The Euro War that Won't Happen (ARI)

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Theme: The pressure being exerted on the Eurozone by the markets is driving the European integration process.

Summary: The hectic activity of the Eurozone markets in 2010 could reignite at any time during 2011, although this is unlikely to endanger the existence of the single currency. The euro's weakness or threats to its integrity must not be confused with the threat of its extinction. Neither should one conclude that a hectic year has hindered the progress of European construction. On the contrary: to date it has done nothing but boost it.

Analysis: It was exactly a year ago that the Eurozone structure began to shake: it would quake throughout almost all of 2010. At the end of the year, and stunned by an earthquake of such a magnitude, some concluded that European construction had remained static for 10 years. Pity! A massive transformation had gone unnoticed under their radar: a period of less than 12 months has witnessed the birth of the embryo of a European debt agency which, under the name of European Financial Stability Facility (EFSF), could acquire debt of up to €440 billion. Not to mention the first significant intra-European support initiative against adversity that were the rescues, first of Greece, and then of Ireland. Or that the European Central Bank should decide to buy bonds issued by the public sectors of the weaker countries in the Eurozone on the secondary market (where current debt instruments are traded).

If to all the above we add that in the midst of the storm the lines of communication between the most directly affected governments and the European Commission remained open, misunderstandings and inopportune statements were cleared up, reforms were begun which –for better or for worse– moved forward in the coordination of policies and that the principle that to speak of the euro is to speak of the European project was established (all between March and December of 2010), the conclusion is fairly evident: the balance of the crisis, with regard to institutions, appears, for now, to be extremely positive. And more so if it is recalled that for the most part of 2010, the opinion that seemed to prevail was that another recession was approaching, which would lead to a double dip in the US, that there was an acute danger of deflation and that Germany was no longer interested in the European project, which fuelled the feeling of every man for himself.

The Euro War 'N'Aura Pas Lieu'

One of the most common misapprehensions during 2010 was that which identified 'the weakness of the euro' with the 'crisis of the euro' (and which, in turn, mistook this for a threat to the 'integrity of the euro').

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However, just by observing the evolution of the common currency since its creation in January 1999, a period stretching from that time to the beginning of 2004 (that is, a period of five full years, accounting for 41% of its existence) could be identified in which the euro had been much weaker against the dollar than at any time during 2010.

What were seen to be 'attacks against the euro' were nothing more than spates of sales of euro-denominated bonds and debentures issued by the Eurozone States which at that time had a larger portion of debt expressed as a percentage of GDP; or had public deficits that were hard to maintain for much longer; or that had economic growth problems that led to doubts as to the generation of income to pay the debt. At a second stage, doubt centred on the solvency of the banking systems of some of these countries. Meanwhile, the rate of the dollar against the euro moved within the same range as that of 2004 to 2009.

Two-speed Communication

The year 2010 saw the return of an expression typically used in the 1990s: that of the two-speed Eurozone which traditionally divides the nucleus from the periphery. At the same time, what was happening was a double-speed process setting politicians against the media: the former at the expected slow speed of decision making and the latter at the very rapid speed brought about by their search for interesting things to tell their readers (something which, if in the past was the object of daily tension for the press and intra-day tension for television networks, has now become online and permanent tension for all). This means that the slow and measured pace required for deliberation and decision making appears to be an absence of purpose, or even incompetence or idleness.

The fast pace that the media reflects so aptly is not only the result of its own need to maintain the attention of the reader, viewer or Internet user, but is rather a reflection of the speed at which events are happening in the capital markets, where the latest technological developments have enabled a significant reduction of the latency of systems and achieve instantaneous trading.

The Abyss can Wait

Though admitting that there may be a dose of every flaw that one may possibly imagine, what is undeniable is that the European governments have made decisions at the appropriate times, almost always at the edge of the abyss, albeit with the awareness that if the agreements were not reached on each occasion, a summit would have followed (also at the edge of the abyss) where the objective would have been achieved.

