A "Two Euro Solution" to a Terminal Illness

The problems of the euro have been eloquently re-hashed by the press, market letters, economists, policymakers and politicians. All kinds of suggestions, both good and bad, have been offered. At the end of the day, it seems obvious that the problems of the eurozone are intractable and the disease is terminal. It is now time to think through the process of ending the current monetary regime and try to plan as best as possible for what will likely follow.

The Three Fatal Flaws

The first fatal flaw in the euro creation was that it was a marriage of convenience among countries with fundamentally opposing philosophies. There are in essence two groups of countries with France straddling the divide.

Group One is essentially hard money, free market, financially disciplined and competitively focused. Voters in these countries tend to elect politicians that espouse such principles.

Group Two's philosophical theme is based on soft money, socialism, statism, union domination and weak fiscal discipline. They elect politicians who abide by this view of the world. A deeply entrenched entitlement mentality has been established. This has naturally led to pervasive, deeply ingrained corruption, as there are so many people feeding at the trough. There is a constant jockeying of position to obtain more at the expense of others.   Politicians learn to get elected by bribing voters with their own money. As there are never enough taxes to pay the bills, the government must use the central bank to make up the difference when the bond market goes on strike.

The second flaw is that the marriage was consummated without putting in place a federal fiscal union or independent supervisory authority over budget deficits, excessive sovereign debt build-ups and, possibly most importantly, powerful, pervasive, centrally controlled independent bank supervision. It is entirely understandable why the soft money countries have an aversion to such discipline and strenuously resist when hard money countries try to impose it.

The third fatal flaw is that the Germans allowed themselves, for various historical reasons, to be pressured into the marriage by smart politicians in the other countries. Their mistake was going ahead with the marriage without appropriate pre-nuptials.

The Germans acquiesced against their better judgment because they foolishly believed that the rules they laid down in the agreement would be adequate protection prior to the creation of the needed institutional structure. Their big mistake was to think that those in the Group Two camp would actually do what they agreed to, forgetting that their politicians would continue to promise what they knew could not be delivered.

There were a number of prescient people, Bernard Connolly perhaps the earliest and clearest, who anticipated the inevitable collapse of the euro.[1] However, what no one foresaw was that the economic conditions from the agreement to create the euro in 1993[2] to 2008 masked these fatal flaws. The Group Two countries could suddenly

[1] Bernard Connolly, *The Rotten Heart of Europe: The Dirty War for Europe's Money*, Faber & Faber (June 1996).
[2] The Maastricht Treaty, which had the goal of creating economic and monetary union by 1999 was approved in 1993.

borrow for the first time at interest rates that increasingly converged with those of Germany. Banks became reckless lenders to one and all, particularly for real estate. This created a gigantic bubble in those countries that inflated incomes, profits, tax revenues and, ominously, wages. Fiscal, banking and competitive problems were hidden as long as the bubble was inflating.

Everyone was delighted, even the Germans. They never had the real estate bubble but they did reap enormous gains from their export machine that capitalized on the rapidly deteriorating competitiveness of the peripheral countries. With everyone seemingly a winner and no one a loser, there was nary a voice of warning raised before 2008 that big trouble was brewing, not even from the Germans.

Interestingly, when the U.S. and U.K. housing bubbles broke—and they were the first—the Europeans were quick to point the finger at those two countries and smugly declared that the "Anglo-Saxon free market" model was broken and much inferior to theirs. Four years later, the finger pointing has stopped as Europe struggles with its sinking ship and the U.K. and U.S. are ironically considered safe haven financial systems with 10-year bond yields around 1.6%. While these two countries are hardly paragons of fiscal rectitude and disciplined credit, they at least are not facing national bankruptcy and deep, endless, economic decline.

Until the late June EU summit (the 20th in 3 years), it looked as though the eurozone was heading into yet another death spiral. The agreements reached (see box below) in the late hours appeared to reverse the spiral of the troubled debtors for a few days and the feared collateral impact of that on the various markets. As always, however, these last minute crisis-driven agreements do not address the real flaws in the eurozone and will not solve the fundamental problems of stranded debt, too little growth and extreme cultural differences in attitudes to economic and political governance. Creation of more debt and rearranging who is responsible for the debt (meaning leveraging off Germany's relatively better balance sheet) can only buy time. Trying to fix the ineffective institutional practices of the eurozone now is tantamount to locking the barn door after the animals have escaped.

