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Q&A: Core concerns in Europe's quest for growth

Andrew Belshaw, head of investment management at Western Asset Management in London, examines possible outcomes in the unfolding eurozone crisis. Andrew, who has over 20 years' experience in the investment industry, joined Western in 2009.

Q. What do you think led to the current crisis in the eurozone?

A. The eurozone crisis is mostly seen as a sovereign solvency crisis, but I believe the crisis evolved from something more fundamental than that. It's a crisis of competitiveness between the core and the periphery.

The periphery members were allowed a cheap entrance fee into the eurozone club in 1999, which was obviously very good for them, at least in the short term. The problem is that they forgot there's also an annual membership fee to belong to that club, and that membership fee was largely ignored by the periphery, and this has led to the current crisis.

Q. Can you elaborate on this theory?

A. The eurozone was a construct. It was set up by politicians in line with the political aims of the European Union, and before that the European Community, who wanted to tighten the integration of the Western European states after the second world war.

There are four things necessary for a successful monetary union: labor mobility, synchronized economic cycles, a central fiscal policy, (or a central transfer union), and capital mobility. At the outset of Economic and Monetary Union (EMU),[1] only one of these necessities was fully met, and that was capital mobility. And you could argue that capital mobility created and exacerbated the problems we've seen over the last three to five years.

Labor mobility was supposed to occur with the Single European Act in 1985. However, if you look at the statistics, labor mobility is a third of that of the U.S. or the U.K., which are both monetary unions. Without that labor mobility, it's difficult for people from areas of high unemployment to move to places of low unemployment. As for central fiscal policy — as we know, there was none.

[1] The **Economic and Monetary Union (EMU)** is a general term for a set of shared economic and fiscal policies adopted by members of the European Union.

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Turning to synchronized economic cycles, the outcome of German reunification in the early 1990s was that Germany was on a deflationary spiral with below-par, subdued growth. The same was true for Italy. Growth was a bit better, but it was still on a downward trend when monetary union came into being. However, for the rest of the periphery — Greece, Portugal and Spain — growth was very strong and above trend. So the various countries came into the monetary union with unsynchronized cycles.

Q. So what impact have these four factors — or their absence — had on the eurozone?

A: There has been an explosion of costs. Since 1999, Germany has kept down its costs to adjust for an overvalued exchange rate when it went into the euro. It has remained competitive. In fact, it's increased its competitiveness. Conversely, the periphery — Italy, Spain and Greece — has seen its labor costs rise, and that has undermined its competitiveness.

This has meant that the relative exchange rates in the periphery countries have deteriorated, both in absolute and relative terms, over the period of monetary union. In practical terms, that makes German exports cheaper on a relative basis than those of the periphery. And Germany will continue to get market share within the eurozone until this competitiveness problem is solved.

The outcome of this competitiveness issue can be seen in the current account balances of many European countries. Coming into the eurozone, most were in a stable position. Italy was actually in surplus. Germany, on the contrary, was in deficit. But this competitiveness was eroded in the periphery and transferred to Germany. Indeed, Germany has run a huge current account surplus for the last few years, between 6 and 6.5 percent of Gross Domestic Product (GDP).[2] Conversely, the periphery has been running current account deficits because they've been spending.

So government deficits in the periphery have exploded and as a consequence they've been the biggest borrowers in overseas markets to fund this underlying deficit problem, which has come about because of a lack of competitiveness and the growth of imports over exports in the last 10 years. This is what I mean when I say the sovereign solvency crisis is a symptom of a wider competitiveness crisis throughout the eurozone.

Q: So how can the crisis in Europe be resolved?

A: The easiest way out of this crisis, while addressing the competitive issue, is for Germany and other core countries to inflate. However, it will take time to generate some inflation to undermine their long-term competitiveness and the question is have they got the time.

The first way to inflate is through monetary expansion, generating inflation through the credit mechanism. But money supply growth in Germany is pretty subdued. Even with the ultra-low rates we've got, not only at the European Central Bank (ECB) but across the German yield curve, credit creation is weak. So I don't see inflation picking up in Germany any time soon.

At the same time, you have to remember that Germany has an anti-inflationary bias for historical reasons. As a consequence, I don't think the political will to generate the required amount of inflation in Germany is there.

Q: What other ways are there of addressing the problem?

