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Will the euro survive?

Market Views

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Last autumn, when the European sovereign debt crisis suddenly took a turn for the worse, The Economist news magazine did not hesitate to write that the failure of the euro might be imminent! Luckily, the announcement of the euro's death was premature. The single currency survived, and it even managed to strengthen somewhat against the U.S. dollar.

Unfortunately, the euro crisis has reignited with a vengeance in the past few weeks. It is still rather unlikely that Greece will drop out of the euro zone, even if it were to default on its sovereign debt, although an exit can no longer be ruled out. Will that be the beginning of the end for the euro?

Will Greece leave the eurozone?

An exit of the euro zone would be very messy, particularly since it would occur amid a deep crisis. This would be totally unchartered territory. No allowance for an exit was made when the European monetary union was designed. One could imagine, though, that the Greek government might announce one day – most likely over a week-end – that all prices, wages, pensions, nominal contracts, financial assets and liabilities held in Greece would henceforth be denominated in new drachmas (on a one to one basis), rather than in euro. It would then immediately devalue the new drachma by, say, 40% for it to only be worth 0.60 euro. If one's salary were 1,000 euro, it would now be 1,000 drachmas, which would be 600 euro. Until new drachma bills and coins could be produced and put into circulation, the euro bills and coins would continue to circulate at a premium. People who would have euro banknotes would win, or at least not lose, for a euro would still be a euro, i.e. 1.67 new drachmas. That sounds easy, but it would take a very strong government indeed to impose this.

The Greek public would get very badly hurt. Households would lose much of their savings, firms – and not least banks – would make huge losses and might go bankrupt. Unemployment would shoot up and poverty would increase dramatically. It would take years for the Greek economy to recover. The competitive advantage brought by the devaluation would be short lived, as inflation would increase, so that further devaluations could be expected in the future.

Legal hurdles exists

An exit from the euro zone would also be a legal nightmare. There would be numerous disputes and lawsuits brought, in particular, by foreign creditors. Some central banks from the euro system are large creditors of the Greek central bank and could make huge losses too. The Greek central bank itself might lose all its equity since it has lent extensively to Greek banks, some of which might default. The government would hardly be in a position to recapitalize the central bank and the commercial banks because it too would be broke, so it would be a hopeless situation.

The Greek government would be forced to live within its means since it would no longer be able to obtain foreign credits. It would essentially have to run a primary balance, i.e. all public expenditures, including salaries and pensions, would need to be financed by current taxes. It might be tempted to raid pension funds or to lean on the central bank to print more money, but this would only impoverish the country further and make a bad situation worse.

The direct impact of a Greek default on the rest of the world would be relatively modest, as Greece is only a small part of the global economy. Of course, foreign creditors, including

international banks, would suffer large losses, but they should be able to sustain these. The reason why a Greek exit of the euro zone might end up being so damaging has to do with the indirect consequences. Contagion might set in. Portugal, Ireland, Spain, Cyprus, Malta and perhaps even Italy would be at risk. Would they be next? A bank run in Spain would have disastrous consequences. European banks might make huge additional losses. The entire international financial system would be destabilized, at a time when governments have little means of support left. There would be the risk of a credit crunch, stock markets might collapse, and Europe could fall into a deep recession.

Bank run in Spain?

A Greek exit from the euro area would undoubtedly put the euro under pressure. The single currency would weaken, perhaps substantially, against the dollar. Of course, one might argue that the euro zone as a whole could emerge out of the crisis strengthened, having rid itself of its weakest link. This might well be true, all the more so because the monetary situation of the United States is far from healthy, but it could take years for the dust to settle. All in all, the European Central Bank has done a fine job, although it was dealt a bad hand. It has become obvious that the euro zone is not an optimal currency area, and the 'one-size-fits-all' monetary policy is inappropriate. Right now, Northern Europe needs higher interest rates, whereas Southern Europe needs lower ones. Nonetheless, the euro will undoubtedly survive. The construction of the European Union and the creation of the single currency count among the most important political achievements of the post-World War II era, and European nations, Germany and France in particular, have too much at stake to let the euro fail.