SUMMIT AGREEMENT POINTS:

- The €100 billion of aid to Spain will go directly to recapitalizing banks and therefore will not appear on the sovereign's books. The bailout loans will not be senior to private debt holders.
- A single bank supervisor run by the ECB will be created, possibly by year-end.
- The EFSF/ESM will be allowed to buy Italian bonds.
- To press on with a fiscal union.
- A compact for growth and jobs worth €120 billion

Reality Check

Group One countries did make some important concessions at the EU summit, as outlined above. However, the key fundamental flaw of the eurozone remains a marriage of two groups of countries that do not have the same values and cultural traditions. The problem is even more complicated because France is still a powerful country within Europe and has been the key partner with Germany in structuring most of the post-war changes in Europe. It is positioned somewhere between the two groups.

Part of France espouses old-fashioned discipline but an even larger and more powerful part has much more in common with Group Two countries in the statist, socialist, over-regulated camp. The recent French election is clearly moving that country even further in that direction.

France is pivotal because of Franco-German geopolitics. This alliance was always seen as a counter-balance to the U.S.S.R. and the U.S., and it was focused on creating enough critical mass in Europe to become a major world player and to put historic rivalries permanently into the past. As France moves further left to placate the entitlement lobby, its competitiveness, deficit and debt will deteriorate further. The country will move more clearly into the Group Two camp and become increasingly sympathetic to their issues, rather than the concerns of Germany and the other Group One countries.

As it stands, France already has some massive problems, existing even before the current leftward shift.

- Youth unemployment of 22%.
- Public debt heading quickly to 90% of GDP.
- Deficit of close to 5% of GDP.
- €33 billion of expenditure cuts needed to meet 2013 targets, yet it has promised to spend more.
- Competitiveness has declined sharply; unit labor costs have been rising 50% faster than Germany's; a current account deficit of €70 billion (2011), yet the new budget raises minimum wage, reduces retirement age to 7 years below Germany's for some workers and makes it even harder to fire workers.
- Government spending is 56% of GDP, one of the developed world's highest.
- Tax burden is also one of the developed world's highest.

- 50% profitability decline has occurred in industrial companies over the past decade.

Group Two countries' problems were not resolved by the Summit. The reality on the ground is that Greece's catastrophic situation is not compatible with eurozone membership. The country is in a 1930s depression—total and youth unemployment is at 23% and 52% respectively, debt is at 160% of GDP and is unserviceable. The country has a huge fiscal deficit, busted banks, no access to capital markets and no effective adjustment mechanism to become competitive and get off the dole. With further defaults and an exit from the euro inevitable, bank runs will continue. Most of the Greek people still remain naïve, convinced that they can keep the euro but end austerity. That is why the bank run has been relatively slow. The new coalition government cannot last long and no government can maintain austerity indefinitely. Before long, Greeks will wake up. Massive capital flight from banks will then occur. Banks will have to be closed and an exit from the euro will be inevitable.

The Path Ahead

As the smoke clears after the EU summit and after the initial big rally in stocks, high-risk bonds and the euro—it is possible to gain better perspective. It would appear that the Group Two countries, while perhaps gaining some time, are clearly not going to find lasting stability. Already, their bond yields have started to back up towards the previous highs:

- Spain: 6.65%
- Italy: 5.98%
- Greece: 25.33%

- Portugal: 10.71%

It is an old truism that countries which cannot find enough money from taxes or borrowing have to get it from the central bank—i.e. print it. If they don't have a central bank, they have a problem which can only be solved by creating one. Greece is now there. Others in the Group Two camp are moving in that direction as indicated by the markets' revulsion for their bonds. The measures recently agreed at the EU summit cannot really change that for very long.

Funding pressures are immense. Greece has been promised €130 billion on the condition that it follows the agreed austerity plan. France, Italy, Spain, Portugal and Ireland need funding (debt rollovers plus deficits) of approximately €2 trillion over the next 18 months. In addition, the euro area banks are in need of roughly €900 billion to cover debt rollovers of marketable securities plus new capital to cover loan losses and Basel III requirements. The deteriorating economic conditions diminish any hope that financing needs will soon start to shrink. Confidence is fragile and there is a widespread perception that the patience of Germany and other Group One countries regarding demands for "joint liability" has run out. Financing for the peripherals is going to dry up. Ultimately, that implies they have to have their own central bank.

