Don’t throw the euro out with the bathwater

Outlook 2014
Content

Preface 3

Is ‘Europe’ becoming a dirty word? 5

Was the euro a step too far? 6

Towards an optimal currency area 12

Big Bang versus muddle-through 16

What’s in it for me? 21

Conclusion 24

Colophon 25

Disclaimer 26
The architects of the euro believed that a monetary union will improve the welfare of the European citizens. That was certainly the case before the crisis. Inflation and jobless rates were low, credit conditions were loose, asset prices were rising and, as a result, economic growth was high. However, a crisis was brewing beneath the surface. Since 2008, resentment towards the monetary union has been rising amid a surge in unemployment. This brings us to three critical questions: (i) when did the eurozone’s fragilities start?, (ii) how can the crisis be resolved effectively? and (iii) does the eurozone need to stay intact? In this thematic study, published in conjunction with our macroeconomic Outlook 2014, Rabobank’s economists provide some answers.

As for the weaknesses of the monetary union, our economists show that the eurozone’s troubles can be explained by the fact that it was not an optimal currency area from the start. By that they mean, the economies of the Member States are dissimilar, flexibility to absorb shocks is missing and there is no fiscal redistribution taking place between countries to moderate economic downturns. So the crisis simply exposed the monetary union’s fragilities.

With respect to ending the crisis and making the monetary union more stable, the researchers argue that institutional reform at the eurozone level has to be fast-tracked. To be sure, policymakers have decided to hasten the integration process. Fiscal and economic coordination amongst Member States are enhanced and a banking union is in the making, albeit at a very slow speed. Even though these are all steps in the right direction, the analysis shows that this still does not make the monetary union immune to crises in the future. More importantly, the European leaders are not taking measures to tackle the combination of fiscal, banking and growth crisis head on. The region will only exit the crisis when sovereign risk is lowered, bank balance sheets are strengthened and economic growth picks up.

As regards the desirability of keeping the eurozone intact, our economists explain that costs of dismantling the union or even the exit of a few Member States are
extremely high. Besides, businesses in the Northern European countries, especially Dutch firms, can continue to benefit from the eurozone in the future once the much-needed reforms are carried out. Although their base-case scenario is that the crisis will not be over quickly, they believe we must look through the crisis to spot new business opportunities. Indeed, the crisis has prompted serious structural changes to the economies in a number of Southern European Member States. This means, in time, Dutch businesses will benefit from a richer market within the monetary union. Furthermore, there will be new opportunities for companies to relocate production facilities to the South of Europe. Once the reforms take effect, these economies will offer a stable business climate with relatively low levels of corruption and red tape, an environment conducive to innovation and high level of competitiveness.

Overall, no one can disregard the fact that the eurozone is currently going through some choppy waters. This is because the monetary union was not only built on shaky foundations, it also lacked an effective fire-fighting department. So the crisis was an accident waiting to happen. But we do believe that the eurozone can be perceived positively by its inhabitants once again. For that to happen, the European leaders must not allow this crisis to go to waste. In the past, the institutional reform process accelerated whenever there was a major setback. Against this backdrop, we can only hope that the right decisions will be made this time round to make the euro a success story.

I trust you will enjoy this publication and find it inspirational, and would like to take this opportunity to wish you a healthy, happy and successful 2014.

Sipko Schat
Executive Board
Rabobank Group
Is ‘Europe’ becoming a dirty word?

The founding fathers of the European Union (EU) believed that European integration would not only end wars amongst countries but will have many economic benefits. The latter has been achieved through the creation of a Single Market for goods, services, capital and people.

The most recent eurobarometer published by the European Commission (EC) shows that the Single Market and peace amongst the Member States continue to be seen as the most positive results of the EU (figure 1).

While this sounds promising, we should note that Europeans seem to be getting less excited about the euro and the future of the EU. The same eurobarometer survey shows that the share of people being positive has dropped considerably since 2007 (figure 2). This is certainly a direct consequence of the crisis in the Economic and Monetary Union (EMU) and the lack of an effective political response to it.