A: Another way is massive fiscal relaxation with the government stepping in either to make tax cuts or direct spending to increase domestic demand in Germany, and lead to reflation that way. But they have to do the opposite of what they've been doing over the last two or three years, and certainly the opposite — and this is a key point — to what the periphery is doing in terms of austerity measures. Unfortunately, there's not much movement on this front either.

[2] **Gross Domestic Product (GDP)** is an economic statistic which measures the market value of all final goods and services produced within a country in a given period of time.

Another way to solve this issue is for the periphery to deflate. And you could argue that's exactly what's going on. The austerity union we've got at the moment, with all the pain of adjustment, is borne by the periphery through spending cuts, rising unemployment and so on.

And you could argue that it's working. Money creation has collapsed in the periphery, particularly in Greece, but also in Spain and Italy. It's getting weaker as we see deposit flight out of these countries into the core. Businesses and households are, quite rationally, moving their cash deposits out of Spanish, Italian and Greek banks into German and other core banks. This obviously doesn't bode well for more credit creation and economic growth, and is therefore deflationary. But how long can this go on for, and is there the will for it to continue, because the cost of this deflationary cycle could be immense?

Q: What sort of costs are you talking about?

A: The most obvious cost is social. We've seen a huge increase in unemployment, for example, over the last three or four years, particularly in Spain and Greece, and more recently Italy. At a national level, Spain and Greece have well over 20 percent unemployment rates, while Italy is near 11 percent. So there's a big social cost involved that ultimately leads to social unrest. And when you look at what's happening in youth unemployment, the social costs these countries have to bear becomes even more intense. Spain and Greece have youth unemployment levels of 50 percent while Italy is 35 percent. These are high levels to carry for any length of time, and lead to disenfranchised youth and social unrest, and have a detrimental effect on a country's long-term output.

So I do wonder whether there is the long-term will to follow through this deflationary cycle, because given the degree of uncompetitiveness and overvaluation, this could be a 10-year-plus cycle.

Q: What other problems are there?

A. There's the tendency to get involved in a debt trap. As austerity picks up, the first consequence is growth slows. This has a negative impact on a country's budget in the short run, when it starts to miss its fiscal targets. The impact of this, as we've seen in Greece and we're starting to see in Italy and Spain, is that the market starts to charge a bigger risk premium to lend to a country, so the interest rates it pays on its debts start to rise.

Again, this becomes self-fulfilling as the market demands more austerity cuts, and the country starts to miss fiscal targets, and therefore the risk premium increases again. Eventually, you get in a debt trap where you cannot finance yourself. Greece encountered this issue last year and had to be restructured.

Q: So if neither austerity programmes in the periphery or inflationary measures in the core are the answer, what's the way out of this long-term problem?

A. I think there's only two ways out, ultimately. One is a formal fiscal union like the U.S. So when you have periods of stress, the wealthier part of the economy will make fiscal transfers to the poorer areas to ameliorate the pain and suffering there, and see them through the adjustment process.

The other way out is a break-up. If you're in the periphery, an external devaluation will result in a cheaper domestic currency, which will result in you becoming more competitive.

Let's examine a fiscal union first. At an aggregate level, the eurozone isn't in that bad a state. The aggregate deficit to GDP is around four percent and projected to go to three percent by the end of this year. The outstanding debt-to-GDP, meanwhile, is around 86 percent. Obviously it's high given what's happened to the economies over the last three to four years, but the eurozone is still in a relative growth position compared to the UK and the US, which are running deficits of around eight percent of GDP currently, and are likely to have gross debt levels of between 95 and 110 percent by the end of the year. Against this backdrop, the eurozone looks manageable in this environment.

Q: Does Europe have the will to go down the route to fiscal union?

A: It means a big mindset change, and it obviously means institutional change. The first thing to have would be a central finance ministry, a unified budget and unified transfers. Going from 17 states to one central state is a big, big ask. At the same time, you've got to have a European banking union, common deposit insurance, and the ECB would have to have common oversight rather than the disjointed banking union we've got at the moment. This would help to shore up banks and curtail transfers and deposits from one country to another, which destabilizes the system.