It is true that each postponement of the right decisions rendered the solution to the problem increasingly hard and led to a rise in the cost of the debt to be issued by each of the affected countries, but it is also true that changes do not usually occur until things are mature and old structures do not usually disappear until the new ones become obvious. Not forgetting that the delay in making some of these decisions was also a way, deliberate or not, to indicate to the governments of some countries with problems which steps should be taken, so much so that the delay ended up becoming one of the parameters in the equation to be solved.

Although the crisis began during the first days of February 2010 (with the first significant drop in European stock exchanges), the most poignant moments occurred towards the end of April and beginning of May (with the four-fold effect of the rescue of Greece, the creation of the EFSF, the start by the ECB of the purchase of public debt and the forcing of the Spanish government to make adjustments in public spending) and at the end of November (rescue of Ireland). Three months thus passed between the clear identification of problems and the first outcome, and even seven more months until Ireland was rescued.

It is interesting to note that the pace which the 2010 crisis reached at its two peak moments is extraordinarily similar to that of the European Monetary System (EMS) timeline in 1992-93. At that time the quakes began as a result of the rejection of the Treaty of Maastricht by referendum in Denmark (June 1992) and reached their first fever pitch in September of that same year (three months later) when the UK and Italy abandoned the EMS and there was a devaluation in the peseta and other currencies. Later, after a few months of relative calm, another sharp episode of instability would emerge in April-May 1993 (seven months later) which ended, among other things, with two successive devaluations of the peseta and a pervading sensation of chaos which the coincidence in time with a general election campaign only served to exacerbate.

Three months later (August 1993) there would be a less spectacular, but in fact more critical, moment: new devaluations and the broadening of the fluctuation bands for the cross currency rates of EMS currencies (reaching a 15% spread in some cases). It goes without saying that requiems were played at that time for the EMS and the project was deemed to be over. However, hey presto!, a little over five years later the euro was born as the culmination of this project.

Nowadays, and having observed the parallelism between what has recently happened and what occurred between June 1992 and May 1993, one can but wonder whether the parallelism will be complete and whether the crisis within the Eurozone has still to endure a great trial during which everything will be ‘at the edge of the abyss’ once again and after which the great European project will be both hopelessly lost and consolidated. And whether the timing shall be once again the same, which would place the resurgence three months away from the previous one, that is, around March of this year

A Great Federal Project Should Have a Single Treasury
Without resorting to the colourful and exaggerated language so well ridiculed by some of our classical writers (whether the object of their derision were baroque or romantic authors), there does seem to be agreement on the fact that we are witnessing the great trial by fire of the single currency project and the project itself. And, as in all trials by fire, a useful alternative may be to escape forwards to speed up the processes and end up achieving goals that, until recently, seemed unattainable.

This is what seems to have happened in the Eurozone to date and this is what could carry on happening. At least the bases for the acceleration of the processes are now in place, founded on principles that practice has turned into guidelines:

- Money for sovereignty. It is not the first time in history, nor shall it be the last, in which countries facing difficult situations accept anything ranging from interference to total transfer of sovereignty in exchange for financial aid. This has been done by all countries that have received aid from the IMF (among them the UK in the years 1977-78, when it received aid from the IMF and the BIS) as did Newfoundland before its final integration into Canada. This is being done in a less obvious way by all EU countries and, among them and to a greater extent, by those who jettisoned their own currencies and central banks.

- Creation of the embryo of a European Debt Agency. It seems that the EFSF or European Financial Stability Fund will end up being nothing less than that. Although right now it might seem distant (and although its role for the time being is limited to obtaining funds to help countries in trouble) a somewhat more versatile role is currently under discussion: that instead of only issuing, it should guarantee the issues of these countries, that it should help to reduce the cost of the debt for Greece by issuing a greater volume than that originally planned and that it should grant loans to Greece to enable it to purchase its own debt in the market, currently traded very much below par (that is, under 100% of the principal).