---

**Figure 1: EU’s relevance in a snapshot**

<table>
<thead>
<tr>
<th>Which of the following is a positive result of the EU?</th>
<th>(% of respondents)</th>
</tr>
</thead>
<tbody>
<tr>
<td>The free movement of people, goods and services</td>
<td>60</td>
</tr>
<tr>
<td>Peace among the Member States</td>
<td>50</td>
</tr>
<tr>
<td>The euro</td>
<td>40</td>
</tr>
<tr>
<td>Student exchange programmes</td>
<td>30</td>
</tr>
<tr>
<td>The political and economic influence of the EU in the rest of the world</td>
<td>20</td>
</tr>
<tr>
<td>The economic power of the EU</td>
<td>10</td>
</tr>
<tr>
<td>The level of social welfare (healthcare, education, pensions) in the EU</td>
<td>0</td>
</tr>
<tr>
<td>The common agricultural policy</td>
<td>0</td>
</tr>
</tbody>
</table>

Source: EC Eurobarometer 79

**Figure 2: EU/EMU’s image getting poorer**

<table>
<thead>
<tr>
<th>What is your opinion on...?</th>
<th>(% of respondents)</th>
</tr>
</thead>
<tbody>
<tr>
<td>The euro</td>
<td>80</td>
</tr>
<tr>
<td>Future of the EU</td>
<td>70</td>
</tr>
<tr>
<td>Situation of the economy</td>
<td>60</td>
</tr>
</tbody>
</table>

Positive Negative

*The figures do not add up to 100% as “I don’t know” responses have been excluded.

Source: EC Eurobarometer 79
Was the euro a step too far?

Most Europeans believe that the eurozone delivers tangible benefits by boosting trade and creating large and liquid financial markets. However, not everyone is convinced that the euro was necessary, especially in light of the current debt crisis, to boost economic growth and welfare. Indeed, a number of politicians and scholars warned that the eurozone did not form an optimal currency area (OCA). According to the OCA theory, countries must only opt for a monetary union if economic shocks are sufficiently symmetric across the region. Moreover, the currency area should have sufficient flexibility to cope with asymmetric shocks. Labour market flexibility is very important when countries trade their own ‘tailor-made’ monetary policy for a ‘one-size-fits-all’ policy. Besides, the adjustment process will be very painful in the absence of a centralised fiscal redistribution system. Finally, a sufficient degree of trade integration amongst members is needed to generate benefits of using the same currency (i.e. eliminating exchange rate uncertainty and improving transparency of the price discovery process).

A brief look at the history of the EMU shows that the economies of the Member States are structurally very different. Therefore, the symmetry criterion was always absent. Similarly, the lack of labour mobility due to cultural/language barriers combined with inflexible wages meant that the flexibility criterion was also missing. With an EU budget amounting to 1% of the combined GDP of Member States, it does not even come close to the automatic cross-border fiscal transfers that take place within the individual countries. Only when it comes to trade integration do we see a clear reason why the EMU members wished to join (figure 3).

Despite the many shortcomings, the European politicians decided to go ahead with the introduction of the euro believing that the benefits will accrue in the long-term (e.g. facilitating free movement of capital) and shall eventually outweigh the perceived costs. Actually, some thought that once a country enters the EMU, the economy adjusts to the new environment. Membership was supposed to increase the correlation

Figure 3: Sufficient trade integration

Source: IMF
of the national business cycles, bringing it closer to fulfilling the symmetry criterion. Structural reforms had to take care of labour market flexibility. And the Stability and Growth Pact (SGP) conditions\footnote{The budget deficit must not exceed 3\% of GDP and public debt must not exceed 60\% of GDP.} were supposed to make sure that fiscal crises do not occur.

**Eurocrats pre-crisis: “I told you so!”**
The first years of the euro were celebrated as a success. The first notable achievement was low and stable inflation rates engineered by the newly born European Central Bank (ECB). Meanwhile, economic conditions in the eurozone improved materially. Growth in the period 1992-98 was 1.8\%, on average, and rose to 2.3\% between 1999 and 2007, which led to the creation of 16 million jobs! Around 60\% of the jobs were created in the five crisis-hit countries, which are nowadays known as GIIPS (Greece, Italy, Ireland, Portugal and Spain).

**Eurosceptics post-crisis: “I told you so!”**
Although Eurocrats were padding each other on the back pointing to the many great features of the euro area, a huge crisis was brewing beneath the surface. As the saying goes, “a rising tide may lift all boats; a falling one reveals who has no bathing trunks on”. Indeed, the headline growth/inflation figures of the EMU masked...
the underlying divergences among the members. The old deutschmark bloc (Germany, France, Austria, Netherlands, Belgium) plus Finland — today known collectively as the ‘core’ countries — experienced lower than average growth and inflation, while the reverse was true for GIIPS. This was because at the start of the monetary union, the latter still had (substantially) lower income/price levels than the core countries. So GIIPS, on average, faced a sustained period of higher growth as they were ‘catching up’. During the convergence process, inflation tends to be higher because wages in the non-tradeable sector, which is not experiencing productivity gains, will rise in tandem with the productive tradeable sector amid high labour mobility.

