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Headline: Why the euro will survive

Why the euro will survive

With low public debt and deficit, and limited fiscal problem, the eurozone pips US, UK and Japan economically

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THE eurozone's economy is stronger, more robust and sounder than the US, the Japanese and the British economies. This has escaped headlines, but is nevertheless true.

Public debt and deficit measured against gross domestic product (GDP) is lower. Contrary to the United States and Britain, the eurozone is not running a deficit on its current account vis-à-vis other countries making it hostage to foreign creditors.

Unemployment is high (11 per cent), but a realistic comparison shows that despite lower official figures due to omitting workers no longer looking for a job, American unemployment is at least as bad.

Growth is clearly higher in the US (2 per cent) but achieved through splashing several trillions of dollars, eroding whatever confidence was left, pushing the private sector towards deleveraging debt, thereby keeping demand low.

The eurozone faces many challenges that must be dealt with at the same time. But even taken together, they do not constitute an insurmountable obstacle.

The first is public debt and/or deficits. The eurozone as a whole is doing well. The public debt is 91.8 per cent of GDP compared to more than 100 per cent for the US, 91.2 per cent for Britain and 230 per cent for Japan. The budget deficit is forecast at 3.2 per cent for 2012 with the corresponding figures being 7.6 per cent for the US, 6.7 per cent for Britain and 8.1 per cent for Japan.

Furthermore, both the debt and deficit are expected to be on a falling trajectory. In fact, the eurozone is close to a surplus on the primary balance – defined as the budget balance excluding net interest payments, a luxury none of the other three economies enjoy.

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Weathering the storm: *The eurozone faces many challenges, but they do not constitute an insurmountable obstacle. The euro area is already turning its economy around under agonising conditions, and debt and deficits are being brought under control; something the US, Britain and Japan have been unable to do*

The fiscal problem is confined to three to four countries: mainly Greece and Italy and to a lesser extent Spain and Portugal. The problems are smaller than the picture given by many financial newspapers. Italy's debt is 123 per cent of GDP, but its deficit only 2 per cent forecast to fall to 1.1 per cent in 2013. Moreover, Italy has a surplus on its primary balance.

Spain's debt is 80.9 per cent and its deficit 6.4 per cent and expected to be marginally lower in 2013. We read a lot of bad news from Greece. But the good news is that its debt ratio is stabilising around 165 per cent of GDP and its primary balance is in surplus.

Looking at fiscal consolidation among industrialised countries over 2011-2013, the top three come from the eurozone (Spain, Portugal, and Greece) all improving by more than 5 per cent of GDP with Italy just below 5 per cent – the fifth on the list. The US is eighth with around an improvement of around 2.5 per cent followed by Britain with just above 2 per cent and Japan about nil.

This reveals a gigantic effort is underway in the eurozone, under political and economic stress rarely seen in modern economic history.

To prevent future fiscal problems by individual member states, the eurozone has agreed on a fiscal stability treaty introducing fiscal discipline. A litmus test of how the Europeans judge it came when Ireland submitted its ratification to a referendum. Some 60 per cent of voters voted "yes".

The Europeans realise the gravity of fiscal discipline, but as the new French President Francois Hollande has made clear, they also want to strike a balance between growth and austerity.

There are rumours about a fiscal union preventing member states from lending above a specified ceiling through the establishment of a central institution to which member states have transferred sovereignty.

The second big problem is a banking crisis. Hardest hit were Ireland that seems to be working itself out of the woods, and Spain which has received support to prop up its banks. The 100 billion euro (S$160 billion) provided to Spain is manageable for the eurozone's rescue funds. A number of Italian banks were recently downgraded by Moody's, but generally its banking system appears to be in better shape, being less exposed to soured property loans.

When the crisis started a couple of years ago, it was obvious that a number of banks, in particular German and French banks, would be hit hard if the Southern European countries faltered.

That was indeed one of the explanations for the tactic that was followed – buying time for the creditor banks to improve their balance sheets and thus enabling them to withstand losses when forced to write off some of their claims.

This tactic looks to have achieved its purpose. Europe's major banks remain afloat despite their reckless lending to Southern European countries that was partly responsible for the crisis in the first place.

The way ahead is to build some kind of banking union with a centralised regulator, a bailout fund, and a European Union (EU) deposit insurance backstop – measures that should have been introduced long ago.

Competitiveness gap

The third problem is the gap in competitiveness between Northern Europe and Southern Europe. The hard truth is that Greece, Italy, Spain, and Portugal suffer from archaic economic structures with licences, regulations and monopolies imposing heavy transaction costs on the economy.

There is no easy way around it, but to reform the economy and go through a couple of years of protests from those being deprived of their privileges.

Some observes advocate quitting the eurozone and depreciating national currencies. That will keep these countries going for a limited number of years, and then they will be back to square one, only poorer through the deterioration of their terms of trade – that is, paying more for imports and getting less for exports.

This is difficult to swallow and some observers refuse to admit it, but their membership of the eurozone will force these countries to embark upon reforms which actually should have been undertaken many years ago. Without such reforms, they will continue on a downward spiral whether they are within or outside the eurozone.

Based on this analysis and the policy responses implemented or in the pipeline, the scoreboard for fulfilling the four conditions to form an optimal currency union looks like this:

◆ Converging economies responding broadly similar to outside economic shocks. Compared to the US economy, the eurozone does not seem to be far off this mark. Its economic and industrial structure may not be perfectly congruous, but is good enough to warrant a satisfactory score.

◆ Labour mobility. Conventional wisdom says that the European scoreboard is bad, but comparisons with the US shows that the difference is not so large after all. One study a couple of years ago finds that in the US, 2.8 per cent of working age residents move from one region to another. The corresponding figure for the EU is 1.21 per cent. Even in the US with high unemployment only one out of 35 workers move. This does not support the thesis of labour mobility as a major factor for adjustment inside an economic and monetary union. In fact, a study a couple of years later showed that from 2007 to 2010 when labour mobility should have played a role in adjustment, it came to an almost abrupt halt with the lowest figure since 1945.

◆ Capital market. The eurozone lacks a banking union, but as outlined above, it is on its way. And with free capital movements and rights of establishment, the scoreboard may not be bad.

◆ Fiscal transfers. Many observers point to the small size of intra-eurozone fiscal transfers combined with absence of rules for fiscal discipline as a major culprit for the calamities – and they are correct. This was well known when the treaties were drafted, but the sentiment was that member states would adhere to the limits set for public deficits and public debt inscribed in the treaty; alas, they did not do so. With the new fiscal pact probably followed by a genuine fiscal union transferring sovereignty to a central institution, this bridge may be crossed.

When the treaties were drafted and the single currency was introduced the global economy was very strong. That coloured the outlook, luring experts and politicians into a complacent attitude. Had they known that a full blown financial crisis would hit the world in 2007-2008, they would surely have chosen another road.

Observing the eurozone facing the crisis – part of it due to the US sub-prime bomb, part of it due to its own failures and shortcomings – some observers may ask too much of the eurozone compared to other economic and monetary unions. The idea that a member state can leave and subsequently depreciate its own currency is in the back of their minds.

They overlook the fact that depreciation is not an end in itself. It is a policy instrument to achieve economic goals. There is nothing depreciation can bring about that cannot be achieved through fiscal and monetary policies.

The plain fact is, however, that even if crisis management could have been better, the eurozone has not done so badly. It is turning its economy around under agonising conditions. Debt and deficits are being brought under control; something the US, Britain, and Japan have been unable to do.

The member states are supporting each other. The political will to stay together and weather the storm is visible for all who want to see it.

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