

EURO ZONE AND DEBT CRISES: CHALLENGES AND OPPORTUNITIES

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“THE BENEFITS OF THE EUROZONE ARE NUMEROUS, BUT RIGHT NOW WE HAVE TO FACE ITS IMPERFECTIONS”

UNDOUBTEDLY THE EUROPEAN debt crises have provoked fears in investors and concerns in economists. Some inherent imperfections of the European Monetary Union (EMU) became apparent. Countries that are a part of the Euro zone, and whose debt is therefore issued in a currency that they cannot manipulate, are facing such strong market pressures that they may have to default on their debt payments. A worst-case scenario may in fact result in a Euro zone without countries like Greece, Ireland, Portugal, and even Spain or Italy. However this isn't a guarantee, we might also see a strengthened monetary union, where countries issue Euro bonds and help each other. Here, I will attempt to explore some challenges posed by the unfolding debt crises in Europe and opportunities to develop the currency union.

MONETARY UNION AND SOVEREIGN DEBT

The benefits of the Eurozone are numerous, but right now we have to face its imperfections. The most clear-cut is that member countries surrendered the right to independent monetary policy by transferring interest rate and currency manipulation decisions to the European Central Bank. Part of the integration process, this step makes monetary union member countries similar to developing countries with respect to their foreign debt. The crucial similarity is that the debt is issued in a currency out of the control of the issuing country. When investors become concerned about holding, for example Greek bonds, they sell them and invest the received Euro in bonds of a lower risk country. This reduces the money supply in Greece and deepens liquidity problems. Therefore, as in the case of Argentina a decade ago, markets can push a debtor country to default.

OWN CURRENCY AND SOVEREIGN DEBT

In contrast, a country that issues its sovereign debt in its own currency retains a number of instruments that can help avoid a default on its foreign debt. If concerns arise about the solvency of such a country bond markets will reflect the risk in higher interest rates, and bond holders will start selling. The currency received in return will weigh on the supply side of the money market, pushing the independent currency exchange rate down. Thus, through a self-regulating market mechanism a country issuing debt

in its own currency will pay debt holders with inflated currency. For example, the UK government debt stood at 76% of GDP in 2010 and Spain's was 63%, however Spain had to pay two percentage points more to borrow in international markets. At the same time Spain's inflation, for the same period, was under 2%, while the UK's stood at over 3%. Spain is part of the Euro zone and the UK has its own currency. Investors understand that Spain faces the rigidity of financial markets without the cushion of its own currency and price this in as a risk premium.

FOREIGN AND DOMESTIC DEBT

The composition of government debt should not be ignored. A country with mostly domestic government debt has the flexibility to control its debt level through taxation, and Eurozone countries have their own taxation powers. Differently, a country with mostly foreign debt holders has no mechanism of controlling its debt level and is exposed to a probability of default similar to a developing country. Research showed (D. Gros, May 2011) that in 73% of cases the spreads on sovereign debt are inversely related to the current account balance, emphasizing the importance of the debt composition. The concerns of the markets about Portuguese debt are mostly fuelled by the high level of foreign debt. While the overall government debt level is lower than some other Euro area member states (e.g. France), whose borrowing cost is closer to the risk free benchmark of German bonds, Portugal has a high foreign debt and thus a higher risk of default.

FORCED TO HELP EACH OTHER

By joining the EMU member countries surrender much of their monetary policy independence. Clearly, this is an important integration step for European economies, with benefits spanning from lower transaction costs to increased business mobility. However, vast regional economic differences are bound to create obstacles on the way. They materialize as debt crises, causing markets to doubt the willingness of member countries to persevere with the common currency. Eventually, there will have to be an effective mechanism for internalising the effects of these differences. The European Financial Stability Facility (EFSF) was established as a lender of last resort in response to this concern. However, it will take more to convince investors that member countries want a long-term Euro. One possible step is the issue of Euro bonds



with member countries liable together, thus minimizing the likelihood of debt crises caused by lack of control over the currency the sovereign debt is issued in.

ADVERSE SELECTION AND MORAL HAZARD PROBLEM

Regional economic differences within a "core-periphery" Eurozone and widely ranging cost of borrowing will fuel adverse selection and moral hazard problems. The countries most likely to default will be the first candidates to participate in Euro bond issues. Countries carrying high risk premiums will have an incentive to borrow excessively together with low risk bond issuers, such as Germany. Finding an acceptable solution will be a major challenge to overcome. Perhaps high risk countries can pay a fee to participate in the bond issue. Reaching a solution may not be only an economic problem but one that has to involve governments at a political level, if investors are to be convinced of the determination of the Euro zone countries to stay together and to deepen the economic integration process further.

EURO-A RESERVE CURRENCY

A successful Euro bond scenario may be an opportunity for the Euro zone countries to attract international investors on a large scale, thus increasing the weight of the Euro in the portfolios of private and institutional investors. This would make the Euro a real alternative reserve currency with a sizable

market, giving investors a reason to hold bonds issued in Euros as core investments, not only as a diversification away from the US dollar. If this is realised, the Euro zone countries will enjoy a lower borrowing cost attributed to the perceived stability of the reserve currency (Gourinchas & Rey, 2007). The appeal of this long term goal can serve as a powerful motivation to look for a solution to the debt crises in further economic integration, not in downsizing the Euro zone.

Euro zone member countries are effectively in the situation of developing economies in international bond markets, deprived of the ability to manipulate the currency in which their debt is issued. Whether the outcome of the government debt crises in Greece, Portugal, and other EMU countries will be similar to the default of Argentina a decade ago depends on the will of member states to develop mechanisms for internalizing the effects of regional economic differences, specifically the risk premiums on government bonds. The moral hazard problem, creating an incentive for high risk countries to pool together with core, low risk countries will be a main obstacle to overcome. If the member countries show that they have the will to persevere and to develop viable Euro bond issues, there will be appealing benefits to all member states. Most importantly, the opportunity to issue debt in a reserve currency, at low cost level, will increase competitiveness and boost economic growth in member states. ◉