But this can provide only a partial explanation for inflation differentials. For one, the economic boom in many of the countries was largely one of employment growth, and not exceptional productivity gains. Moreover, some economies witnessed high inflation while performing relatively poorly. Another relevant factor for inflation differentials is that the one-size monetary policy clearly failed to fit all. Figure 4 plots estimates of optimal monetary policy based on rates of inflation and unemployment (i.e. Taylor rules) for GIIPS versus core countries. The contrasts are striking. Although such Taylor rules serve as rough guides, the picture makes it clear that during the boom phase, GIIPS needed a much tighter monetary policy. Not only were real short-term rates too low but so were real long-term rates as investors piled onto debt in GIIPS in search of higher yield. Several other factors such as lower inflation and

Figure 4: One-size-fits-some

Source: IMF, Reuters EcoWin, Rabobank
default risk perceptions fuelled risk appetite. The elimination of exchange rate risk was an extra incentive. The differences in real interest rates was the reason why Sir Alan Walters, a counselor to Margaret Thatcher, argued against the UK joining the EMU. According to the Walters’ critique, uneven inflation rates in a monetary union produces real interest rate differences that exacerbate divergent economic trends. Countries facing low real interest rates are encouraged to borrow and those facing relatively high real interest rates are encouraged to save. This is exactly what happened in the eurozone. The left panel of figure 5 shows that, on aggregate, households and firms in the core countries increased their net lending (as income gains exceeded the rise in spending) after the euro introduction while most governments continuously ran budget deficits. This was partly due to higher real interest rates that discouraged private sector borrowing. Since private sector net lending exceeded public sector net borrowing, on aggregate, the core countries started to export more capital. Now if we look at the right panel of figure 5, we see that households and firms in the periphery countries, as a whole, were actually living ‘prudently’ before the euro era. The public sectors were doing the opposite though. Upon euro’s introduction, the periphery countries started to live ‘beyond their means’. In some countries this was mostly the public sector (e.g. Greece) while in others it was the private sector (e.g. Spain and Ireland). In any case, the ‘extravagant’ lifestyle was sponsored by capital imports, partly arriving from the core countries. The result of the external imbalances has been a massive credit boom in some of the periphery countries. Internal imbalances were worsening too as credit-fuelled growth was increasing inflation. The result was a loss of price competitiveness that widened current account deficits.

Figure 5: The go-go years of the eurozone

Source: IMF, Rabobank
The financial crisis spoilt the party

The feast in GIIPS ended as soon as the financial crisis made landfall. Falling asset prices, incomes and credit availability combined with a surge in jobless rates led to extreme private sector frugality. As a consequence, households and businesses started running surpluses from 2009 onwards. Given the negative feedback loop between private sector saving and economic activity, budget deficits started to balloon. But bond investors realised that not all governments had the fiscal space to run enormous deficits without bringing their own solvency into question. The result was a gradual loss of confidence in sovereign bonds of all the periphery countries and an ensuing rise in interest rates. The situation was still controllable until investors realised that previous Greek administrations had cooked their fiscal books. Concerns about Greek debt sustainability surged and many wondered whether Portugal, Ireland, Spain and Italy were in a healthier shape. When it became apparent that the eurozone institutions were not able to cope with such a shock, foreign investors panicked and started to rush for the exit. The fact that European leaders were constantly behind the crisis curve did not help as well. Their foot-dragging eventually pushed Greece, Ireland and Portugal into the arms of the ‘troika’ (the International Monetary Fund (IMF), the ECB and the EC). Spain also received a support package for its banking sector.

Super Mario saves the EMU…for now

Systemic stress in the markets returned when Italy and Spain were engulfed in a debt crisis (figure 6). During the first half of 2012, market participants were even openly debating about the exit of some eurozone countries from the EMU. The ECB managed to bring an end to all the speculations. Upon assuming office, the new president of the ECB, Mario Draghi, slashed interest rates and injected an unprecedented amount of liquidity (around EUR 1trn) into the banking system. Since this was not deemed enough to alleviate market concerns, in the famous London speech he stated the following: "Within our mandate, the ECB is ready to do whatever it takes to preserve the euro". Those magical words struck a chord with investors as they realised that the ECB not only has a big bazooka, namely the power to print unlimited amount of euros, but that it may use it if threatened. Draghi backed his claim by introducing the Outright Monetary Transactions (OMT) programme that allows the ECB to purchase unlimited amount of short-term government bonds subject to conditionalities.

Figure 6: Much indebted to the ECB

Source: ECB
Ever since, financial conditions have loosened substantially and talks of eurozone exit are no longer prevalent. We must admit that the ECB was reluctantly pushed into this unnatural role due to the limitations of the European Stability Mechanism (ESM) to act as an effective fire-fighting department.

