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- How is Europe dealing with the financial crisis? What future for the EU?
- Professor Joergen Oerstroem Moeller, Visiting Senior Research Fellow at the Institute of Southeast Asian Studies (ISEAS), Singapore. Adjunct Professor Singapore Management University & Copenhagen Business School.

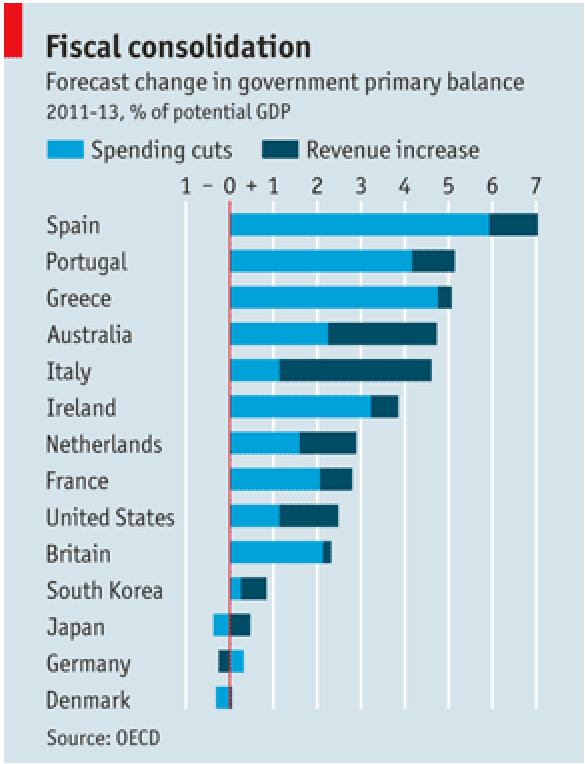
I. Crisis. What crisis?

- Global crisis – actually not much to do with EU or Euro.
- Global debt.
- Countries have overspent.
- Lack of discipline and coordination.
- Rise in commodity prices.
- Shift from the West to emerging markets – Asia.

II. Something rotten in Euroland? Yes and no!

- Deficit Gov budg. EUROzone. 2009: 6,2% , 2010: 6%, 2011: 4,2%, 2012: 3,6%, 2013: 3,2%. Compare (2011) US 9,1%. Japan 8,3%, UK 8,8%.
- Sovereign debt. 2011. US 100%, Eurozone 85%, UK 80%, Japan 230%.
- Primary balance 2011 (excl interest payments): EUROzone 1,5%, US 8%, Japan 8,9%, UK 5,6%.
- But not evenly spread among member states. The South of Europe.
- Can the EURO work? Yes but needs treay change.

II. Something rotten in Euroland? Live within our means – who means it? Source: The Economist 26 May 2012.



III. EU/Euro. Analysis. 1/9.

- The history of the European Union (EU).
- Crucial points. 1) Franco-German reconciliation, 2) Euro is the – so far – final step in a long proces from customs union to single market to single currency.
- Why? 1) better off inside than outside, 2) problem grinder, 3) stability, security, peace, growth.
- From six to 27/28 and queue to get in.
- Why did the original six embark on this venture and Britain chose to remain outside?

III. EU/Euro. Analysis. 2/9.

- Sovereignty. NOT give up sovereignty but pool it or transfer it to exercise it in common with adjacent countries pursuing analogous political goals.
- Because nations by so doing enhance their influence on the international economy compared to being alone – otherwise not do it, of course.
- Economic globalization lifts economic transactions out of natinal framework. To be in control political steering mechanism must follow. Example: Haze!

III. EU/Euro. Analysis. 3/9.

- The single currency's history goes back to 1969.
- 1970s chaos on global currency markets - depreciations and appreciations proved disruptive.
- 1979 EU decides to opt for fixed but adjustable currency rates. Fixed why? Adjustable why?
- 1992 decision on single currency, Euro. 1993-1994 attacks on the system, but it survived.
- 1999 the Euro as denominator, 2002 the notes in your hands.
- Not out of the blue, because the other currency systems failed.

III. EU/Euro. Analysis. 4/9.

- Flexible currency rates worked until1970s-80s.
- Ec. Glob. open economies. Currency rate changes were soon eaten up by domestic prices and wages. Depreciation gave a competitive advantage, but wages and prices rose correspondingly.
- Outsourcing more important than currency rates.
- The disadvantage was underminig efforts to pursue stable domestic policies. Inflation even stagflation (stagnation and inflation).
- EU conclusion: Flexible current rates not a suitable policy instrument under ec. glob./open economies.