The implication is that we are heading in the direction of a "two euro" solution. If managed properly, it would be the least chaotic and expensive outcome. The worst case scenario would be to maintain the status quo and wait until some or all of Group Two countries exit in panic, forcing each to create its own central bank to get the financing required. An early, unmanaged exit from the euro by Greece could well create the sort of contagion that would overwhelm any possibility of bailing out the other troubled debtors and would terrify the public and politicians in the Group One countries.

The Road to Two Euros

As we see it, Germany and the other Group One countries (with France straddling the two groups but shifting toward Group Two) clearly understand the flaws in the creation of the euro. The resulting sovereign debt and banking problems can no longer be patched over, even with conditional lending. That is because there is no hope that the troubled debtors can generate enough growth to allow austerity and to make them solvent within a timeframe that would avoid social and political chaos. The current miners' strike, demonstrations and violence in Madrid is a case in point.

Understanding Germany's strategy is critical. Many have suggested that Germany should be the one to exit the euro. However, for historical reasons, Germany does not want to appear to be the trigger for a break-up of the existing eurozone arrangements. We believe that German strategy, which has been very consistent, is to press on with the sort of reforms that should have been incorporated into the original eurozone formula. These include:

1. A fiscal union putting Europe (i.e. Germany) in control of questionable budgets and debt levels.
2. A banking union with Europe-wide supervision to control member country banks with the power to close them down if necessary.
3. Deposit insurance with a Europe-wide controller and Europe-wide insurance payments and a link to the independent bank supervisory authority.

4. Clarity on the role of the central bank as lender of last resort only to solvent but illiquid banks.
5. Continuation of bailout funds under strict, onerous, conditional terms.
6. Streamlined governance procedures so that each decision does not require 17 unanimous votes. If structured properly with devolution of powers to the new Europe-wide authorities, decision-making would be similar to federal structures such as those that exist in Canada and the U.S.

These are the conditions that Group One countries would require to make a common currency viable. They would take years to be put in place at the current pace. In the meantime, Germany and other Group One countries would avoid any significant increase in joint (i.e. Group One) liability funding for the troubled debtors without demanding increasingly severe conditions and probably collateral (e.g. gold bars, state-owned assets, etc.)

As Group Two countries plus France move deeper into recession with a parallel increase in social and political tension, Germany would effectively make life impossible for the seriously troubled debtors and they would be forced out of the existing euro. Some (Ireland, for example), might try to make the sacrifices to stay. Who actually stays and who goes would depend on political will and social cohesion in accepting the needed sacrifices.

The least chaotic way of managing this process would be to declare a bank 'holiday' over a very long weekend before it becomes obvious to markets. During this 'holiday' period, an announcement would be made that certain countries would remain in the old eurozone regime and the ECB would continue to be their central bank but with new powers to enter into quantitative easing (the polite term for debt monetization) to tide member countries over until they could put their finances in order. This would become a "soft" euro and it would probably open up 30%-50% lower on the first day of trading.

The announcement would also say that the other members of the existing eurozone would use the Bundesbank as their central bank with a new ("hard") euro and all members having agreed to the reforms that Germany has always insisted on. This central bank would be a traditionally independent central bank with a mandate to keep inflation low and stable and to act as lender of last resort only under traditional terms—expensively on good collateral to sound financial institutions. This would obviously be a hard euro.

The benefits of these arrangements are obvious. Group Two countries could resolve their problems the way they have always done—debt monetization, devaluation and inflation. Virtually all of their debt would be in the home (i.e. soft euro) currency and therefore could be inflated away.

They would have a quick adjustment to their competitive problems, end extreme austerity and probably get a resumption of growth. Creditors would be repressed through inflation rather than default, bank runs could be halted with foreign exchange controls combined with the prospect that a quick over-shooting of the currency on the downside would soon create expectations of some recovery. Another huge benefit would be that it would break the insidious and destructive nexus between insolvent banks and insolvent governments. Both could be made whole by the central bank.

What happens in the longer run would depend on whether the countries involved used the breathing space to get their houses in order. If so, they could, if they wished, rejoin the Group One countries in the hard euro with the new, reformed institutional arrangements that should have been part of the original eurozone.

Group One countries would gain by getting the troubled debtors off their back and by gaining the ability to write the rules as they saw fit. This would create the viable currency that they have always wanted and put an end to the continuous crisis atmosphere.