So is the euro crisis truly over now? The short answer is no. The eurozone crisis is no longer in an acute phase but we cannot say that the stability of the euro is safeguarded. The ECB’s measures are temporary sticking plasters because public debt cannot be monetised without jeopardising the price stability mandate. Furthermore, crisis resolution requires that all three crisis types in the eurozone – fiscal, banking and economic – be addressed at the same time. The negative sovereign-bank-growth feedback loop will not get better with ECB intervention alone. And tackling the fiscal crisis without the banking and economic crisis, as the troika have done until now, will further worsen the situation. The result of highly contractionary fiscal policies has been collapsing economies, surging jobless rates and rising non-performing assets in the banking sector.

2 The ESM, with a lending capacity of EUR 500bn, was simply too small to be credible.
Towards an optimal currency area

To end the crisis and lower the risk of jumping into another, eurozone countries have pushed for further economic and political integration. To clarify the steps taken so far, we have broken down the integration process under three sub-branches: fiscal, financial and economic. Below we shall briefly present each category (for details see Verduijn, 2013). In the following section, we shall explain why we think the integration process is not ambitious enough.

1. Fiscal integration

The SGP rules, which proved to have no teeth as virtually all Member States broke them at one point in time, were amended in 2011 to improve both its design and compliance. Two main adjustments are worth mentioning. First, a debt rule is introduced, which requires Member States with public debts exceeding 60% of GDP to reduce the portion above the norm by 1/20th per year. Second, a number of measures are taken to enforce stricter compliance with the rules. For example, potential fines have increased (max. 0.5% of GDP) and sanctions are imposed in an easier manner if the rules are violated.

In early 2012, Member States agreed to a Fiscal Compact. Among other things, countries have committed to a debt brake rule, which states that the structural budget deficit must not exceed 0.5% of GDP in the medium term. This must be enshrined in national law, preferably at the constitutional level.

In mid-2013, the Two-Pack was implemented, consisting of two regulations. Through the first regulation, the EC has attempted to increase its control over the Member States’ budgetary plans. For that matter, if a budget proposal fails to satisfy the EC, a revised proposal should be submitted. Budget plans shall be based on independent macroeconomic forecasts. The second regulation relates mainly to Member States in the ‘excessive deficit procedure’ and those that receive financial support. This will give the EC more options to assess the plans of these Member States.

2. Financial integration

The process of establishing a European banking union is currently underway. The plan of the President of the European Council, Herman van Rompuy, identifies four building blocks for a banking union:

- A single organisation must carry out uniform supervision in order to avoid regulatory capture – national regulators acting in the interest of their own ‘national champions’ at the expense of the union.
- A Single Resolution Mechanism (SRM) should be established so that a level playing field is created with clear guidelines for resolving and restructuring troubled banks, as well as creating a framework for coordinated action if the bank in question has
branches in other European countries. In this way, ambiguity regarding the level of bail-in – the write-down or conversion into equity of unsecured claims when a bank is heading for bankruptcy – can be avoided.

- With a common resolution fund, the banking union will help break the vicious sovereign-bank link because banks’ rescue operations are no longer financed using funds of the Member State itself.
- The introduction of uniform Deposit Guarantee Scheme (DGS) rules backed by a common fund strengthens the trust of deposit holders and can, therefore, help prevent a deposit flight. A DGS at the Member State level can do the same, but uniform rules and fund help create a level playing field and sever the link between sovereigns and banking systems.

To be sure, only uniform supervision is close to being operationalised. A Single Supervisory Mechanism will be established, in which the ECB will be responsible for the regulation of all 6,000 European banks (including from non-EMU EU-countries that voluntarily participate). Until now, Member States have not found common ground when it comes to launching resolution and emergency funds.

3 Economic integration

The financial emergency aid to various Member States during the crisis allowed the EC to exercise control over economic policy through a reform programme, but this mechanism works on an ex-post basis, i.e. when the stability of the EMU has already been jeopardised. To avoid this in the future, countries have agreed to two new rules.

3 The ECB will supervise banks that 1) have assets in excess of EUR 30bn or 2) assets exceeding 20% of the GDP of their country or 3) have received or applied for financial support from the bailout funds. The ECB is also authorised to take over any other institution at any time.
European Semester
The European Semester was established in 2010 in order to improve coordination of economic policy and be able to exercise control on the Member States’ policies in a timely manner. The Semester is an annual cycle in which the EC assesses fiscal/economic policy plans of members and makes country-specific recommendations based on the national reform programmes submitted.

Macroeconomic Imbalance Procedure (MIP)
The MIP is attempting to prevent macroeconomic imbalances from building up, and to correct for them when they do arise. The MIP involves an annual cycle that starts with a scoreboard (consisting of 11 indicators) based on which an initial assessment is made of the existence of imbalances. In addition, the MIP allows the EC to make recommendations to the Member State. If countries fail to address excessive imbalances, they risk incurring a fine (max. 0.1% of GDP).

