

THE SYMBOLIC VALUE OF THE EURO IN THE EUROZONE CRISIS

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ABSTRACT

This paper compares and contrasts the current Eurozone crisis with the Latin American crisis of the 1980s, an economic episode so serious that it very nearly collapsed the US banking system. The author finds that the European crisis is far more severe, yet Eurozone policymakers seem more concerned with the survival of the Euro as a currency, than the stability of the European Banks. It is argued that the symbolic value of the Euro, what it represents for the French and German policymakers, is interfering with their sense of economic reality.

I. INTRODUCTION

In the face of the current sovereign debt crisis, Eurozone policymakers have placed their own political legacy above that of the stability of the European banking system. It is not sufficient for the Euro as a currency to survive – few doubt that it won't – but a line in the sand has been drawn, the prestige and symbolism of the Euro requires that not a inch of the Eurozone be ceded in the form of nations being allowed (or forced) to drop out. No Eurozone politician wishes to be remembered as having been at the helm should that eventuality come to pass.

The gesture is stubbornly romantic. In 1916 French General Robert Nivelle uttered the words “*Ils ne passeront pas*” at the opening of the Battle of Verdun. Twenty years later, and with considerably less success, Dolores Ibárruri Gómez, a member of the Communist Party of Spain, uttered the same “*¡No pasarán!*” as General Franco's Nationalist army prepared to take Madrid. For his trouble, Nivelle was recognized by his countrymen with the Grand Cross of the Legion d'Honneur. For her part Gómez was forced to flee to the Soviet Union.

This paper compares and contracts the current Eurozone crisis with the last great sovereign debt crisis, that of Latin America in the 1980s. The latter came within a whisker of collapsing the US banking system, yet in terms of magnitude it was considerably smaller than the former. Moreover, the Latin American case was more a crisis of liquidity that one of solvency, in the sense that the main players: Argentina, Brazil Mexico and Venezuela were, once the oil shocks of the 1970s had dissipated, able to grow their way out of their predicament. The same cannot be said of the cast in the current European crisis. Portugal, Ireland, Italy, Greece and Spain (the PIIGS), all owe relatively larger amounts and have stagnant demographic growth with an aging population.

In the case of their exposure to the PIIGS sovereign debt, European banks find themselves in a marginally better situation than that of the US banks in the 1980s, yet this one glimmer of hope is being slowly extinguished by the insistence on the part of European policymakers that, in order to keep Greece within the Eurozone, more Greek debt must be forgiven. At the time of writing – late October 2011 - the current “haircut” stands at 50%, with no guarantee of any end to further erosions of bank reserves.

The paper will proceed as follows. Section identifies the sources of data. Section III summarizes the economic and banking situation for both crises. Section IV outlines the Latin American crisis. Section V the European crisis.. Section VI concludes

II. DATA.

All macroeconomic data comes from the IMF 2011 World Economic Outlook. In some cases the IMF data differs from similar data collected by others organizations such as Eurostat and the World Bank. Whilst the author recognizes the existence of these differences, they are neither quantitatively or qualitatively significant. European banking data comes from Bloomberg and the Goldman Sachs report: European Banks (July 13th, 2011). The US banking data comes from the FDIC.

III. A COMPARISON OF CRISES

Table I compares three key macroeconomic indicators: The Debt-to-GDP ratios, the Current Account as a percentage of GDP and the rate of GDP growth. Considerable caution must be exercised in interpreting the data, indicators should not be viewed in isolation, but instead, as part of a whole. This is especially true of the Debt-to-GDP ratio since alone it is not indicative. Firstly, on a national scale, no standard exists to say what is too high and what is too low. For example, the country of Belgium has almost invariably maintained a ratio of more than 100% with few disapproving murmurs; the tolerance coming from the fact that GDP growth is relatively stable and the current account rarely threatening. In contrast, both the US and UK have ratios below 100%, but slower growth rates and deleterious current account balances. Secondly, when compared to infinitely lived corporations, tolerances for debt appear to be different. Many highly rated public corporations are able to borrow and thrive with Debt-to-EBITDA ratios as high as 500%, levels that would be deemed unacceptable for a sovereign.

