 and 1948. From then on, the decline of debt as a percentage of GDP was achieved almost exclusively by GDP growth.

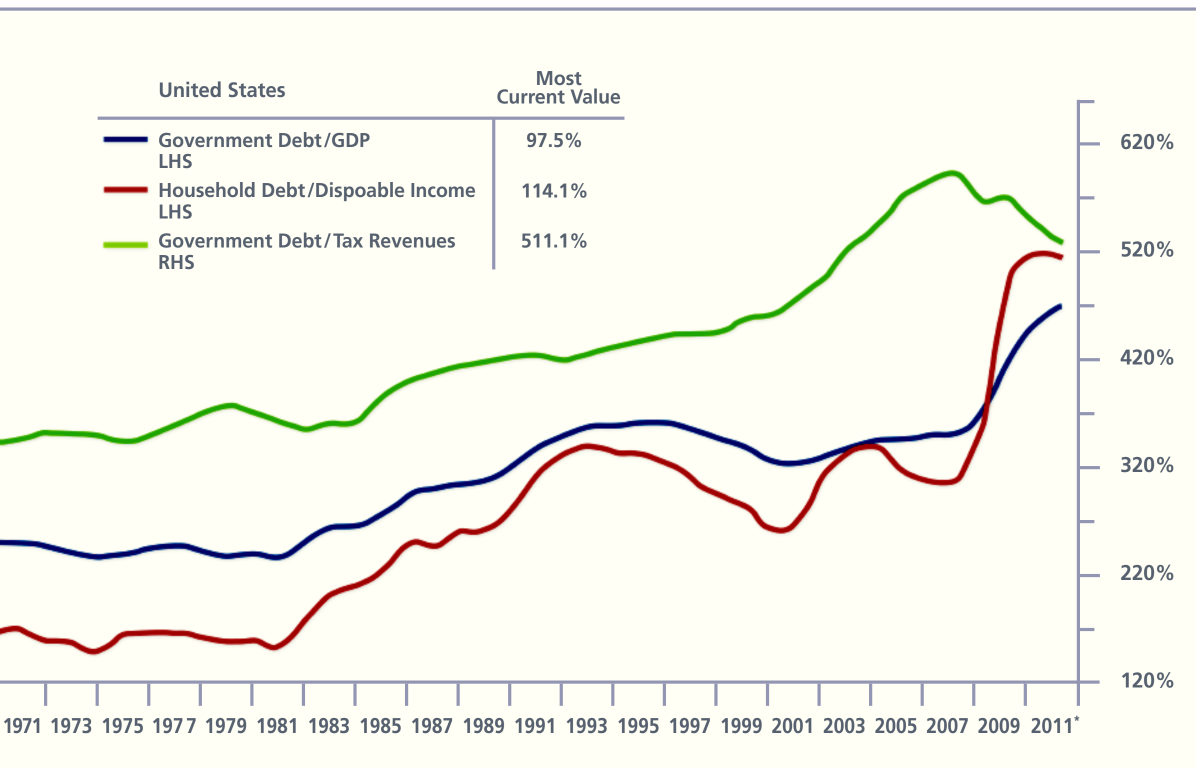
Chart 4. Lessons from History: Strong Growth The Best Solution to a Debt



the banking sectors were in crisis in Sweden and Finland as a result of collapse of asset bubbles, which plunged their economies into recession. A McKinsey study examines the process through which these two countries recovered from their respective debt crisis and eventually returned to robust economic growth.[3] Two distinct stages were involved as they worked their way out of debts. In the first stage, both private and household sectors deleveraged aggressively, while the public sector debts soared. The economy went into recession, but the government substantively increased fiscal spending, funded with equally massive borrowing, which arrested a potentially self-reinforcing downward spiral. In the second stage when growth began to recover, the government then started cutting spending to reduce its debts. In both Sweden and Finland, booming exports were also very helpful in assisting the recovery (not an option for the crisis countries in the Euro Zone today, unfortunately).

There is a significant difference between the experiences of these two countries that is instructive. Sweden did not begin its budget cutting until the economy had returned to solid growth. Finland, however, attempted budget cutting earlier before the economy was out of the woods, which then worsened the recession. The government in Finland quickly reversed course, but it delayed the recovery. Once growth returned, both governments also seized the opportunity to conduct sweeping structural reforms. The economy was overhauled in the wake of the debt crisis, with banks restructured, major sectors such as retailing deregulated. The reforms improved efficiency, raised productivity, which led to an investment boom. The fast-growing economy then in turn made the government's task of debt reduction easier.

