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**STRATEGIC ECONOMIC DECISIONS**

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**TODAY'S EURO CRISIS  
– A Triple-Decker Bus –**



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## TODAY'S EURO CRISIS

### – A Triple-Decker Bus –

Here I am in Zurich in the middle of it all. Europeans from all over are rushing to secure Swiss francs, pounds, and dollars. Headline predictions of “Euro-Geddon” are commonplace. Fears of a double-barreled Greek and Spanish financial meltdown are increasing.

This very brief Memo is being written on the road, first to explain to SED clients how serious the crisis is at a much deeper level than normal, and exactly why this is so. In a few days, I will follow up with a lengthier Memo addressing other headline events: The JPMorgan Chase crisis and its true import, along with various myths and half-truths that have confused the headline issues of “deficits,” “austerity,” and “growth.” Contemporary usage of all three of these terms is very misleading. By reinterpreting each of them from a *proper* theoretical standpoint, it will be possible both to identify and to implement policies that significantly brighten the longer-run prospects of the West.

I am fundamentally an optimist, and part of my job both in private and in public is to declare that good policy solutions DO exist — win-win solutions, in fact, that can help terminate today’s political gridlock both over here and at home in the States. This was, of course, the motivation for having written my recent book *American Gridlock — Why the Right and Left are Both Wrong*. It set forth hard-hitting solutions to challenging policy problems now causing gridlock. Enough gloom and doom.

### Three Root Problems – Not One

The gravity of the Euro crisis stems from a conflation of three quite different problems, the interactions between which makes the concept of a “solution” highly problematic. In my view, this is why it is so hard to get one’s hands around this problem, and why there is so little consensus as to what will happen and why.

## Problem 1 – The Tinbergen “Non-Controllability” Problem

Several past Memos have stressed this issue, since it is the root issue, and since most commentators overlook it. Let’s forget banking crises, contagion, and other financial market aspects of the crisis. For these financial issues are merely manifestations of a deeper more fundamental issue that simply cannot be ignored even if it is difficult: Is the concept of a single euro for 17 nations a *good* concept, or is it *bad*? If, in some well-defined sense, the adoption of a common currency in 1999 was a good policy, then the euro is probably worth salvaging. If the policy was not wise, then perhaps it not only will but should be scrapped, whatever the cost. But how do we know whether it was wise? What exactly is “good” policy in this knotty context?

Professor Jan Tinbergen a half century ago first taught us how to answer this question in his 1952 masterpiece *The Theory of Economic Policy* (Amsterdam: North Holland Publishing Co., 1952). He was a Dutch economist who would share the first Nobel Memorial Prize in economics ever to be awarded. So it is well worthwhile to understand his logic that is rarely discussed today.

**Good versus Bad Policies:** Let us agree that any public policy is “good” if its benefits **B** outweigh its costs **C**. The benefits of having a euro and indeed the EU itself are obvious: the increased flexibilities of cross-border trade and migration and lack of exchange-rate barriers have raised output and employment. Econometric studies suggest that European growth *would* have increased by 0.65% annually during the period 2000 – 2012 by having a common currency. I say “would” because I am netting out the decrease in growth due to the Global Financial Storm of 2008 – 2010 which has nothing to do with the existence of the euro proper. Of course, such estimates are all over the map. But both theory and practice suggest that, other things being equal, a reduction in myriad commercial barriers can only be good for growth.

What about the costs **C**? The obvious cost is the reduction in growth due to the fact of “macro-non-controllability,” Tinbergen’s main concept. When each nation joins the currency union, it gives up its ability to utilize its customary macro policy instruments (interest rates, money growth, currency tools). Now it is all up to one new central bank. The problem is that a one-size-fits-all policy will *not* generally suit all. So rather than each government optimizing for its own people’s well being by utilizing its own independent policy levers, it must hope that a centralized policy will work well enough on its own.

But will it? Before answering this, it must become clear exactly how to measure the cost **C** of having a single currency, the cost that must be netted out from the benefit **B** before we judge the wisdom of having adopted a single currency system. *This cost is the algebraic sum across the 17 member economies of the lost growth in income and employment that results from each nation’s lack of controllability over its own economy.*

Now how should we think of this overall cost **C**? What exactly is it a function of? Moreover, might this cost change over time, and if so, why? The simplest answer is that this cost is a function of the *correlation between the GDP growth rates* of the member countries. And this correlation structure can, and has, changed. Suppose all economies do move in lock-step, perfectly correlated. Then while none possesses Tinbergen controllability once having joined the eurozone, it doesn't matter a whit since the centralized ECB policy will be optimal for *all* 17 nations. What is good policy for any goose will be good for any gander. The cost **C** of non-controllability will be 0. Now, when we first analyzed the correlation between the 17 economies during 1985 to 2007, we computed 0.58 as the average pairwise coefficient of GDP growth changes. It would be nice if this number were 0.9, but 0.58 isn't so bad. That between the US states lies in a similar range. [Many safety valves like labor mobility help mitigate this problem, especially within the US, until recently.]