TABLE 1

COUNTRY/YEAR	DEBT/GDP Ratio	CURRENT A/C (%)	GDP Growth (%)
Argentina (1985)	55.9	-1.08	2.00
Brazil (1985)	58.9	-0.90	5.31
Mexico (1985)	79.3	0.37	3.41
Venezuela (1985)	55.2	0.51	2.21
Portugal (2010)	93.3	-4.55	1.13
Ireland (2010)	94.9	0.49	-0.43
Italy (2010)	118.4	-3.29	1.13
Greece (2010)	144.9	-10.45	-4.35
Spain (2010)	61.7	-9.89	-0.15

The data illustrates that the situation in Latin America in the 1980s was considerable better than in Europe today. The Debt-to-GDP ratios were lower and the Current Account and GDP growth rates were by mid-decade still largely intact. The crisis was one of liquidity.

In contrast, the PIIGS have considerably higher Debt-to-GDP ratios, their Current Accounts and growth rates show no prospect of improving. The crisis is one of solvency. Further, as mature economies, the European quintet not only have less capacity to grow their way out of difficulty quickly, but will have to do so from a poorer macroeconomic starting point.

Table 2 examines two banking indicators sensitive to sovereign debt: loans as a percentage of total assets and loan reserves as a percentage of total assets.

TABLE 2

	Sovereign Loans/Total Assets	Loan Reserves/Total Assets
US Banks (1985)	9.4%	0.90%
US Banks (1989)	7.4%	3.47%
European Banks (2010)	1.2%	2.21%

Although European bank exposure to PIIGS debt is substantially lower than that of US banks to Latin American debt in the 1980s, and their loan reserves higher. US banks were able to both reduce their exposure and increase their reserves relatively quickly thanks to the regulatory forbearance that will be described in the next section. There is little evidence that such accommodation is taking place in the Eurozone, since policymakers have prioritized the currency over the banking system. The October 29th settlement – the last of the string of settlements before the referendum/vote of no confidence fiasco that led to the resignation of Greek Prime Minister Papandreou – saw policymakers and Eurozone banks agreeing to a 50% haircut. The Greek government took no part in the negotiation.

IV. THE 1982 LATIN AMERICAN DEBT CRISIS

In August 1982, then Mexican Finance Minister Jesus Silva-Herzog “Flores” declared a 90 day moratorium on his country’s debt service and called for both a rescheduling of payments and new loans to cover those payments. By October of that year, a further twenty-nine countries owing \$239 billion had joined Mexico or were in the process of doing so. Wellons (1987) reported that of those twenty-nine, sixteen were from Latin America and the four largest: Argentina, Brazil, Mexico, and Venezuela - owed 74% of the total. That December, the Federal Financial Institutions Examination Council (FFIEC) estimated that the eight largest U.S. commercial banks were owed approximately \$37 billion, which constituted nearly 150% of their capital reserves.

The 1982 Latin American debt crisis has been well studied. As U.S. corporations sought opportunities for international expansion in the 1950s and 1960s, U.S. commercial banks expanded with them and provided funding through the growing Eurodollar markets. As oil prices began to rise in the early 1970s, the funds deposited by oil-exporting countries were redirected towards the oil-importing countries in the form of dollar denominated loans. Although the inflationary shock slowed growth in the Less Developed Countries (LDCs) to an average of 4.5% (Beek 1977) continuing demand in the commodities, minerals and agricultural markets allowed them to keep pace with their obligations.

However, by 1974-1975, the quadrupled oil price precipitated a stagflation that lingered into the early 1980s. Since the LDCs, especially those in Latin America, had assumed syndicated medium and long term loans with floating rates priced to LIBOR, their increased debt service could no longer be offset by export revenue.

As the old adage goes: When a borrowers experiences difficulties repaying a \$10,000 loan – the borrower has a problem. When the borrower has difficulties repaying a \$10 million loan – the lender has a problem.

The 1982 LDC Debt crisis was particularly inopportune for the US banking system. Domestically, commercial banks had been losing their share of household depositors to other financial intermediaries, whilst simultaneously losing their large corporate borrowers to the commercial paper market- thus, the lure of a large overseas loan market. Yet it was not the international nature of the loans that caused concern, but the dollar volume. Congressional hearings on LDC debt were held in 1975 and in 1977. The Senate Subcommittee on Foreign relations noted, “The most immediate worry is that the stability of the U.S. banking system and by extension the international financial system may be jeopardized by the

massive balance of payments lending that has been done by commercial banks since the oil price hike.” (Italics added).

Again in 1977, speaking at Columbia Business School, no less a figure than Arthur Burns, chairman of the Federal Reserve Board warned that:

Many countries [as a result of increasing oil prices] will be forced to borrow heavily, and lending institutions may well be tempted to extend credit more generously than is prudent. A major risk in all this is that it would render the international credit structure especially vulnerable in the event that the world economy was again to experience recession on the scale of that from which we are now emerging.