In the early 1990s, Sweden and Finland illustrated that economic growth is the best way to get out of a debt in their handling of a crisis brought on by the collapse of asset bubbles.



* 2011 Data is from Third Quarter
Source: US Treasury, BEA, FED

The ECB especially has shown leadership with its recent introduction of Long Term Refinancing Operations, or "LTRO."

Thus, the message that growth is the best way out of the debt crisis is beginning to command more attention among policymakers.

A New Focus on Growth

The good news is that the message that growth is the best way out of the debt crisis has started to command more attention among policy makers. The ECB especially has shown leadership in this regard since Mario Draghi assumed the top post at the ECB in late 2011. Draghi and the executive board at the ECB put together an unprecedented offer last December to banks of cheap loans with a three-year term, in any quantities they liked (known as Long Term Refinancing Operations, or "LTRO"). It made a dramatic impact. Five hundred and twenty three banks promptly borrowed a total of €489 billion, roughly equivalent to 5% of the Euro Zone GDP. ECB thereby provided a tsunami of liquidity which will enable banks to cover virtually all the refinancing needs of maturing sovereign bonds in the first quarter this year. This action by the ECB also led to a fall in the borrowing costs for some of the crisis countries, and is widely seen as having averted a major credit crunch in the Euro Zone.

This ECB action under Draghi is precisely the kind of pragmatic policy that can make a difference in the Euro Zone. The bond buying program under his predecessor Trichet had not been effective; and was seen by the Bundesbank as edging perilously close to violating the EU ban on central banks directly financing governments. In contrast, ECB's LTRO last December is effectively a form of quantitative easing that avoids being labeled as such. There is no sign that the Bundesbank objected to the loan offer to the banks since Draghi is on solid ground; it is a central bank's core mission to provide liquidity to solvent lenders. A second round of similar loan offer is now being prepared, and banks could borrow as much as twice the amount of the first offer.

ECB's LTRO is having the desired effect in reducing the banking sector risk in the Euro Zone. Some critics see that many banks borrow funds from the ECB only to redeposit the funds back with the ECB instead of lending them out. To these critics, this indicates that the ECB action is ineffective. But this is to miss the point entirely. Rising bank deposits at the ECB is actually thawing the interbank markets, which is critical for bank reserves to be used efficiently. At the level of individual banks, they must plan their cash holdings to cover their daily needs on an ongoing basis. When a bank's cash need is expected to be higher than what its existing reserve could cover, the bank borrows from its peers. Interbank borrowing and lending is therefore a form of risk pooling, since variance in cash demand for the banking system as a whole is less than the variance of cash demand for each individual bank.

When the interbank markets in the Euro Zone froze last year, Euro Zone banks were basically neutered in their role as financial intermediaries. They were forced to hold cash balances assuming the worst case scenario, and hoard reserve money and stop lending to other banks. When interbank lending ceases due to rising risk aversion (as was the case late last year in the Euro Zone), then demand for cash from the central bank surges as it is the only and last resort. If the central bank fails to meet the demand, banks will have no choice but to shrink their illiquid assets to cope with their need for cash, especially when the outlook is uncertainty. What the ECB did last December is therefore a powerful and pragmatic policy move that restored to a significant degree, the efficient functions of the banks. Even if many banks re-deposit their borrowed funds back with the ECB, such growing deposits are not evidence that the monetary easing is ineffective. On the contrary, they indicate that the system is working again. Simply put, a bank that is sitting on a large amount of cash has lower liquidity risk and its peers are less reluctant to lend to it, and it also can borrow at a lower interbank offer rate. Thus, Euro Zone banks' deposits at the ECB today are not just sitting there, but actually working to reduce risks in the entire European money market. As cash balances continue to accumulate, the interbank system will begin to operate more efficiently in the Euro Zone. To be realistic, cash balances in the Euro Zone banks are unlikely to fall given the ongoing crisis, but banks will be able to lend again at some point. This will go a long

way to re-supply the real economy with much needed liquidity, while simultaneously reducing the risk of asset deflation.