What About the Costs and How To Deal With Them?

This, of course, is a huge issue. However, it must be assessed in the context of what the costs of a chaotic, unplanned collapse of the euro would be. These costs would be much greater but unknown, triggering a massive loss of confidence and flight of capital out of all European countries. A planned break-up as outlined above would create very large but measurable losses and they could be put behind in due course.

Obviously, there would be windfall gains and losses. Those with assets in the new hard euro and liabilities in the old soft euro would gain. Those with assets in the old soft euro would lose.

The gain in competitiveness of exporters in the soft euro countries would be offset by losses of exporters in the hard euro countries. The opposite would be true with importers in the soft euro losing and importers in the new hard euro gaining. Those who anticipated the euro break-up by moving funds to the Group One countries or the U.K. and U.S. would have gained. Those who did not, would lose by devaluation and subsequent inflation. The list could be extended and no doubt there would be some very complex situations that would require special treatment. Politicians and financial experts would have their work cut out for them. Doubtless, there would be some rough justice and a lengthy period of helping out in grossly unfair situations. However, the Germans did this after re-unification and all European countries eventually regained their financial footing after World War II. The difficulties in those situations were far greater than would be the case in a two euro world.

There is no doubt that the costs would be great but they would be transitional. The benefits would be enduring and much greater. And it would not be difficult to imagine some countries outside the hard euro wanting to come in after they adjust. They would be signing on to a system that was viable, known and the discipline required would be transparent.

TARGET2 Losses

While European heads of state have been pulling all-nighters to negotiate the channels of official aid to Spain and recently to Italy, a silent and larger transfer of funds continues to shuttle capital from the euro's core to its periphery. The TARGET2 payment system within the Eurosystem, which supports the ECB, works automatically without the need for any political wrangling. Since the beginning of the euro debt crisis, it has provided more liquidity than the combined capacity of the EFSF, ESM and official bailouts for Greece, and it continues chugging along as the crisis intensifies.

To explain how this shadow bailout works, we need to review the inner workings of the ECB[3]. The European Central Bank was set up to be a center for making decisions on policies which are in fact then carried out at the national central banks of each of the 17 euro members. Commercial banks within the eurozone never directly interact with the ECB, but rather make deposits etc. with their country's national central bank. The TARGET2 system allows payments to be instantaneously transferred between national central banks as in the case of cross-border transactions. When funds are transferred from a deposit account in Portugal to one in Austria, the money is first destroyed at the Portuguese Central Bank and then a corresponding amount is printed by the Austrian Central Bank to carry out the transaction. The excess liquidity this process generates in Austria gets deposited back to the European Central Bank, giving the Austrian Central Bank a claim on the Eurosystem as a whole. The diminished liquidity it creates in Portugal gets replaced by lending from the Portuguese Central Bank, which acquires a liability to the Eurosystem. At the end of the day, the monetary base in each country remains the same.

The system is somewhat akin to the old gold exchange standard with fixed exchange rates. What typically happened was that deficits in the key currency countries would result in foreign exchange accumulation in the surplus countries. Jacques Rueff, the famous French economist and advisor to President Charles de Gaulle, used to call this "deficit without tears", referring to the U.S. running persistent deficits in the 1950s and 1960s while France was exposed to ever greater risk on its growing dollar holdings

[3] For a detailed explanation see Hans-Werner Sinn and Timo Wollmershaeuser, "Target Loans, Current Account Balances and Capital Flows: The ECB's Rescue Facility", Forthcoming in International Tax and Public Finance (July 2012). Also published as NBER Working Paper No. 17626, 2011 and CESifo Working Paper #3500.

as it bought dollars to maintain its currency peg. This would tend to increase its monetary base. Ultimately, France started converting its dollars into U.S. gold reserves and this forced an end to the Bretton Woods system in 1971. Currently, Group One countries are facing the same risk and could well try to convert TARGET2 claims into something else.