Arthur Burns was not John the Baptist crying in the wilderness. His successor at the Federal Reserve Paul Volker expressed fears that, “...rising oil prices would mean some rescheduling of debts owed by developing countries.” (*Barron's* 1/7/1980). Similarly, in 1981 *The Wall Street Journal* noted:

It does not show up on any maps, but there's a new mountain on the planet – a towering \$500 billion of debt run up by the developing countries, nearly all of it within a decade...to some analysts the situation looks starkly ominous, threatening a chain reaction of country defaults, bank failures and general depression matching that of the 1930s.

From the initial Mexican default in 1982, it took almost a decade before US banks and the LDCs recovered, yet the success of the recovery hinged on a policy of forbearance. Far from rigidly enforcing regulations and capital standards, US regulators – without overt political interference or meddling – were allowed to proceed pragmatically. Brinkman, et al. (1996) comment:

Had these institutions been required to mark their sometimes substantial holdings of underwater debt to market or to increase loan-loss reserves to levels close to the expected losses on this debt [as measured by secondary market prices], then institutions such as Manufacturers Hanover, Bank of America, and perhaps Citibank would have been insolvent.

The slow approach was beneficial in two ways. Firstly, US banks were allowed time to build up reserves against the inevitable LDC losses, and secondly, they were allowed to continue, albeit in a much curtailed fashion, to extend loans to the LDCs, giving the LDCs time to slowly liberalize their trade, fiscal and privatization policies..

Husain (1989) reports that the key to engineering the *soft landing* was the understanding that the LDC crisis was essentially a crisis of liquidity rather than solvency. Prior to the final oil spike in 1974-1975, the Latin American economies had held their own. Economic growth had declined from 6% in the late 1960s to approximately 4.5% in the early 1970s (source: IMF). Once the demand for commodities returned, they was plenty of slack left for the LDCs to grow their way out of debt and back to some level of prosperity.

By 1989, the crisis had been sufficiently stabilized to allow the remaining debt to be securitized in the form of the so called “Brady Bonds”. Broadly speaking, the bonds came in two types, fixed rate and floating. The principal and first three coupon payments was collateralized by the purchase of zero coupon US Treasury securities of like maturity. When the first coupon payment was made, the collateral associated with it was “rolled” so as to collateralize the fourth coupon payment. When the second coupon payment was made, its collateral was rolled forward to collateralize the fifth coupon, and so on.

Thus, as each coupon payment was made a greater proportion of the outstanding amount became collateralized by US Treasury securities. In certain cases asset recovery rights provided additional collateral.

Although the exact indenture varied from country-to-country, there was enough standardization that an active secondary market in outright bonds and in inter-bond spreads emerged by the mid 1990s. This, together with the partial collateral allowed US banks to clear much of the debt from their balance sheets. With the exception of Russia and Ecuador, who both defaulted in 1999, all other Latin American countries were able to retire their Brady bonds prior to maturity.

V. THE CURRENT EUROZONE CRISIS

While the LDC crisis of the early 1980 was solved in a slow and systematic manner, with considerable care being taken not to alarm the financial markets; the current Eurozone crisis appears scripted for the 21st century news cycle. The players in the LDC crisis were, for the most part, the regulators who massaged the exposure of U.S. banks to the point where, in 1989, it was possible to securitize the debt into Brady Bonds which could then be traded off the balance sheet. In contrast, the Eurozone crisis has politicized beyond mere party politics, but all the way up to the head of state level. Such is the apparent urgency that French President Sarkozy missed to birth of his child in order to meet with German Chancellor Merkel.

Throughout the LDC crisis the objective was clear. What was at risk was the stability of the U.S. banking system, and every effort had to be made to restore stability. Arbitrarily, we can carve the European problem away from the greater global situation by returning to the collapse of the Icelandic banking system in 2008. The islands three largest banks: Glitnir, Landsbanki and Kaupthing were nationalized following their inability to obtain short-term funding from the international money markets. These banks (and others) had so aggressively pursued depositors outside of Iceland that by late 2008, the banking system itself was responsible for over 80% of the country's external debt, which stood at 705% of GDP. Leftly (2008) writes that on October 7th, David Oddsson, a governor of the Central Bank of Iceland announced:

We [the Icelandic State] do not intend to pay the debts of the banks that have been a little heedless.

For good measure, he added:

If we were tied to the euro ... we would just have to succumb to the laws of Germany and France.

Most depositor losses were incurred in the United Kingdom where the mechanics of deposit insurance are more opaque than in the US, thus for many, the prospect of recovering their money will be long and drawn out. Both the UK and Dutch government were able to negotiate a settlement from Iceland where a portion of Icelandic GDP (4% for the UK, 2% for the Dutch) would be paid from 2017-2023.