The euro will survive

If contagion sets in, third world countries would be deeply affected as well. Emerging economies and commodity exporting countries are very dependent on sustained growth in the advanced countries. Risk aversion could also lead to large capital outflows from these countries. Switzerland, too, would be badly affected. A deep European recession would be hard to sustain, and yet another global financial crisis is exactly what Swiss banks do not need. A plunge of the euro against the dollar would imply a substantial rise of the dollar against the Swiss franc as long as the Swiss National Bank (SNB) would enforce the floor rate of CHF 1.20 for one euro. Would the SNB be able to hold that rate? Yes, if it chooses to! As emphasized on numerous occasions by the SNB, it has the means and the will to do so. Indeed, it can produce unlimited amounts of Swiss francs in exchange for euro. But would it be wise to do so? A big increase in the value of the US dollar would threaten price stability in Switzerland. Monetary policy would be unable to act as long as the floor rate would be in place. Large purchases of euro would expose the SNB to huge potential foreign exchange losses if eventually it were to give up the floor rate after all. The longer it waited, the bigger the losses. And as long as it waits, it could not normalize interest rates, threatening price stability. The SNB would be caught between a rock and a hard place. It makes little sense to tie oneself to a sinking ship. The SNB might end up having to define the floor rate not in terms of the euro, but in terms of a basket of currencies including the US dollar. One option would be to opt for the SDR (the special drawing rights, issued by the International Monetary Fund).

SNB in a dilemma

Further direct interventions in the foreign exchange market are apparently being contemplated by the Swiss government. Capital controls, negative interests on deposits held by non-residents, or a Tobin tax are among the ideas that have been raised. Such measures would probably prove ineffective as there are always ways to evade them, including by going through foreign banks and using derivatives. More seriously, they could be very damaging to the reputation and the good health of the Swiss financial industry. Moreover, there seems to be a fundamental contradiction between the pledge to buy unlimited amounts of euro at CHF 1.20 and a simultaneous effort to limit capital inflows. Adding quantitative restrictions or other constraints to the already existing price restriction just multiplies the sources of distortions and can have grave, unforeseen consequences that eventually require even more interventions.

Eurobonds, a bad medicine

What is to be done? Will austerity in over-indebted countries not make the situation worse by causing recession, reducing tax receipts, and increasing deficits even further? Should the European Union not issue common bonds (Eurobonds) in order to syndicate the existing sovereign debts? Should Germany not give in and rescue Greece? This might well be what is going to end up happening, but the issuance of Eurobonds would raise new problems, not least one of moral hazard. If it becomes known that countries can behave irresponsibly and that eventually they will be bailed out by others, then there is no incentive for them to improve their behavior. Politically, it would be very difficult to explain to German taxpayers why they have to vouch for Greece. There are poorer countries than Greece in the European Union and they have their houses in order. One can always argue that the time is not right to take difficult measures. It is never the right time for austerity, but the longer one waits, the harder it will be. Yes, like a detoxification cure, austerity might make the situation worse at first, but it is the only way to make it better in the long run. The patient will live on and eventually he will recover. The time to act is now. In fact, action should have been taken a long time ago. But with or without Greece, the euro will survive.



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Portas Capital Ltd., asset manager and advisor in matters of investment strategy, portfolio construction and product selection, is expanding its consulting team. Prof. Ulrich Kohli advises Portas Capital Ltd. and its clients on macroeconomics and monetary policy beginning 2012.

Ulrich Kohli holds a licence ès sciences économiques from the University of Lausanne (1971), an M.A. in Economics from Queen's University in Kingston (1972), and a Ph.D. in Economics from the University of British Columbia (1976). He has been an economist at the Bank of Canada in Ottawa (1975 – 1977), and an economic adviser at the Swiss National Bank in Zurich (1983 – 1985). In 2001 Ulrich Kohli was appointed Chief Economist and Alternate Member of the Governing Board of the Swiss National Bank (Switzerland's central bank) by the Swiss federal government, a position he kept until the end of 2009. In January 2010 he returned to the University of Geneva as a visiting professor. Ulrich Kohli has published over seventy articles in refereed journals in the areas of international trade, aggregate production theory, economic growth, monetary economics, and macroeconomics.

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