The Australian

Better for Club Med to stay in eurozone and face up to reform

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IT is far easier to make a fish soup out of an aquarium than the other way around. And once the soup has been made, it is a bit late to try to extricate a particularly inedible goldfish.

None of that should surprise the leaders of the eurozone. For as former German chancellor Helmut Kohl said, with the euro "integration became irreversible".

But that irreversibility is not merely because of the euro's design, which lacks any mechanism for a country to leave, much less be expelled from, the common currency. Rather, it is mainly because an exit is not in the best interests of any of the eurozone's key decision-makers.

To begin with, any unwinding of the euro involves far-reaching risks. Moreover, those risks have only increased since the crisis started, and nowhere more so than in the Club Med (Greece, Italy, Portugal and Spain).

With the European Central Bank flooding liquidity into Europe's financial system, Club Med banks, rather than expand credit in stagnant economies, have bought government bonds yielding 6 per cent or more.

As a result, they are even more exposed to sovereign risk than they were 12 months ago. And the quality of their commercial loan books has also deteriorated since then. The turmoil of an exit from the euro would deliver those banks a final blow, while their governments, lacking room for fiscal manoeuvre, would be in no position to recapitalise them.

Nor would the problems end there. As Club Med banks have bought their countries' bonds, banks in the north have sold them. That has reversed the direction of financial flows in Europe. Especially from 2003 to 2008, it was banks in the north that invested in high-yielding bonds issued by governments in the south. Savings were thereby transferred from north to south, making it possible for the Club Med countries to buy more goods and services from the north than they sold to it.

The eurozone's stronger economies, in other words, were financing the current account deficits of the weaker ones, which were losing competitiveness as their relative wage costs increased and as northern firms took advantage of the scale economies the move to a single currency allowed.

But with banks in the north liquidating their holdings of southern debt, that financing has now disappeared. In 2008, some E20 billion flowed each quarter from Germany to the stressed eurozone economies; last year, the flow was of about E15bn per quarter but going the other way.

Yet the countries of the south are still running substantial current account deficits. So how are those deficits being financed? By the central banks of the north.

Specifically, the imbalances appear, in the European Central Bank's TARGET2 clearing scheme, as claims by (say) the Bundesbank on its Club Med counterparts. Nor are the sums at stake trivial: in February this year, Germany's total TARGET2 claims amounted to a staggering E547bn, equal to 20 per cent of German gross domestic product.

In theory, those claims are backed by collateral given to central banks in the south by commercial banks. But it would be unwise to count on that collateral's quality; and with the claims in TARGET2 not having been cleared since the global financial crisis, it is plain no one has wanted to.

For so long as the Club Med countries remain in the euro, those claims are bookkeeping entries, much as would be claims within the Australian currency union by a hypothetical central bank of Victoria on one of Tasmania. And they would probably run down as economic growth returned. But an exit would convert them into immediate assets and liabilities, and force settlement. So even if it was only Greece leaving, concerns about contagion would almost certainly impose a cleaning-up of TARGET2 balances more widely.

With massive write-offs inevitable, the resulting losses would, under the ECB's rules, be distributed among the remaining central banks in proportion to country shares in eurozone income.

Governments in the north would therefore have to absorb those losses, potentially compromising their fiscal targets. As for any countries exiting the euro, the settlement would probably leave them without foreign exchange reserves, making even more painful the balance-of-payments crises they would face.

True, these losses could be viewed as one-off, and worth bearing for longer-term benefits. But those benefits from an exit seem highly uncertain.

After all, once the leavers have left and the dust settles, the euro would appreciate strongly. With all of Germany's mainstream political parties having their base in export-oriented manufacturing, that would hardly be an attractive prospect.

More important, to shore up confidence in the euro, Germany would have little choice but to accommodate France's push for "common economic governance", including by issuing eurobonds that transfer the risks associated with France's infrastructure white elephants to German taxpayers. Compared with that option, which invites wasteful public spending on a vast scale, cutting the Club Med a bit more slack looks like good value. Angela Merkel therefore has every incentive to blink.

As for the Club Med countries, exit would give them the ability to devalue, helping restore lost competitiveness. But if the euro was so popular in Europe's periphery, it was because of long experience with devaluations that left underlying structural problems unresolved while fuelling inflation that rapidly undermined any initial cost advantage.

Devaluations therefore bought only momentary relief between successive crises. And those crises impose a startlingly high cost: research shows that even after 25 years, a country that has had a serious currency crisis has a per capita income 18 per cent lower than one that has not.

Of course, exiting countries could seek assistance from the European Union and the International Monetary Fund. But once they were no longer pivotal to the eurozone's survival, aid would come with even tougher conditions than those imposed to date. Faced with those conditions, there is every risk of the Club Med countries descending into puerile leftism and economic collapse.

Remaining in the euro may therefore be the most palatable alternative for the south too. And if it does force desperately needed structural reforms, as it is to some extent doing, it could offer the best hope for sustainable growth.

None of that is to downplay the current difficulties, nor the flaws in the original design. But as Italy's Prime Minister, Mario Monti, wrote years ago, "Italy needs the euro constraint because it cannot have Mrs Thatcher".

Better reform at high cost than not at all.

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