III. EU/Euro. Analysis. 5/9.

- The German point of view. Stability policy. Create confidence, if so growth is compatible with low inflation. Successful in Germany.
- Problem? In EU if other countries depreciate currency Germany's competitivenes undermined jeopardizing the German model.
- Answer: Get the other EU members to follow same economic model as Germany. This explains Germany's interess in Euro.
- The other's interest? Follow the German success!

III. EU/Euro. Analysis. 6/9.

- What would have happened if Euro had not been there?
- Competing competitive depreciations throwing EU into chaos and disrupting global financial markets further.
- The Euro has been a bulwark against global currency turmoil.
- A Greek depreciation would have served to preserve a rotten economy.

III. EU/Euro. Analysis. 7/9.

- Currency rate changes is a policy instrument.
- Nothing it does cannot be achieved by fiscal policy, monetary policy or a combination of both.
- Wrong to say that a national currency - Greece - would have been able to solve its problems.
- Imbalance: overconsumption out of line with production capacity. They must be brought into line.
- It can be done in many way. Depreciation, real income falls because import prices go up, poorer!
- Crucial. Domestic burden sharing!

III. EU/Euro. Analysis. 8/9.

- No one foresaw that weak countries could borrow ‘unlimited’ sums of money paying the same interest rate as the strong members. Misissipi - Massachusetts. Banks went for profits, did not exercise due diligence.
- Fiscal rules correct, but not respected. Germany - France 2003/2004.
- And then came the US financial crisis hitting the Euro showing its weaknesses.
- The system flawed but not irreparable.

It's All Connected: A Spectator's Guide to the Euro Crisis

Charting the web of debt exposure among sagging economies.

HOW TO READ THIS CHART Arrows show **imbalances of debt exposure between countries.** Arrows point from debtors to their bank creditors; arrow widths are proportional to the balance of money owed. (Figures, released last week, are from June 2011, in billions of dollars.)

For example, French borrowers owe Italian banks $50.6 billion; Italian borrowers owe French banks $416.4 billion. The difference — their imbalance — shows France's banking system more exposed to Italian debtors by about $365.8 billion.

There is no complete accounting of debt between countries. The Bank for International Settlements compiles the most detailed data, listing amounts that banks based in one country are exposed to by debtors in other countries, both government and private.

THE COLOR OF TROUBLE The risk to countries' debts and economies is indicated by color:

More worrisome →

COMPARISON OF ECONOMIES Circle sizes indicate the scale of each country's gross domestic product, in dollars.

SCALE OF GOVERNMENT INDEBTEDNESS Each country's **gross government debt** as a percentage of its G.D.P., as tallied by the International Monetary Fund.

Spain
G.D.P. $1.4 TRILLION
56%

Bill Marsh is a graphics editor at The New York Times.

THE global financial system is highly interconnected. So problems in one part of the world can reverberate almost everywhere else — risking a cascade of default, contagion, contracting credit and collapsing economic activity. Exhibit A now is Europe.

European Union leaders are meeting this week to at last deal with a debt crisis rattling investors worldwide who once thought lending to euro zone countries was virtually risk-free. The graphic here helps you see the intertwined complexities.

1 It Starts With The Euro ...

In 1999, most countries in the European Union adopted the euro as a common currency. This union allowed poorer countries like Portugal, Italy, Ireland, Spain and Greece to borrow money at the same low interest rates as rich and financially prudent Germany, even though their inflation rates were higher. That gave them a strong incentive to borrow.

2 ... And Goes Bad In Greece ...

Greece financed a large public-welfare state and built up huge debt for its size that it has scant hope of repaying now. In 2010, European financial institutions began bailing out Greece (later Ireland and Portugal, too); lenders were prodded to agree to modest, voluntary debt write-downs, or "haircuts."