During normal times, the claims and liabilities in the eurozone net out for each country as capital and goods are exchanged. Until the beginning of the 2008-2009 crash, the Eurosystem imbalances were small: less than €50 billion in January of 2007. However, under conditions of capital flight, the claims and liabilities become more and more uneven and the TARGET2 system works as an automatic loan from national central banks making deposits in the Eurosystem to national central banks withdrawing to lend to commercial banks─in effect replacing the capital which has left. As of June 2012, Germany, Finland, Austria, and the Netherlands (the Group One countries) combined had over €1 trillion worth of TARGET2 claims[4]. As no resolution mechanism exists, it is unclear how the imbalance would be settled in the event of a break-up. What is clear is that the Group Two nations are not capable of fairly paying back these loans. TARGET2 imbalances will grow as flight capital continues and they will, without a doubt, feature in the losses resulting from the split of the euro.

[4] National Central Banks' statistics, compiled by Euro Crisis Monitor, Institute of Empirical Economic Research - Universität Osnabrück, July 2012.

Two Special Cases

Where do France and the U.K. fit in? France clearly has a hard money tradition as is evident from those who have read Jacques Rueff[5] and Charles Rist[6] and followed the Poincaré financial reforms in the late 1920s. However, France has an even stronger and longer tradition of inflation and currency debasement. There was the *assignat* inflation that led to the French Revolution[7], the inflation after WWI and again after WWII, up until France joined the euro process after Maastricht.

France has long had a powerful statist, anti-wealth, anti-free market culture. Government expenditures at 56% of GDP is one of the highest in the developed world and the new government is determined not to cut. It will try to close the fiscal gap with increased taxes on the rich and on companies. While this may placate the unions and the have-nots, it will further erode France's sharply deteriorating competitiveness and thereby its ability to finance its entitlement society.

Therefore, we see France fighting the putative two euro solution but losing and being forced to choose whether to be in the hard or soft euro camp. The latter is the more likely but not inevitable.

The U.K. has been congratulating itself for some time on its narrow escape from the euro disaster. It is clear that some Brits foresaw the problem at the beginning but it was far from obvious at the time. The U.K. has a huge fiscal and debt problem. Deficit is 8% of GDP and debt is approaching 90% but they have their own central bank and therefore there is little risk of default on British sovereign debt. Hence, it is considered a

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[5] Jacques Rueff, *The Age of Inflation* (Regnery) 1963.
[6] Charles Rist. *History of Economic Outcomes,* 1909 and *Triumph of Gold,* 1961.
[7] Andrew Dickson White, *Fiat Inflation in France,* 1896.

safe haven. It is also true that the U.K. has not defaulted on its debt for over three hundred years and that there is a remarkable social and political consensus that their fiscal house must be put right. The U.K., having avoided disaster, will not readily join the new hard euro core.

Also, the U.K. has bitter memories of their forced exit from the Exchange Rate Mechanism (ERM) in 1992 as a result of German monetary and interest rate policy following reunification. However, it is likely that they will watch carefully as the new euro regimes evolve. If the transition were to be successful, the proper mechanisms put in place and the U.K. could get the sort of protection it needs to preserve London's powerful financial position, it is entirely possible that the U.K. would consider joining if it helped protect its trade interests in the EU. It clearly would be much easier to contemplate such an action if France were not part of the hard euro as France and the U.K. rarely see eye-to-eye on economic and political issues. Joining a hard euro with Germany and other Group One countries would give the U.K. a much more powerful voice in shaping the future of the EU.

Conclusions

The eurozone continues to be moving in the direction of a train wreck. To minimize the damage, it is essential to create a new resolution process before the crash. The least painful way would be to put the Group Two countries into a lifeboat of their own with some pocket change and send them off to find their own destiny. Group One countries would, at the same time, create a new, hard euro based on proper institutional structures to safeguard its long-term viability.

Putting odds on this outcome is impossible but we would see it as better than 50-50. It is logical and would resolve the major problems of the eurozone in the least expensive way. The costs would be high but manageable, just as the German reunification was expensive but manageable. However, it is critical that policymakers take the long view. Those in Group One generally do. Those in Group Two do not because it is not in their culture. That is why they are in such a mess.

If the two euro solution were adopted, the major risk markets of the world would open dramatically higher because it would remove the deflationary sword of Damocles hanging over everyone's head and end the continuous crisis atmosphere.

Safe haven currencies and bond markets would sell off in the short run as funds would flow back out on changed expectations. High yield bond markets would likely improve as the risk of a debt deflation would recede.

Gold would probably sell off in the short run. However, it would be boosted by demand in the soft euro countries as inflation fears would obviously heat up. In the long run, too much debt in the world would require sustained monetary inflation, higher taxes and more regulation, and that has always created a friendly environment for gold.

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