Alongside LTRO, Draghi is also working on revising the collateral rules that define eligible assets that national central banks can accept as collateral to lend to Euro Zone banks. Currently the ECB already accepts "asset-backed securities" as eligible collateral, which are bonds back by loans. Draghi would like to see national central banks be given more leeway in deciding what additional assets they would accept as collateral for new loans, but the national central banks will have to bear the risks themselves. In other words, if a bank that has borrowed from a national central bank and runs into trouble and defaults, the losses will have to be borne by the lender alone; whereas the arrangement today is that such losses are shared by all Euro Zone countries. Should Draghi succeed, liquidity conditions across the Euro Zone could be boosted further. For instance, the national banks of Italy, Ireland, France, Spain, and Austria could accept more collateral as a result of some easing on the eligibility criteria, and new eligible assets could add up to as much as €700 billion by some estimates.

Pragmatism is evident not only in the ECB, but in the IMF as well. One of the three parties in the troika, it was an advocate of austerity until recently. But the IMF is now promoting a more pragmatic approach, and has repeatedly stressed in its public statements that reviving economic growth is critical to resolving the crisis. The IMF has also been pushing the German government to commit more to create a bigger European rescue fund, without which fundamentally solvent countries like Italy and Spain could yet face new bouts of financial instability. So it appears that the troika is no longer speaking with one voice, and pragmatism is getting a more favorable hearing.

These new pragmatic measures will not solve the crisis by themselves. But they are critical in breaking the vicious circle described above and, more importantly, setting the stage for reviving economic growth. As long as the crisis countries are in the grip of a downward spiral of higher borrowing costs and higher debts, reviving economic growth is simply out of the question, which is why austerity has failed so disastrously. However, when borrowing costs are being brought down by proactive central bank actions and when market panic stops, then the crisis countries can turn their focus on growth. And a key prerequisite for returning to growth is structural reform.

The Crisis as an Opportunity for Structural Reforms

As the popular saying goes "never let a crisis go to waste", the current crisis may prove to be the best opportunity to implement tough structural reforms, especially in the crisis countries. There are signs that some governments in the crisis countries are beginning to seize the opportunity to do just that. The government in Spain last year accepted and implemented austerity programs as demanded by the troika. But it is now planning to liberalize its rigid labor markets with an eye to stimulating employment growth. The Italian prime minister, upon entering office last year, first raised taxes and cut spending in accordance with the dogma of austerity, but is now focusing more on reviving economic growth. The fact is that the potential of new economic dynamism that can be released by structural reforms in the crisis countries and, for that matter, in many other Euro Zone countries, is huge.

To ensure that structural reforms can deliver more growth in the short to medium term, more fiscal spending would be needed in selected areas. What happened in Greece is instructive in this regard. In accepting the austerity program demanded by the troika for the first bailout, there is no evidence that the Greek government had attempted to cut spending carefully and selectively. Many infrastructure investment projects that are essential to improving productivity, such as road building, were cut. So it was not just the fat, but also muscle and bones of the economy that were being cut. On the other hand, productivity boosting reforms like liberalizing the trucking industry was not even considered. The famously high costs

The current crisis may prove to be an ideal opportunity to implement much-needed structural reforms — and already there are initiatives underway by a number of governments in Euro Zone markets to become more efficient.

Rejuvenating economic growth to the markets in crisis would also address one of the primary causes of the crisis: the divergence in competitiveness between the German-bloc markets in the north and the markets in crisis in the south

of trucking in Greece have hurt Greek businesses and consumers for years, and these high costs are a direct consequence of the fact that no new trucking licenses had been issued since 1971. Issuing more new trucking licenses could ratchet up competition and even encourage new investment in this sclerotic industry, driving down trucking costs to the benefit of the economy as a whole. And no new spending is needed by the Greek government to accomplish this.

Rejuvenating economic growth in the crisis countries would also address one of the primary causes of the crisis: the divergence in competitiveness between the German bloc countries in the north and the crisis countries in the south. For instance, in the decade leading up to the crisis, the per-unit labor cost of Germany had remained flat while output rose, whereas the labor costs in the crisis countries had soared even as their outputs stagnated. With sharply divergent productivity trends, the single currency became a straitjacket that fit no one, and thus significantly contributed to the crisis. Raising productivity in the crisis countries and improving their competitiveness will be an important development that helps the crisis countries to return to growth.

