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The Euro Will Survive (and Thrive)

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June 30, 2018

For the fifth time since 2012, I was invited to participate with a select group of European and American economists at a symposium hosted by the National Association of Business Economics. We met in April at the Madrid headquarters of our co-host, The Bank of Spain. This stimulating and insightful gathering is limited to 40 Europeans and 40 Americans. Our group included economists working in business, finance and public policy. Over the past six years, we have been in regular dialogue about the ongoing economic situation in Europe.

Sitting across the Atlantic Ocean, many Americans think the euro crisis was a discrete historical event rather than an ongoing process. In 2011 government bond prices plunged and interest rates surged in the financially troubled “PIIGS” countries of Portugal, Italy, Ireland, Greece and Spain. Investors worried about bank failures, government solvency and the viability of the euro currency. Fears of contagion rocked world markets, with the U.S. stock market dropping 19% during this period. As the crisis reached a fevered pitch, the European Central Bank (ECB), led by Mario Draghi, stepped in to calm world financial markets.

In a speech on July 26, 2012, ECB President Draghi uttered this famous phrase that saved the euro: “Within our mandate, the ECB is ready to do whatever it takes to preserve the euro. And believe me, it will be enough.” In the following years, the ECB doubled and tripled down on its pledge with aggressive Quantitative Easing (QE) monetary policies and negative interest rates. In the process, the ECB purchased large percentages of outstanding sovereign and corporate bonds in the Eurozone.

Although the euro crisis faded from American consciousness, it steadily percolates in Europe. Every so often events bring it to a boil, generating headlines in the United States and roiling global financial markets. The recent election of a populist government in Italy provided one of these moments. Investors fear the new Italian government might push Italy's government debt to GDP ratio above its already exorbitant 130% at present and potentially lead Italy out of the euro.

An Italian exit from the euro would be an economic catastrophe for Italy and possibly a source of contagion for other euro members. Italy's currency (formerly the lira) would almost certainly devalue drastically, while its debts would remain valued in euros. Debt default and economic collapse would be highly likely. With such severe consequences, it seems unlikely any Italian government would make this choice.

The Euro is a Blood Pact

The potential for catastrophic consequences is the blood pact that binds euro member countries to each other. For centuries Europe was the world's most violent continent. It experienced wars of religion, revolution, nationalism, and imperialism, which culminated with the horrors of World Wars I and II. Peace and prosperity are the carrots motivating the EU toward "ever closer union", but the euro is the stick. Of course, the architects of the euro did not envision it that way. The economic challenges over the past decade, however, revealed the risks of euro departure exceed the costs of euro membership.

The exit door is locked even though the 19 euro-member countries make strange bedfellows. Germany is law-abiding and solvent, while Greece is corrupt and bankrupt with everyone else somewhere along a spectrum. Britain correctly understood the euro and the European Union will eventually become synonymous, but British Common Law and dynamic capital markets are quite distinct from Continental Europe.

Most Americans misperceive the eurozone economies are sclerotic at best and perhaps doomed at worst. On the ground, the picture is quite different. With the exits barred, euro member countries face pressure to implement politically difficult economic reforms. Often the people and their politicians do not like the choices available to them, but their options are quite narrow. Greece elected a radical left-wing government vowing to repudiate its debts, abandon the euro and rebel against market capitalism. In the end they did none of those things despite the economic collapse Greece endured.

The Eurozone is a Crucible of Economic Reform

Rather than abandon the euro, the eurozone is instead a crucible of reform. Weak countries such as Greece or Italy cannot devalue their currencies or inflate their way out of debt as they did throughout most of their history. Their only viable option is to implement politically grueling policies that are anathema to many of their people.

For example, Spain recapitalized the government-owned banks at the heart of its housing bust with taxpayer funds and then privatized them. Private shareholders will reap future rewards while the state is unlikely to receive its money back in full. They also overhauled their cumbersome labor laws, diluting worker privileges to incentivize hiring. Following these changes, the Spanish economy started to recover and create jobs.

Even the chronically unstable Italian government enacted major financial system reforms. Italy forced its government-owned Popolari savings banks to convert into joint stock companies. The idea is to merge 400 local lenders into larger, more efficient and better-capitalized banks. Bank regulators are also starting to force banks to restructure non-performing loans and raise additional capital. In addition, the Italian government legalized a variety of financial services that we take for granted in the United States, such as alternative lenders, the transferability of receivables and certain types of asset backed securities.

More broadly the 19 eurozone countries agreed to move forward with three major initiatives: Banking Union, Capital Markets Union and Deeper Monetary Union. The goal of these initiatives is to simultaneously transform separate national financial systems into a European system, morph Europe's rigid bank dominated economies toward more flexible capital markets, and establish a supranational regulatory framework for finance.

The Euro is the Bumblebee that is not Designed to Fly, Yet it Does

The euro region is not an ideal currency union. Not only do its member countries have different cultures with different languages, but they also operate diffuse political and legal systems. Labor and capital do not move easily throughout all member countries. The European Union and the eurozone are quite far from a "United States of Europe". Due to these diversities and dichotomies, numerous observers regularly predict the euro's demise. They are wrong.

The single currency pressures member countries to harmonize legal differences, lower trade barriers within and across countries, and improve mobility for labor and capital. The eurozone did not start out as an ideal currency union, but it is moving in that direction one halting step at a time. While the entire world remembers Mario Draghi's famous "whatever it takes" phrase, they forget that in this same speech he compared the euro to the bumblebee. Just like the bumblebee, Mr. Draghi said "this is a mystery of nature because it shouldn't fly but instead it does."