Our take
The sections above demonstrate that the institutional reform process of the eurozone has been accelerated since 2010. Although it is too soon to judge the effectiveness of these measures, we believe that even if all steps are taken fully, the EMU cannot get closer to becoming an OCA without further integration.

When it comes to fiscal integration, the measures make budgetary policy very rigid. In the new regime, governments will have less leeway to conduct counter-cyclical fiscal policy if they are not running a large budget surplus. We must note that during serious economic downturns, allowing so-called automatic stabilisers\(^4\) to operate in full may prove insufficient. If the EC were to allow the deficit to rise to mitigate the economic effects in such cases, then the credibility of the new fiscal rules may come under question. Besides, we need much deeper fiscal integration. More concretely, the EMU members must consider pooling fiscal risks in the context of eurobonds, which provide for common sovereign borrowing. This will help prevent sharp increases in borrowing costs due to country-specific or euro-wide shocks (see Boonstra, 2011).

As far as the banking union proposals are concerned, we must stress that an integral approach is necessary to lower the frequency and impact of systemic banking crises in the future. By that we mean all four aspects of the banking union must be implemented simultaneously. Imagine that the ECB deems a specific bank to be insolvent while the national authorities, in charge of bank resolution, maintain that the bank is solvent to minimise their costs. Or even if supervision and resolution are carried out at the European level but that there is no common fund to resolve the bank, so the government must pick up the bill. This can increase pressure on other banks given their exposure to sovereign debt. Even if all these items are in place, a

---

\(^4\) The automatic increase in government spending and reduction in tax revenues due to slower growth.
country's banking sector can still come under pressure if depositors withdraw their money out of fear that the resolution fund is not large enough to bailout the entire national financial system. In other words, a uniform DGS backed by a common fund is necessary.

Finally, the economic integration plans look good in theory but we are not sure how much influence the EC will have over a country’s macro policies. Although the EC can make recommendations at an early stage (European Semester), the implementation of an enforceable mechanism is possible only at a later stage (MIP) and does inevitably involve political influence. For example, a country can ignore the EC’s advice. In other words, prevention will be difficult and cure will likely be painful as it comes too late. Another important matter is if the EC treats countries with significant political weight differently.

To strengthen economic coordination at the eurozone level, it will be better to give the EC extra power (i.e. make recommendations binding). In addition, countries must be placed under the ‘excessive imbalance procedure’ if a number of indicators in the MIP cross their respective thresholds. This way, the EC will have more power to correct the imbalances of the influential countries.
Big Bang versus muddle-through

The relevant question to ask is why do policymakers continue with their muddle-through approach when they are aware that the eurozone remains vulnerable? They could decide to fast-track the European integration process by completing the banking union, introducing eurobonds and significantly enhancing macroeconomic coordination. For their part, the periphery countries could take more structural reform measures and bring forward the privatisation plans. We would call this the Big Bang approach.

To understand why the Member States have opted for

Box 1: Game-theoretic application

We can assume the following game:

- **Number of players:** 2 (Core, GIIPS)
- **Strategy profile:** (Big Bang, muddle through)
- **Payoff function:** \( a > b > c > d \)

In theory, this game is played in one round and both players make the move at the same time without having knowledge of the other player’s strategy. Let’s look at the best response of GIIPS given the strategies available to the core player. If core chooses Big Bang, then GIIPS is better off with muddle through (\( a > b \)). This makes sense as GIIPS can do less austerity/reform while core is carrying out a lot of cost sharing. The economy gets a bit of breathing space, borrowing costs drop and the status quo pleases vested interests. If core chooses muddle through, then GIIPS must again go for muddle through (\( c > d \)). It would be irrational to implement many austerity/reform measures while core remains reluctant to share the costs. So no matter what core decides, the dominant strategy for GIIPS is to choose muddle through. Since the game is symmetric, the same applies to core. Thus, both players will choose the muddle through strategy (it is the Nash equilibrium of the game) even though the payoff (\( c \)) is less than when they both select the Big Bang strategy (\( b \)).