The competitiveness of Italy, Ireland and France is already being supported by the lower exchange rate of the euro. Chart 5 shows the levels of euro/US$ exchange rate at which the different Euro Zone countries could achieve a balanced current account; in other words, being competitive (see Appendix A for the methodology used). The overall trade-weighted exchange value of the euro has already declined by over 12% since the beginning of 2010. It stood at US$1.29/euro in mid-January, 2012; exactly the level where Italy could balance its current account. It is already below the level where Ireland's current account can be balanced, and close to where France can do the same. And at US$1.29/euro, Germany is hyper-competitive since its equilibrium exchange rate is estimated at US$2.35/euro. A weaker euro is especially useful for Italy, Spain and France since about 50% of their imports and exports are with countries outside the Euro Zone. Needless to say, Germany's exports will continue to perform strongly with a weak euro.

Pragmatism needed in both Economic Policies and in Politics

Finally, pragmatism also means that governments in the crisis countries will have to be prepared to cede some authority in fiscal policy to the European Commission and ECB. Currently momentum is building for some kind of oversight and intervention on how crisis country governments can and cannot spend. For example, in providing the next bailout to the Greek government, a new Franco-German plan was tabled in February 2012 for creating an escrow account to accept the new bailout funding instead of sending it directly to Athens. Then bondholders will be paid from the escrow account instead of by the Greek government. Furthermore, the fund can also be withheld from the Greek government if its deficit targets are not met. It is unclear as yet if the Greek government will accept the plan, but then, it may have no choice.

What may evolve is a process of incremental fiscal integration; each step is negotiated in return for some more flexibility from Germany in funding the crisis countries. For example, Germany has indicated that it is open to boosting the size of the Euro Zone rescue fund to €750 billion (€250 billion of unused funds in the existing European Financial Stability Facility, and an injection of €500 billion into the European Stability Mechanism to be launched later this year), if the crisis countries are prepared to accept strict budget rules in a new "fiscal compact" for all the member countries in the Euro Zone. This is the sort of tradeoff that the German government needs in order to placate an unsympathetic German voting public. Thus, pragmatism on the part of the crisis countries will go a long way to provide the necessary political capital for the German government to convince its parliament and German taxpayers that there will be accountability for the funding support that they are providing to crisis countries, not just another instance of throwing good money after bad.

Competing Visions of the Future of Europe

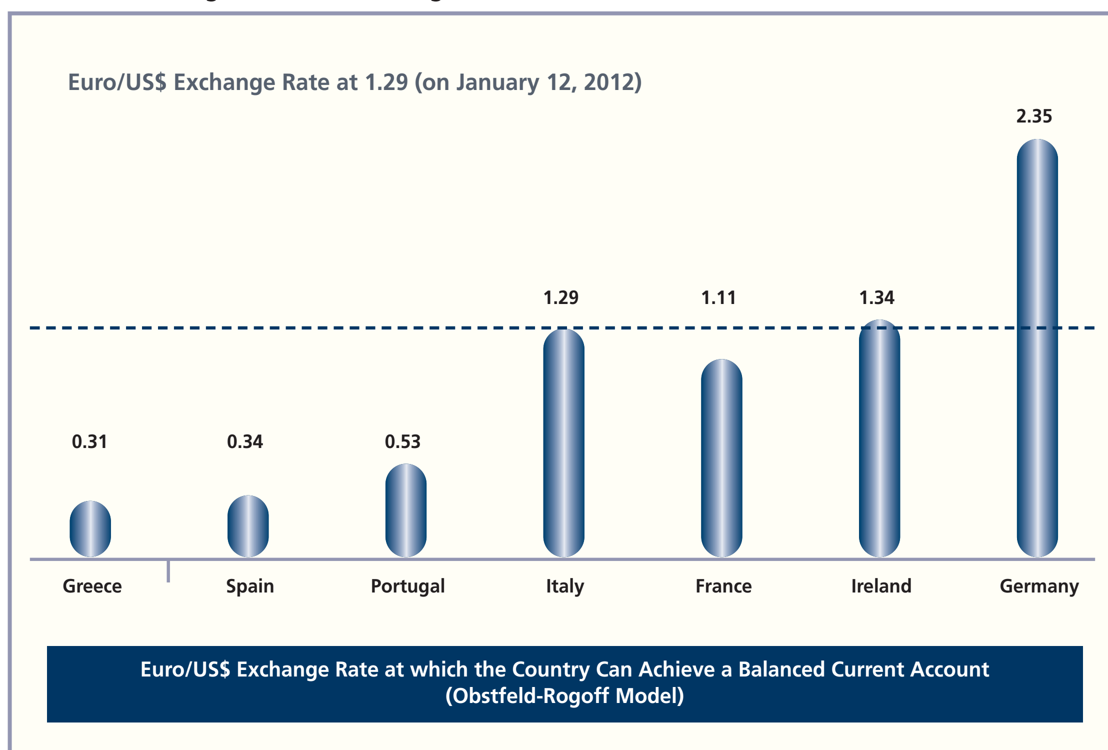
There are risks associated with both the pragmatic and the dogmatic approach. The pragmatic approach requires massive injections of liquidity in the short term, which could set the stage for accelerating inflation when asset deflation is arrested and growth begins to recover. Incremental fiscal integration could also lead to political backlash in some crisis countries, even the exit of the Euro Zone by some. The dogmatic approach, on the other hand, risks a deep recession in the crisis countries, and potentially a systemic crisis in the banking sector as a result of the stress of austerity. It is even more likely to provoke a severe political backlash and stronger likelihood of exit by some members of the Euro Zone.