It would also mean some loss of sovereignty, which politically may be unacceptable. And ultimately it would mean a new treaty for eurozone countries. The question is given what's happening in the markets, is there time to move towards full fiscal union, given the amount of change we've got to have? I don't think there is time to put a formal fiscal union in place, but if you had a clear commitment, rather than the wishy-washy thinking we have at the moment, and a clear time scale, the markets would give you the benefit of the doubt.

Q: So what about the breakup option?

A: A breakup of the eurozone is one way for the periphery to regain its competitiveness. A new currency will depreciate quite quickly, and then with the combination of a default, they can quickly wipe out their debts and start again. It has a lot of advantages. Once you can pursue an independent monetary policy, you can print your own currency to recapitalize your banks, and then adopt policies likely to stimulate growth. The exchange rate will quickly depreciate, so hopefully that will lead to a sharp rebound in tourism for places such as Spain and Greece, along with other exports. Ultimately, it could bring about economic growth rather than recession, as we're seeing in the periphery at the moment, and, in the case of Greece, depression.

However, there are potential costs. The first of these is a potential banking crisis, as capital flies into other parts of the eurozone with harder currencies. It would probably difficult for affected countries to get access to capital markets if they needed to borrow, certainly in the short to medium term. Then there's the question of contracts. There are a lot of contracts written in euros and you'd have to look into the legality of converting them into drachma or pesetas or whatever.

However, although it's not a cost-free, easy option, I think these problems can be surmounted. You can implement exchange and credit controls. You can make a massive liquidity injection into your own central bank. And one would hope that other central banks would be coordinating policy measures to make sure the financial system was stabilized for the good of the global economy. So there are ways to solve these problems.

Q: So what do you think will happen?

A: The fiscal union and the breakup options are diametrically opposed to one another. If it's a fiscal union, the price of Italian, Spanish and Greek debt is cheap at current yield levels. It also means that the price of German and Dutch debt is expensive because they will likely no longer be AAA if they are to assume some of the liabilities of the periphery.

If it's breakup, the opposite is true. The core debt in Germany and the Netherlands has good value and a safe haven quality to it. Periphery debt will likely become problematic. In fact it could go like Greece, and a default means you won't get your money back.

The key point for me is that both of these outcomes are unknowable and at the whim of the politicians and the wider population. Ultimately, they will come down one way or the other. In terms of the long-term outlook, it's this uncertainty which is undermining not only the European economies but also global growth. If we can remove that uncertainty by getting a clear decision either way, that would be positive for the global economy, and then we could move forward.

Q: What confidence do you have that Europe's leaders will implement a decisive solution to the crisis, instead of dragging it out for months to come?

A: I think it all depends on the political will. At the moment, I think we're still in the phase of kicking the can down the road and looking for short-term palliatives, as we've done over the last two years. These palliatives have bought us a little time, but each time the positive effect lasts for a shorter period, as we've seen with the Long Term Refinancing Operations[3] in December and February, that quickly ran out steam by second quarter of this year.

I think we're getting to the point where there's only one palliative now and that's for the ECB to become the lender of last resort, and pursue an aggressive quantitative easing program — buying Spanish and Italian debt and therefore cutting their yields.

This doesn't solve the underlying competitiveness problem at all, but it does buy you time. So, in short, I don't think we'll get a definitive solution over the next two or three months we'll probably have another palliative — but the time for a definitive solution is drawing ever nearer.

Q: Set against this backdrop, does Western Asset think that economic growth will remain positive?

A: Yes, we do think growth will be positive. There have been a lot of policy initiatives not only in the eurozone, but also the UK and the US. So there's liquidity there, which will drive growth. I also think there's still more measures that can be taken by central banks. Ultimately what they have to do is get the credit mechanism working again.

Q: How you are positioning your portfolios in light of an unknowable outcome in Europe?

A: Well, this is the problem. When you have a binary outcome, you have to be conservative and cautious. You have to take some risk, but you know you can't take a lot of risk. You look at the balance of probabilities, see where there's long-term value and put your risk out there, but you have to be cautious and conservative, and not take excessive risks.

I still think this is a positive environment for good quality risk assets, because there's obviously plenty of liquidity out there, and ultimately we think growth is going to be positive. So I'm cautious but optimistic.

[3] **Long Term Refinancing Operations** is the European Central Bank's program of providing euro-area banks with loans in order to provide liquidity to the market and prevent a credit crunch and an interbank lending freeze from hurting the financial sector.

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