In reality, the game is played in several rounds. This allows players to enhance their coordination and also to build up trust. When this happens, the eurozone institutional reform can speed up. Of course, we are still far away from such a scenario.
the muddle-through approach, we use some simple game-theoretic concepts where we shall look closely at the incentives of different players. The game illustrated in box 1 is a classic prisoner’s dilemma game where both players do not cooperate even when they would be better off if they did. The reason for the non-cooperative equilibrium in the eurozone is simply the lack of trust and coordination amongst members. The ‘prudent Northern’ members believe making life too easy for their ‘profligate Southern’ neighbours will lead to moral hazard risks. Reform measures will be postponed and bailout costs will continue to rise as the EMU turns into a one-way transfer union. So the best response is to do just as much to avoid the breakup scenario while pushing GIIPS towards economic modernisation. The crisis-hit countries, in turn, believe that doing too much will upset their domestic constituencies and place an enormous strain on their social fabric as recoveries remain sluggish. Their best response, therefore, is to drag the crisis so long that the core countries also share some of the costs.

The tit-for-tat strategy whereby countries only take steps subject to great rewards or severe punishments means that we may move from one crisis to another until the necessary institutional reforms are in place. More importantly, the current crisis will take longer than is necessary when countries decide to muddle through.

In the ideal Big Bang scenario, a short-term crisis resolution would be provided that includes three main ingredients: lowering sovereign risk, lowering banking sector strains and supporting growth.

1. **Lower sovereign risk**

Governments that are under market pressure must continue with their fiscal adjustment programmes by putting more emphasis on spending cuts as opposed to tax hikes, which dampen growth more. If a country’s debt is deemed unsustainable, then debt restructuring and even a partial writedown should be considered an option. Kicking the can further down the road will lead to bigger problems. And we must not forget that the OMT programme cannot fend off markets forever if bond investors completely lose trust in a country’s public debt. To ensure that sovereign default/restructuring does not trigger a banking crisis, the ECB must ensure that all solvent banks have access to sufficient liquidity. The insolvent ones must be either wound down or be recapitalised.

---

5 The subject of game theory involves players, strategies they can choose from, and pay-off functions that evaluate the outcomes for each player.
2. Lower banking sector strains

Until now, the liquidity provision of the ECB has avoided a string of bank failures in GIIPS. Between 08Q1 and 13Q1, the total external debt of periphery banks dropped by 39%-points of combined GDP (figure 7, left panel) as foreign investors moved out. In the same period, the external debt of the central banks in GIIPS rose by 22%-points of GDP owing to heavy reliance on central bank funding. Sadly, the side-effect of ECB’s liquidity provision was the worsening of the fiscal-financial nexus. This is because falls in foreign demand for public debt in GIIPS and the resulting refinancing gaps were filled mostly by domestic banks, if not the foreign official sector or domestic nonbanks. Figure 7 (right panel) shows that total holding of public debt by periphery banks doubled from 17% of aggregate GDP in 08Q1 to 36% in 13Q1.

Against this background, dealing with weak banks in GIIPS forms an essential part of resolving the euro crisis. The first step should be a highly credible Asset Quality Review (AQR) to be conducted by the ECB so that transparency improves. The ESM must be utilised to plug the holes in bank balance sheets if they seriously damage a country’s fiscal sustainability. Recapitalisation through the government, as was done in Spain, is undesirable since it enforces the vicious sovereign-bank feedback loop. Only when legacy problems are resolved without putting extra burden on the sovereign, will credit start flowing into the real economy.

---

6 Periphery banks have an incentive to support their sovereign debt given the large impact lower bond prices have on their balance sheets.
3. Support growth

To ease downward pressure on economic activity, the troika must realise that GIIPS need more time to improve their fiscal imbalances and competitiveness. The core countries must be ready to give extra support during the painful adjustment phase and should also stimulate their domestic demand. The latter can be helpful for the export sector of the periphery countries. The ECB must run a sufficiently accommodative monetary policy, consistent with the recognition that deflationary dynamics in GIIPS, once in train, are particularly difficult to reverse. Even if that comes at the cost of a temporary rise in inflation in the core countries, then so be it.

If these measures are taken resolutely and simultaneously, the eurozone may enter a virtuous circle whereby lower sovereign risk, stronger banks and higher growth support one another to push the region out of the crisis. Obviously, institutional reforms must be carried out at the same time so that countries do not have to go through the same costly crisis-resolution measures in the future.

Naturally, countries will not take all these steps given the lack of trust and coordination. The muddle through approach not only prolongs the crisis, with negative repercussions for the unemployed, but it will also mean that the EMU will remain vulnerable to economic and political shocks. The risk is that the simultaneous private and public sector deleveraging in GIIPS under this scenario pushes them deeper into the red, which could have profound social ramifications.

Should I stay or should I go?

The lack of ambition to (i) end the current crisis and (ii) implement more institutional reforms to avoid future ones has made some advocate the break up of the monetary union. In this sense, the EMU is often likened to an unpleasant marriage that must end in a divorce. Exit from the euro even has the added benefit for GIIPS as they can allow their currencies to depreciate instantly, instead of suppressing wages that hampers private sector deleveraging, thereby benefiting from higher price competitiveness. The core countries benefit too since they retain power over their tailor-made monetary policy. Not to mention that they will no longer need to write ‘blank’ cheques for the profligate ‘Southerners’.