While the risk of some crisis countries may exit the Euro Zone is present in both approaches, the exit, should it come about, will likely be a managed one with better cooperation between the exiting country and the European Commission in the pragmatic approach. The exit scenario in the dogmatic approach, in contrast, is likely to be more acrimonious and chaotic, hence more at risk of things spinning out of control. And it should be recognized that choosing to exit the Euro Zone is not necessarily the end of the world. Yes, there will be many challenges, and many things can go wrong. There will likely to be a run on the banks in the exiting country, which will require capital control and negotiated settlements of debts, which could be lengthy and complicated. For the exiting country, there could well be shortages of essential imports due to its new currency which is massively depreciated against the euro. The high costs of imports (in local currency terms) will also mean the risk of importing inflation. Thus, the economy of the exiting country is likely to continue to contract for some time before stabilizing.

It is therefore critical that the exit is well managed within a cooperative context in order for this inevitable period chaos and uncertainty to recede and replaced by new procedures and rules. It is often pointed out that there is no mechanism for leaving the Euro Zone provided by the Maastricht treaty in 1992, and its successor the Lisbon treaty

The lower exchange rate of the euro to the US dollar is boosting Euro Zone trade by permitting goods and services to be priced more competitively both within the Euro Zone and in foreign markets.

Chart 5. Declining Euro/US$ Exchange Rate a Plus



in 2007. But that does not mean that it cannot be done. In February the Czechoslovakia koruna was split into the Czech koruna and the Slovakia koruna (the Slovakia koruna was subsequently abandoned when Slovakia join the Euro Zone in 2009), and it was a reasonably well-managed affair. Sure, the situation today is far more complicated, but as long as the exit is not unilateral and acrimonious, it can be managed. And for Greece to return to a vastly depreciated drachma, for example, could actually mean a better prospect of economic growth later, especially if it could push through the needed structural reforms in the process.

In essence, there are two sets of ideas on the best way to solve the Euro Zone crisis.

While one side wishes to see a return to the status quo and views austerity as the solution, the other side advocates reviving economic growth as the most effective way.

The future of the Euro Zone will be decided by which of these two paths forward is ultimately selected.

Behind the rhetoric and technical jargon in all the debates on how to solve the Euro Zone crisis, there is in essence, a struggle between two sets of ideas on the future of Europe. In this report they are characterized as pragmatism versus dogmatism. Pragmatism sees reviving economic growth as the best way to extricate the Euro Zone from the crisis, even if some of the original principles enshrined in the architecture of the Euro Zone need to be compromised. In contrast, dogmatism is intent on preserving the status quo of the Euro Zone, and insisting on austerity as the solution to the crisis. These are two very different visions of the future of Europe. How the Euro Crisis is resolved will depend on which set of ideas prevail in the end.