Looking at this correlation issue in a slightly different manner, the correlation between the "blocs" of nations I have dubbed the Sinners and the Winners was quite high. The northern and southern blocs moved pretty well in tandem, suffering equally during the early 1990s, and then recovering together. Germany was in a somewhat special situation given the timing of its absorption of East Germany.

*So in some sense, perhaps policy makers were correct to think (abetted by some blind optimism and a political agenda for a Grand Europe) that a currency union had benefits **B** greater than costs **C**, and that, therefore, the euro was a good idea on balance.*

But then things changed. As detailed in our January Memo, Angela Merkel blessed Europe and global stock markets in December with her \$500 billion liquidity Christmas gift. But her price was *austerity* for the group of nations I have called the Sinners. [To be sure, austerity was already a reality for several Sinners.] Now austerity for these nations — already in deep trouble due to the Global Financial Crisis and due to incompetent macroeconomic management for years — had already given rise to two new developments:

1. The bloc-wise correlation between the growth rates of the Sinners and the Winners would drop way down, with the performance of the Sinners in the south moving in an opposite direction to those Winners in the north that were beginning to recover.
2. The spread between the average growth rates amongst Sinners and Winners *reversed*, and exploded. Prior to 2007, the overall growth of those nations now in trouble often exceeded that of the rate of nations in Northern Europe. During the last two or three years, however, this growth spread *reversed* by over 3%. Sinners now suffer from major recessions, if not outright depressions, whereas the northern nations are at least hanging on.

In this context, the cost **C** of having a currency union (with a one-size-must-fit-all set of policies) becomes huge. Sinners desperately require currency depreciations, very low interest rates, and inflation. Winners do not — at least not yet. To conclude, viewed from a Tinbergen standpoint, the cost **C** of having a common euro now greatly exceed any benefits **B**. The sorry reality is that the envisioned Cost/Benefit blessings of possessing a euro have imploded and reversed. Many commentators miss this root point because they implicitly measure the benefits from maintaining the euro in terms of crisis management variables (“as long as it holds together, then there will be no bank runs”). *But such measures are wrong from a public policy stance.* What ultimately matters is the sum of the income and employment growth (or decrease) enjoyed by the peoples of the 17 nations involved. That is why I have started off with this dimension of the euro problem, deliberately ignoring today’s more immediate issues of debt, contagion, and crisis. First things first.

## **Problem 2 – The Debt Problem, Both Sovereign and Banking**

Were non-controllability the only problem bedeviling the fate of the euro, that would be bad enough. But it is not. It is compounded by the current debt crisis, a crisis logically independent of the controllability issue. Tinbergen’s work was carried out in abstract form with no thought to the kind of debt crises we are experiencing today. The twin sovereign and banking debt problems we now confront make matters much, much worse. The essential point here is that that the aggregate loss of human welfare (sum of lost jobs and income across 17 nations) due to a one-size-must-fit-all ECB policy is greatly magnified by the present of the debt crises. They cause the resulting pain from non-controllability to be vastly greater than it otherwise would be. It is debt that is causing soaring local bond yields and fears of illiquidity, solvency, bank runs, and God knows what throughout Europe. This exacerbates the cost of each nation’s *not* being able to going its own way, which it could do were there no eurozone, and were each nation in possession of national controllability.

Even worse is the pernicious nature of today’s debt crisis. It is bad enough that banks are in trouble. But these banks have balance sheets that are intertwined with those of their sovereign nations. The sovereigns expect their banks to acquire national bonds, but when sovereigns get downgraded by Fitch or whomever, then so do the banks. *And vice versa.* The situation is a surrealistic inversion of the absurd.

A final point about debt is in order looking forward. Pundits talk about “the” current debt crisis as a “problem” that can, in principle, be fixed, whether by restructuring, forgiveness, or whatever. *Even if this were true, the essential point is being missed here.* The root cause of sovereign debt almost everywhere is one and the same: Never-ending borrowing for social spending on popular welfare state programs. But by published projections covering almost all Western nations, especially in Europe, spending on such programs is going to mushroom during the next several decades. Markets will learn that even if past debt is restructured, *future* annual

deficits will be adding up to ever-worse future stocks of sovereign debt, especially as no non-Nordic governments are willing to confront this problem. Even Germany has a largely unfunded welfare state. Arguably, Australia and Switzerland are “best” in these leagues, *but demography will prove fiscal destiny in coming decades*, so the “debt crisis” we are currently focusing on may be minor compared to what will be coming. This last point now feeds right into our third dimension of today’s crisis.