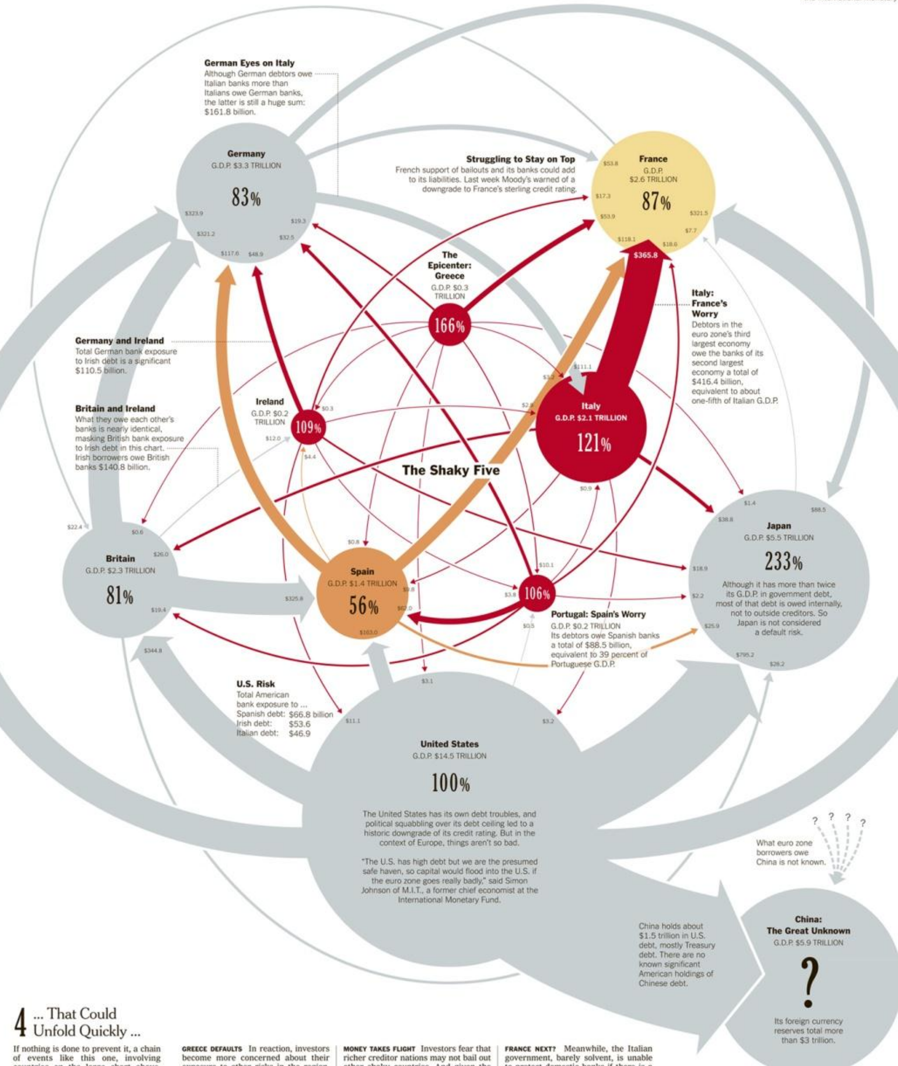
But Greece still needs money. And its credit bill grows ever larger as lenders charge more and demand government cutbacks, which in turn have provoked civil unrest. After years of propping up the spendthrift Greeks, the Germans are fed up.

The problem is, a chaotic Greek default could hurt all European banks and pension funds that have extended Greece credit down the years, and maybe cause a wider bank panic. So bailouts continue — for now, at least:

BEST CASE Bailouts in the form of new European credit eventually work. Greece pays down its hefty debts with a combination of growth and continued domestic austerity for years to come.

MORE LIKELY Bailouts don't work. Greek debt grows in an anemic or shrinking economy. The country defaults, either in a negotiated, orderly manner or chaotically, forcing lenders to take big losses either way. But damage could be contained if countries in the euro zone can erect a financial firewall to backstop the credit of the four other shaky nations: Ireland, Portugal, Spain and Italy. This is what the European Union is trying to agree on this week, as France prods a more reluctant Germany.

WORST CASE? See below.



3 ... Threatening Contagion ...

If the firewall fails to materialize, or inspire investor confidence, or proves inadequate, it would be easy to imagine a run on banks, because the single currency makes it easy to shift money across borders from risky economies to safer ones. That and the lack of central banks in each country — those went away with the arrival of the euro — make the euro zone "the ultimate contagion machine," said Kenneth Rogoff, the Harvard economist and co-author of "This Time Is Different: Eight Centuries of Financial Folly."

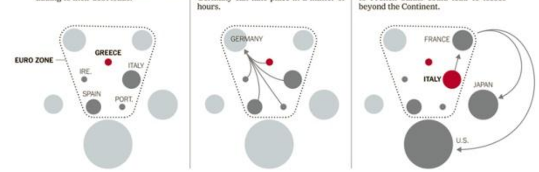
4 ... That Could Unfold Quickly ...