Appendix A: Obstfeld-Rogoff Methodology

Estimates of how much the euro will need to appreciate/depreciate in order for the current account to balance for the key Euro Zone countries are based a methodology adapted from the Obstfeld and Rogoff (2004) paper - "The Unsustainable US Current Account Revisited," which creates a two-country model. It takes into account terms of trade and the relative prices of tradables in terms of non-tradables in order to find a level of dollar depreciation that would allow a subsequent balancing of the US current account deficit without a downward deviation of output, employment and inflation. Obstfeld and Rogoff's preferred partial equilibrium estimate (i.e. neglecting the rest of the world) of the required change in the dollar (log change in the price of foreign currency) was 25.3%. This estimate does not, however, take into consideration the effect of sticky prices or incomplete pass-through from exchange rates to prices, and (as Obstfeld and Rogoff suggested) if pass-through from exchange rates to prices were 50% this number would have to be roughly doubled, meaning a depreciation of the dollar of 50.6%. Initially, the calculations will start off using 25.3% estimate of dollar depreciation, scaled for the size of the current account deficit in relation to the traded sector, and consider the effects of inflexible prices later on. So, with an approximation of dollar depreciation and a ratio of the current account as a percentage of GDP and trade as a percentage of GDP their model can be adapted to the Euro Zone and the crisis countries in particular.

The first steps in the calculations are to construct a proxy for the CA/T_E (the ratio between current account deficit as a percentage of GDP and the output of the traded sector as a percentage of GDP) for each of the current account deficit countries. The proxy for the traded sector as a percentage of GDP is (Exports+Imports)/GDP.

The CA/T_E ratio for Greece, whose current account as a percentage of GDP is 0.162 and trade as a percentage of GDP is 0.596, would be 0.162/0.596 = 0.2717. Having found the equivalent figures for the other current account deficit countries, then the ratio between the CA/T_E and CA/T_{US} (the ratio between current account deficit as a percentage of GDP and trade as a percentage of GDP for the US – 0.166) can be equated, and then multiply this by the estimated dollar depreciation, 25.3%, to find an improvement in competitiveness necessary for each current account deficit country to stabilize output and employment as the current account deficit adjusts. Therefore, using Greece as an example the result is: (0.2717/0.166)*25.3 = 41.41% to be its required level of improvement in competitiveness.

However, to take account of general equilibrium effects (i.e., to take account of the change in the ratio of traded to non-traded goods prices in the rest of the world as, by hypothesis, the rest-of-the-world current account moves towards balance) these figures were, following the procedure in Obstfeld and Rogoff (who assume 50% pass-through of exchange-rate changes into prices) then multiplied by the countries' relative weight within the world. This was proxied by adopting Obstfeld and Rogoff's assumption that US GDP made up a quarter of world output and comparing each country's output with that of the US. In Greece's case, which only has 0.7% of world output, it is multiplied by its required depreciation, on a partial equilibrium basis, by 1.007 to get a new figure for improvement of 41.676%.

Following the procedure in Obstfeld and Rogoff (which is an adaptation of the classic Dornbusch analysis of relative speeds of adjustment and thus of exchange-rate overshooting), inflexible prices and incomplete exchange rate pass-through are taken into account by doubling the figures. This gives the final levels of required real exchange-rate depreciation.

But the current account deficit countries share their currency with each other and with all the other members of the euro area. Thus a given depreciation of the euro translates into a smaller effective depreciation for individual current account deficit countries, since part of their trade is with other euro-area countries. In order to find the euro depreciation necessary to produce the required effective depreciation, each current account deficit country's relative trade with the rest of the world outside of the euro area needed to be accounted for. Consider the example of Greece once again. 49% of Greece's trade is with the euro area and 51% is with the rest of the world. That implies that to produce the required effective depreciation for Greece would require an appreciation of external currencies versus the euro of 162%!

Given the estimates for euro exchange rate changes in the individual current account deficit countries and assuming that the dollar moves in line with other external currencies, one can derive, for illustrative purposes, the required changes in the Euro/Dollar exchange rates based on the initial exchange rate of 1.57.

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1. Eurostat data, 3Q, 2011.
2. Eurostat data.
3. Croxson, K., S. Lund, and C. Roxburgh. January 2012. "Working Out of Debt". McKinsey Global Institute.

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About the Author

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Yuwa Hedrick-Wong is currently HSBC Visiting Professor of International Business at the University of British Columbia, Canada.

Yuwa is an economist and business strategist with 25 years of experience gained in over thirty countries. He is a Canadian who grew up in Vancouver, British Columbia, and spent the last 20 years working in Europe, Sub-Sahara Africa, the Indian Sub-continent, and Asia/Pacific. He has served as strategy advisor to over thirty leading multinational companies in the Asia/Pacific region.

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