### **Problem 3 – The Growing *Non-Governability* Crisis**

In modern welfare state democracies where voters expect and indeed have been promised generous social benefits, how much pain will voters accept before they throw out governments that renege on such benefits in attempting to honor their ECB and EU restructuring commitments? And what will this, in turn, imply for the future of the euro? Just consider what has happened within Greek politics of late, and indeed in elections throughout Europe in the past few months. In particular, consider the stance of the new Greek firebrand Alexis Tsipras of the left-wing Syriza party. He has promised that if his party wins the forthcoming Greek election, he will renege on many of the agreements reached by the previous government in obtaining rolling financial aid from the European institutions that have rescued Greece to date. “It is obscene that other governments can destroy the prospects for Greek living standards in this manner, and I will not allow it.” He goes still further and challenges European institutions to go ahead and kick Greece out of the eurozone. “Watch what you wish for: contagion and a collapse of financial markets and banking will occur in Portugal, Spain, and Italy — and possibly worldwide. So Germany, think twice. Such an outcome would be *far worse for you* than continuing to bail Greece out on my terms.” (Said in so many words.)

His comments are not to be taken lightly. He is speaking for millions of people throughout Europe who do not understand what is happening, and who will vote for anyone promising shorter-term relief from the agony of collapsing wages and income. This is what democratic politics is all about. Expect more of it. Is it any coincidence that a Europhile Dutch leader had to resign? That Hollande was elected in France? That Merkel experienced stunning losses in Germany? And so forth? And if all this can happen in a period of relative calm *before* a storm, what can we expect if and when outright depressions occur, as many predict they will?

This issue here is rarely discussed for what it truly is: *The growing issue of non-governability*. Greece has no government at all at present, a situation that was not expected even two months ago. There is outright discussion of armed gangs taking control of the country should it be forced to exit the eurozone and be deprived the ability to purchase desperately needed imports after adopting a currency worth (optimistically) 50% of the value of the euro. Similar outcomes are thinkable for other Sinner nations.

But non-governability also arises at a much more global level. Just consider the European experiment itself, keeping in mind that Europe possesses the largest economic bloc on earth, and the world's second-most-important currency. Already, any degree of consensus as to what lies ahead or what to do about it has fragmented to the point that it is commonplace to hear "No one is in charge of Europe, and who could be?" To be sure, Germany has the money bags, and the best economy as well, but her people are dead set against the scale of bailouts for losers in the south that may be necessary for the European project to continue to exist. The bald reality is that European leadership does not and probably will not exist at the very time it is most needed. Crises of the current kind do not "wait" for wise counsel. Rather, action must be taken at once by true leaders. Or else.

## **Summary**

The point of this Memo has been to suggest that today's unfolding crisis is much deeper and more complex than most accounts suggest. The three dimensions of the crisis we have identified do constitute a triple-decker bus of issues that are rarely acknowledged individually, much less jointly. The real worry is that the three are mutually reinforcing in an extremely pernicious manner. The fact that, at this writing, US bonds yields are their lowest in history is just as it should be. In this case, markets just may get it right.

## **What Others Are Saying**

Opinions and predictions abound here in Europe, and are ranging all over the map. Today's hope lies in some form of Eurobond solution, or "direct capitalization of any and all banks in distress." This will doubtlessly be tried, but it merely scratches the surface of the three much deeper problems identified and discussed above. The FT's Martin Wolff proclaimed last Friday, May 18 in a full page leader: "If Greece goes, an exit is likely to shatter faith in the eurozone's integrity forever, leaving the bloc with a stark choice between a much stronger union and outright disintegration." Wow, and this from the dean of global financial commentators! Other FT writers claim that Europe cannot and will not force a Greek exit. Finance Minister of Poland Rostowski has called for a promise by the ECB to buy "an unlimited number of sovereign bonds if there is a Greek exit or banking crisis." And so on.

In a very significant paper, ING's Mark Cliffe has sought to analyze the cost of a eurozone disintegration. He concludes that the economic cost to Europe would be huge, and not the least to Germany itself. GDP in Germany could drop by 7% in Germany to 13% further in Greece. Inflation would soar in peripheral nations, whereas deflation would beset core nations. All pretty grim!



I myself am as lost in making predictions about these matters as you are. My guess is that the authorities *will* be forced to take steps that they loathe — Germany most of all — given the stark alternatives they confront required to prevent a *disorderly* collapse of the euro. The eurozone could thus survive in the shorter run. But the logic of the analysis set forth above suggests that the entire euro project may be doomed in the longer run.

Along these lines, the most interesting paper I have read was by the writer and historian Andrew Roberts. He envisions what has happened as yet another historical case study of “Imperial Overstretch” — this time on the part of benighted bureaucrats in Brussels over the past few decades. His own unorthodox conclusion (which nests well with my more formal logic) is that “Europe” should return to the original concept of the Treaty of Rome, and recenter itself around the core of *six great nations* as originally contemplated. They alone should have a Euro.

“This union should keep the euro only for those countries that deserve membership on the logical grounds of genuine economic synergy. These nations are removed from Brussels’ hubristic fetish of global hegemony dreamed up two decades ago.” While this is not as precise as what Tinbergen might prescribe from his grave, I suspect he would approve.

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