If nothing is done to prevent it, a chain of events like this one, involving countries on the large chart above, could unfold:

GREECE DEFAULTS In reaction, investors become more concerned about their exposure to other risks in the region, especially the other four most troubled economies. Borrowing costs rise for Ireland, Italy, Portugal and Spain, adding to their debt loads.

MONEY TAKES FLIGHT Investors fear that richer creditor nations may not bail out other shaky countries. And given the ease of shifting money across borders in the euro zone, a flood of money from risky economies to safer ones like Germany can take place in a matter of hours.

FRANCE NEXT? Meanwhile, the Italian government, barely solvent, is unable to protect domestic banks if there is a loss of confidence in them. French banks, heavily burdened with all manner of Italian debt, totter. Exposure to French banks could lead to losses beyond the Continent.



Note: The B.I.S. data used here do not include debts between non-bank entities. Figures show amounts that bank systems, based in or controlled from one country, are exposed to debts from borrowers in other countries.

Sources: Bank for International Settlements (bank exposure data; table 9D of Preliminary International Banking Statistics Report, released Oct. 20, at www.bis.org); Simon Johnson, Massachusetts Institute of Technology; Kenneth S. Rogoff, Harvard University; International Monetary Fund (G.D.P. size and general government debt-to-G.D.P. ratios); Congressional Research Service (American bank exposure)

5 ... And Reach American Shores ...

American lenders and money-market funds are already moving their money out of European banks, which are balking at lending to one another, writes the economist Laurence Kotlikoff. "This is exactly what happened before the bankruptcy of Lehman Brothers Holdings Inc. in 2008," he adds.

American banks are heavily exposed to Spain, Ireland and Italy. (American banks' exposure to Greece is smaller and less direct.) On top of this, American exports to the European Union — collectively the biggest American trading partner — could suffer if the crisis slowed European growth and caused the euro to depreciate against the dollar.

6 ... Unless Bailouts Are Big Enough ...

The troubled euro zone could, by some estimates, require about $1.3 trillion to $2.06 trillion in bailouts — an amount perhaps bigger than the Spanish G.D.P. or more than half the size of the German economy.

The bailout fund set up last year by euro zone countries goes by the ungainly title of European Financial Stability Facility. The fund has only about $600 billion on hand. Here are total European bank exposures to the five most distressed economies, according to the Bank for International Settlements, compared with the size of each economy:

		EQUIVALENT PERCENT OF EACH COUNTRY'S G.D.P.
Italy	$837.5 BILLION	41%
Spain	$643.2	46
Ireland	$380.1	184
Portugal	$196.7	86
Greece	$120.8	40
TOTAL	$2.178 TRILLION	

7 ... One of Many Crisis Unknowns

Bank secrecy, government secrecy, a paucity of global financial statistics: all contribute to large information voids that leave experts uncertain. Here is a sampling.

WHO'S EXPOSED TO BAD DEBT? Some banks are more forthcoming than others — there is no consistent disclosure. American money market funds are thought to have significant investment in European banks.

So-called stress tests of big banks earlier this year are now widely believed to have understated the level of bank risk. Meanwhile, banks say they have been struggling to lessen their exposure to bad debt.

WHO INSURED BAD DEBT? Banks and hedge funds sell insurance against investor losses from default by their borrowers. These "bets" that losses won't occur are called credit default swaps.

With defaults in Greece and elsewhere a real possibility, issuers of these swaps could be on the hook for losses that once seemed unlikely. How those billions would be covered is unknown; who, precisely, insured Greek debt is also unknown.

WHERE ARE THESE ECONOMIES HEADED? Signs are not good. Some economists argue that government austerity measures being put in place to cut public debt also dampen economic growth: a hobbled private sector is not hiring, and now neither is the government.

A slow economy generates less in taxes; the debt — which doesn't go away unless there's a default — is not paid down. "When you have a financial crisis, growth is slow for a long time," Mr. Rogoff said.

HOW MUCH IS CHINA OWED? Chinese exposure can only be guessed; whether China will participate in bailouts is uncertain. The same holds true for other big global creditors like Saudi Arabia and other petro-states.

Seth W. Feaster, Nelson D. Schwartz and Tom Kuntz contributed reporting.

III. EU/Euro. Analysis. 9/9.

- The conditions for an EMU to work is:
- 1) Convergence – business cycle - responding broadly similarly to outside shocks, 2) Labour mobility, 3) Capital market, 4) Fiscal transfers. Does the Eurozone fulfil these conditions? Not quite.
- But nor is it the case for the US - Mississippi is still poor - or Australia (Western Australia – Victoria) or Malaysia (Sarawak – Johore) or Indonesia (Bali – Sumatra).