In our view, however, a divorce is neither necessary nor desirable. The costs of a potential break-up of the euro would be enormous. This would, therefore, be a very unattractive policy option for all the countries involved. We have identified at least five sets of economic costs that are associated with partial (individual countries leaving) or total dissolution of the single currency.

First, the continuity of contracts implies that once a country leaves the euro, it may not be able to convert its euro denominated liabilities to its own currency. Apart from complete bankruptcy of an exiting country, a weak country will see its net liability position shoot up in its new currency thanks to sharp currency depreciation. It is also unattractive for strong countries to leave as they will see the value of their net assets as
expressed in their new currency decline because of strong appreciation. Second, the country leaving will immediately lose access to the Single Market under current treaties. This will be a huge blow to the export sector. Third, the exchange rate risk re-emerges. This will result in the need for additional buffers in international financial flows, but also makes the international fragmentation of production chains and the ensuing trade flows less attractive. Fourth, the intra-eurozone trade would fall significantly. This will be a heavy blow for the financial sector, companies, households, the tax base of governments and the general standard of living of the eurozone population. Fifth, it is an illusion to expect that any country can simply leave the euro in an orderly manner. There will inevitably be many months between the time that the exit is announced and the actual reintroduction of the national currency. In the interim, everyone will move their money to the safest haven. Collectively, this can only result in complete chaos, which would make the collapse of Lehman Brothers seem like child’s play.

Thus, getting marriage counseling makes more sense than calling the divorce attorney. And the resolve of the policymakers in pressing ahead with further integration, instead of booking their exit ticket, underscores this assessment.
What’s in it for me?

To be clear, we are not supporting the eurozone just for the sake of it. As we have described, the costs of going back are immense. This is in fact why some joke that the EMU, like the Australian bird with the same name, cannot walk backward. We do acknowledge, at the same time, that the transition towards deeper political and economic integration is going to be very challenging. But the effort will pay off in the long-term, in our view. If all goes according to plan, we shall continue to benefit from the Single Market and the increased level of economic, fiscal and financial policy coordination. Furthermore, the reforms taken by the eurozone countries will eventually push long-term growth rates upwards in the whole region, to the benefit of all European citizens.

In specific, company executives operating in the core countries are likely to benefit significantly from eurozone’s transition towards an OCA. To appreciate this, we can look at the relative institutional and economic strength of the eurozone members (figure 8, left panel). This is based on six indices, which broadly measure (i) how easy it is to do business, (ii) the difficulty in getting goods across borders, (iii) the level of corruption, (iv) the level of innovation, (v) the level of competitiveness and (vi) the educational attainment of the workforce. To compare countries, a z-score is constructed in order to interpret relative positions. The greater a country’s z-score, the stronger its institutional setup and economic potential. The lower the country’s z-score, the higher the catch-up potential.

Figure 8: Catch-up potential

Source: Rabobank calculations
Unsurprisingly, the core countries come out on top when compared to GIIPS. Ireland being an exception though. This shows that there is certainly a huge upside potential when it comes to the Southern European countries. Those who support the Southern members to leave the euro must realise that these countries will no longer be under any pressure to carry out structural reforms to close the gap with their peers in the North. Once outside the EMU, they may resort to the usual recipe of currency devaluation and high inflation that plagued their economies in the past. Most importantly, the elimination of the euro in some countries may even place the internal market and the economic integration process on a slippery slope.

Some argue that the eurozone is already marginalised by the rise of the emerging markets (EMs), especially Asian countries, so why must we bother with the eurozone at all? The emerging world currently accounts for around half of the world’s economic activity and no less than 82% of its population. And thanks to their faster growth, economic opportunities lie outside the eurozone.

Although no one can contest that economic growth is very important, we would argue that many other factors determine a country’s attractiveness for businesses (see Bruinshoofd, 2013). For exporters, a country’s relative income/prosperity is very relevant because consumers of richer nations can afford to purchase more luxury/durable goods. The scope for selling those same goods in the EMs can expand rapidly with sustained growth.

But it is necessary to realise that most of these markets still have a long way to go.

To illustrate this, figure 8 (right panel) shows the prosperity levels of various countries. The figure demonstrates that the EMs still have an enormous amount of ground to make up in terms of per capita income. So in Europe, we may look at the growth figures in the EMs with barely concealed envy but we would hardly want to swap their growth for the size and prosperity of our sales markets. This holds true today and will certainly continue to do so for the next few decades.