In isolation, the Icelandic affair would soon have been relegated to a footnote in the history of banking, but it occurred at a particularly inopportune time from the point of view of the investor community. In the United States, the government had failed to intervene in the collapse of both Bear-Stearns and Lehman Brothers; more sobering still, they had favoured stakeholders over bondholders in the bail-out of General Motors. In Europe, first the Icelandic government had refused indemnify foreign depositors in Icelandic banks, then the depositors found, at least in the case of the UK and Holland, that deposit insurance was selective. Local authorities and corporate depositors were not insured since they were both deemed to have a greater capacity to bear losses and, were supposedly, "sophisticated investors" [who should have

done their homework!]. Thus, the suspicion was engendered that a government's commitment to the investment community might not be as strong as was hitherto believed. Not surprisingly, many investors started to re-examine their holdings and those who found themselves holding Greek government debt were given pause for thought. The cloud of anxiety floated from Reykjavik to Athens, and the spread between the yield on German and PIIGS debt began to widen.

Rather than accept the verdict that the investor community was concerned with the state of Greece, European policymakers encouraged the media to put the cart before the horse and blame the markets for the crisis. Inconveniently however, the Greek data stood out so badly that the focus of attention had to be changed. A purer more sympathetic victim had to be found, a victim that so sacred that it had to be defended at all cost – The symbolic Euro.

We shall defend the Euro whatever it take.

Olli Rehn -EU Commissioner for Economic and Monetary Affairs (May 2011)¹

The Euro is an essential element of Europe. We cannot leave it to the speculators. We will not let others undo what generations have created.

French President Nicholas Sarkozy (May 8, 2011)²

Speaking before the Bunderstag on 28th October 2011, Chancellor Angela Merkel implored lawmakers to approval additional disbursements to the joint EU/IMF “bail-out fund” for Greece.

Nobody should take for granted another 50 years of peace and prosperity in Europe ... that's why I say: If the euro fails, Europe fails. We have a historical obligation: To protect by all means Europe's unification process begun by our forefathers after centuries of hatred and blood spill. None of us can foresee what the consequences would be if we were to fail.

Ignoring the fact that for much of history the global economy had a single currency – gold – and it did little to preserve peace, Chancellor Merkel and other policymakers have realized that public tired of bank bail-outs and even less sympathetic towards Greece. Thus, it was the Euro itself that had to be threatened – after all “Saving the Euro” makes a better slogan than “Saving the French Banks (again)”.

VI. CONCLUSION

The symbolic value of the Euro cannot be overemphasized, and like most good symbols it is both forward and backward looking. In one sense it serves as a cenotaph to the victims of the “centuries of hatred and blood spill” that Chancellor Merkel alluded to in her speech before the Bunderstag. More specifically for Germans, it might give some meaning to the losses suffered in their two great defeats in the twentieth century.

Both France and Germany entered the twentieth century as world powers, yet half a century later they were both bankrupt, broken and defeated states; with neither the ability, nor possibility, of ever recovering their former influence. Yet together, and with the addition of the Benelux countries and Italy, they formed first, the Common Market, then the expanded European Community and, finally, the European Union. The common currency became their economic voice and, as the Eurozone expanded, the voice grew stronger. The Euro became the symbol for a return of prestige and influence. More tangibly still, the Euro stood as the symbol for the Bundersbank, the institution charged with ensuring that, never again, should economic mismanagement result in extreme political consequences. The extension of the Bundersbank

into greater Europe is almost akin to reparations for past belligerent expansions', a desire for some measure of redemption.

The package is so enticing, that Eurozone policymakers regard any reverse as being a threat to the entire edifice and all that it stands for. Thus, no Eurozone policymaker dare risk their legacy by being associated with such a reverse.

Outsiders, unencumbered with the symbolism, have the luxury of objectivity. The Euro existed before Greece joined (2001) so it is unclear why the Euro should perish without Greece. Taken to a further extreme, there is no reason to believe that the Euro could not survive if the Eurozone were shrunk to its Carolingian core, say: Germany, France, the Benelux countries and a few others. As Harvard University economist Martin Feldstein wrote in the Economist (June 2011):

Current strains within the euro zone show why it may not last for another decade without at least some of its members leaving. If that happens, the remaining euro zone could be stronger and more cohesive and the countries that leave would be able to avoid the problems that they face in the current crisis.

Feldman is right, but then Euro would not be the Euro anymore.

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