IV. EU/Euro. Crisis management. 1/4.

- EU fumbled facing the crisis, contributed to it growing worse. From the beginning the action plan:

1) Give Greece and other weak countries time to rebalance their economies.
2) Prevent the crisis from being contagious dragging down especially Spain and Italy ‘large’ economies.
3) Give Germany and French banks having loaned recklessly to weak countries time to improve their balance sheets.

IV. EU/Euro. Crisis management. 2/4.

- Some kind of fiscal union with ‘bite’ so member states HAVE TO follow rules.
- But fiscal transfers inside the Eurozone NOT the same magnitude as fx the US because welfare benefits are not the same size. Therefore cannot compare US and Euro.
- Eurobonds – bonds not only nominated in Euro, but guaranteed by the Eurozone as such.
- European Central Bank.
- More European private banking system. Banks must loan among themselves.

IV. EU/Euro. Crisis management. 3/4.

- From the outside.
- US political and economic interests. Britain.
- Global financial institutions.
- China. Yes China will invest in the Euro, but not because of Euro or EU. China will act according to its own interests – not be alone with the USD, not have the USD as the sole global currency, alternative investment opportunities than US treasury bonds.
- Punish speculators.

IV. EU/Euro. Crisis management. 4/4.

- The world is going to see two economic models.
- The European one cutting the coat according to th cloth – however painful it may to get there.
- The American one disregarding debt building up almost insurmountable claims on the US held by foreign countries.
- We will see, but odds are that the new, stronger nations like China will favour the first model.

V. EU/Euro. Outcome. 1/5. Identity.

- Over the last couple of years the European Union has moved towards defining its identity.
- The proposed constitution was a big step in that direction. For the first time a text saying what the EU is and is not plus what Europe stands for. The Lisbon Treaty embodies these elements.
- *Article 1a*. The Union is founded on the values of respect for human dignity, freedom, democracy, equality, the rule of law and respect for human rights, including the rights of persons belonging to minorities. These values are common to the Member States in a society in which pluralism, non-discrimination, tolerance, justice, solidarity and equality between women and men prevail.'.

V. EU/Euro. Outcome. 2/5. Two tier.

- All member states on board?
- No, we will see a two tier or whatever it is called EU with a core of member states pulling together and the rest circling around as more or less loose satelittes.
- The core. Original EU plus some of the Southern Europeans plus some of the Central- and Eastern Europeans.
- Out. UK, Sweden+Denmark, some SE and CEE.

V. EU/Euro. Outcome. 3/5. The core.

- This will not be announced with trumpet fanfares, but it will happen.
- The core maps the course, the rest can follow/quit. Sooner or later it will be formalized, but it may take a while.
- The Franco-German axis still the driver.
- What drives it are self-interest, the prospect of failure is so appaling that they will do it.
- In reality back to pre-1973 with a two tier Europe, but this time inside the same institutions.

V. EU/Euro. Outcome. 4/5. International.

- The changed global picture contributes.
- The US losing strength.
- Russia not knowing whether it wants to be part of Europe or not.
- Turkey gaining strength and influence.
- Ukraine, caucasus – Europe has to respond.
- North Africa waiting for a European response.
- It is dawning upon the European leaders that the time as a sidecar to the US motorbike is over.

V. EU/Euro. Outcome. 5/5. The limits.

- New institutions on the back burner, go slow.
- Not much further integration, but continued deepening of what we have.
- Go slow on enlargement, Turkey not member because Turkey itself declines.
- Not likely that we are going to see a common defense, but more coordination. Europe not building capacity to project power, not willing to do so.
- Can it be an international player nevertheless?
- Yes to a certain extent, but limits clearly visible.

VI. Conclusion. (1).

- A slow growth Europe, but all right. EURO OK.
- Demographics. Stagnant population. Immigration?
- Trimming of welfare societies but still OK.
- Political maturity in the sense of looking for consensus & compromise. This is the European political model.
- A force to be reckoned with in global politics. Ready to shape value based politics, but not to exercise power.

IX. Conclusion. (2).

- The main problem for Europe is as for the rest of the world that
- The political system – liberal democracy – and economic model - market economy - that has driven Europe and the US for two hundred years may have run their course. This is not the same thing as saying that Europe is out – it is a global problem.
- But this is another story!

- Joergen Oerstroem Moeller
- Author
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- joergen@oerstroemmoeller.com.