- ECB intervention in debt markets. Failure to do so placed the Eurozone at a disadvantage against what is usual practice by the Bank of England, the US Federal Reserve or the Bank of Japan, although that intervention has not gone so far –as far as we know– as to sell European public debt cover using the CDS (Credit Default Swaps) market. This last resort, in addition to allowing it to use the leverage provided by derivatives (leverage readily used by other market members), would provide the income typical of an insurance premium. In fact this use of CDSs could be also made by the European Financial Stability Fund: to sell CDSs of a country's public debt is one of the ways available to guarantee that debt.

- 'Well understood solidarity'. This is what is being done in Germany and France, lending their resources and their ratings to the EFSF in exchange for the adoption of fiscal rigour measures, something that is not highly welcomed by the affected countries but that was inevitable in the next one or two years. Although there is a surplus in world savings to fund government deficits, nobody except for the US can expect the sustained funding of an enormous deficit (in the Spanish case this translates into the fact that nobody can go around for more than one or two years spending double what it earns).

- Coordination of fiscal and economic policies. Times of economic crisis help to move in this direction for, although it would be much easier to do so in times of prosperity, with more room for manoeuvre, it is hard to find a government willing to 'upset the apple cart'. If someone has doubts about this, just think back to the real estate bubble in Spain and other countries: everybody was aware that the trend was unsustainable but nobody did anything to soften the blow.

- Convergence in productivity, which seemed to be in the 1990s an essential basis for the creation of the single currency, now returns 'with a vengeance'. Irrespective of one's opinion on the proposal, it is clear that as it stands, or a moderate variation thereof, it would strengthen the bases of the system and would render the whole more competitive against the outside world (a caveat: there are countries, like Spain, whose competitiveness abroad is habitually being undervalued; living proof of this statement is the good performance of exports).

- And, in short, a Single European Treasury. After what happened in 2010, even the possibility of creating a Single European Treasury no longer seems a distant and totally unrealistic goal. In fact, the creation of the EFSF is also an important step in this direction as the European Debt Agency and the Single Treasury could be created as separate institutions or as part of one single institution. When we speak of creating a rescue mechanism to replace the EFSF as of 2013, with much clearer rules and much greater financial power, we are really speaking of a federal mechanism which, regardless of the name it goes under and the role it is given, will be carrying out the duties typical of a Single Treasury. The extent of which such an attribution of duties will depend on the political time and, above all, on the pressure brought to bear on Europe by the so-called 'bond vigilantes', that shady figure which according to one of Bill Clinton's advisers, had the ability to intimidate everybody.

The need for a Single Treasury/European Debt Agency will become more evident at one of those times of intimidation, when we come to understand that one of the defence barriers against speculative movement is that Europe is not fragmented into small national debt markets in which it is much easier to move prices due to less liquidity. A unified European public debt market would be at a level with that of the US (around US$9 trillion) and would compete with it in both depth and liquidity which, moreover, would consolidate the euro as a global reserve currency at a time like the present in which the sustainability of the US deficit is being questioned. And in order that no country (Germany or France) should complain that their funding becomes more expensive with this system, the Single Treasury could assign the funds obtained at different prices for different countries, with prices set according to historical price of the debt of each, the rating at the time or both at once.

Banks, Real Estate and Eastern Europe
The period of instability being experienced worldwide still has between five and 10 years ahead of it. We must consider that problems will come in fits and starts: commodities, instability in the Middle East, the real estate bubble in China, interest rate rises… But there is also another one, surprisingly set to one side for the last two years: the risk of European and US banks in Eastern Europe. The EU should have an intervention mechanism ready for when the banks turn their attention to this matter. This is where the Stability Fund could end up as a multitasking body (although it could be divided into three bodies with different roles: Single Treasury, European Debt Agency and 'Restructuring Fund') as Europe lacks the support bodies that the US and China have, be they Government Sponsored Enterprises (Fannie Mae, Freddie Mac) or Asset Management Companies.

Conclusion: The difficulties of the year 2010 have been a nightmare for Eurozone countries. Unless a miracle occurs, the incorrectly named crisis of the euro might become a blessing that has enabled us to get ready to face more difficult times. In fact, it would have only been the rehearsal of something much more complicated yet to come.

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