The eurozone is not only attractive as a sales market, it is also an excellent location for firms to operate in. If we look back at figure 8, we see that the EMs are actually ‘weaker’ than GIIPS when it comes to institutional strength. The eurozone offers a stable business climate
with relatively low levels of corruption and red tape. Moreover, firms operating at the higher end of the value chain need an educated workforce, an environment conducive to innovation and high level of competitiveness. Again, the EMU offers that more than the EMs.

Thus, if the crisis is successfully defeated and the eurozone is put on a stable path, the region will continue to be attractive for doing business. Actually, the upside potential for GIIPS should not be underestimated given the numerous amount of reforms they have been implementing since the start of the crisis (figure 9, left panel). In time, the periphery countries will not only become a major export destination for the core countries, but also become highly interesting locations for investment. We must not forget that the periphery countries have improved their competitiveness in the past years, which has led to a sharp correction in external imbalances (figure 9, right panel).

Figure 9: Fundamentals of GIIPS improving

Source: OECD, IMF, BIS, Reuters EcoWin, Rabobank
Conclusion

The eurozone is going through some choppy waters at the moment. As such, there is a lot of resentment towards the monetary union nowadays. This is understandable given that the architects of the euro did not fully appreciate the negative consequences of a sub-optimal currency area. The absence of an effective fire department made the situation worse and resulted in millions of jobs being destroyed. At the hour of need, the ECB stepped in to stave off a complete collapse of the union. This has helped buy some time, but it is not enough to put the eurozone on a stable path.

Against this backdrop, policymakers have decided to hasten the integration process. Fiscal and economic coordination amongst Member States is enhanced and a banking union is in the making. Although these institutional reforms are welcome, they do not go far enough to completely make the EMU immune to crises in the future. What’s more, the current crisis will not be sufficiently addressed if short-term measures are not taken to tackle the combination of fiscal, banking and growth crisis in the euro area head on.

In our view, the most likely scenario is that the eurozone problems will not go away overnight. The European leaders will continue with their muddle-through approach for some more years. The upshot is that the periphery countries will eventually come stronger out of this crisis if given enough time. And this should benefit the entire monetary union, especially businesses in the Northern European countries. As the saying goes, “all good things come to those who wait”.

Colophon

**Author**
Shahin Kamalodin

**Editing**
Allard Bruinshoofd
Wim Boonstra
Enrico Versteegh

**Project management**
Maartje Wijffelaars

**Infographics**
Reinier Meijer
Selma Heijnekamp

**Art direction and production**
Click Communicatie, Utrecht

**Contact address**
Rabobank Nederland
Economic Research Department
Telephone: + 31 30 216 26 66
E-mail: economics@rn.rabobank.nl
www.rabobank.com/economics
www.rabobank.com/outlook

**Used country abbreviations:**
AT = Austria
AU = Australia
BE = Belgium
BR = Brazil
CA = Canada
CH = Switzerland
CN = China
DE = Germany
DK = Denmark
ES = Spain
FI = Finland
FR = France
GB = United Kingdom
GR = Greece
ID = Indonesia
IE = Ireland
IN = India
IT = Italy
JP = Japan
MX = Mexico
NG = Nigeria
NL = Netherlands
NZ = New Zealand
PH = Philippines
PT = Portugal
RU = Russia
SE = Sweden
TR = Turkey
US = United States
VN = Vietnam

| Outlook 2014 | Don’t throw the euro out with the bathwater |
Disclaimer

The text of this publication was completed on 11 September 2013. In creating the text, we used sources we consider reliable. These data were incorporated into our analyses with care. Rabobank Nederland accepts no liability whatsoever in the event that any data or forecasts contained in this publication contain any inaccuracies. Use of the contents, or part of the contents, of this publication is permitted only provided that the sources are listed.

The information provided by Rabobank* in the Outlook documents or through its websites does not constitute an offer, investment advice, or any other type of financial service. While the information provided by Rabobank is based on sources considered reliable, the accuracy or completeness of this information cannot be guaranteed; it represents general information that is subject to change.

No rights can be derived from the information provided. Past performance does not guarantee future results. Rabobank and any other parties providing information in this publication and on the websites listed therein accept no liability whatsoever for the contents thereof or of information provided on or through the websites. Rabobank accepts no liability whatsoever for the contents of this publication or of websites it does not maintain itself and to which this publication refers or that refer to Rabobank websites.

The user of the information is responsible for the choice of information and any use thereof. The information may only be used by the user personally. This user is prohibited from transferring, reproducing, editing or disseminating the information. The user is required to comply with the instructions provided by Rabobank regarding the use of the information. The laws of the Netherlands apply.