



Special Report

March 5, 2012

The Netherlands & The Euro The Full Report

Statement of Purpose: A study of the fundamental flaws of the Economic and Monetary Union (EMU) and the damage done by the euro to date to The Netherlands was commissioned from Lombard Street Research by the Dutch Partij voor de Vrijheid ('PVV', the Party for Freedom). This is the main report on which the Special Report, "The Netherlands and the Euro" is based. The two should be considered together, so this report will not have a summary and conclusions, since the Special Report starts with those.

The study falls into five chapters and two appendices, covering the flaws of the euro in principle, the debt crisis in Mediterranean Europe ('Med-Europe') and Ireland, the damage to The Netherlands and Germany from euro membership, the superior performance in the past ten years of non-euro Sweden and Switzerland, and the benefit to The Netherlands from quitting the euro as soon as possible. The first appendix covers the global economic background and prospects. The second covers the ECB.

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The Netherlands & The Euro

The Full Report

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Chapter A: The inherent economic flaws in EMU

This chapter will explain in detail both why the euro was highly likely to fail from the start, and other aspects of the development of Eurozone economies since 1999 that have made the current position worse. The subsequent two chapters will describe the build-up of the debt crisis in Mediterranean Europe (hereinafter 'Med-Europe') and Ireland, with its forecast consequences if the stricken economies all remain in EMU, and the damage the euro has done to The Netherlands and Germany, the supposedly strong Eurozone economies. The following topics will be covered:

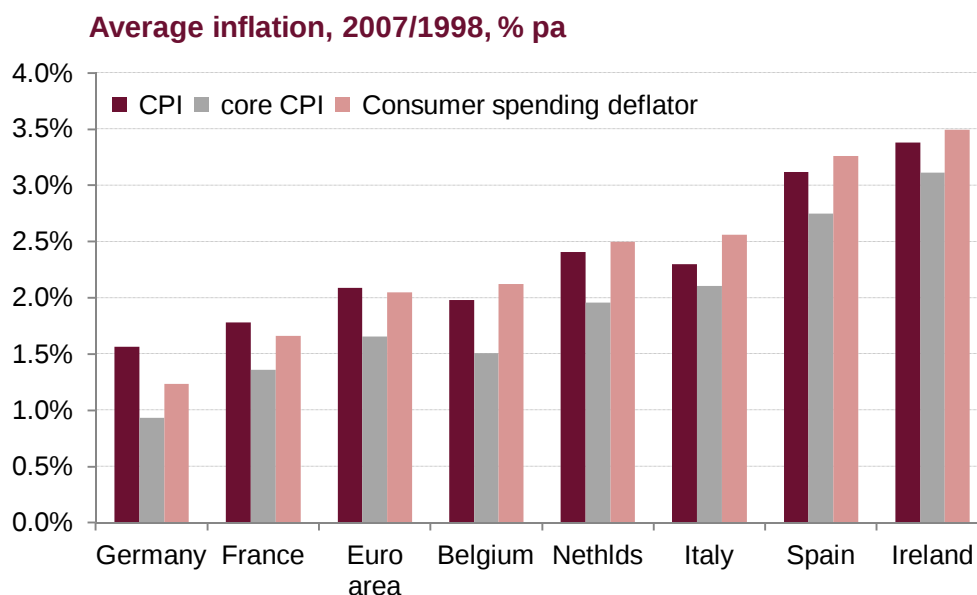
- The high likelihood of divergent inflation that was clear before the start of EMU in 1999, leading to large cumulative variance of cost competitiveness between countries. This is distinguished from the deeper concept of competitiveness that arises when productivity is increased – ie, real output per hour worked – or products or processes are in other ways improved, permitting higher prices to be charged for what on the surface may seem an unchanged product or service.
- Strongly divergent potential growth trends – either through relatively low-income countries catching up with more advanced economies (eg, Spain and arguably Greece) or through the combination of catch-up potential with plentiful resources, permitting fast growth via employment of more labour, capital and land (Ireland)
- “One size fits none”! – the perverse operation of a common nominal interest rate in all the countries of the euro, despite their different inflation rates and potential growth rates, an effect that was reinforced by the low-growth and low-inflation countries largely coinciding. This single interest rate has been higher in real terms (ie, inflation-adjusted) for the “slow” countries and lower (often negative) for the “fast” countries, in both cases reinforcing and distorting their divergences
- As the divergences accumulated, “slow” countries moved into large current-account, ie, trade, surpluses and “fast” countries into deficits, though the Eurozone remained roughly in balance with the rest of the world.
- Inevitably, the “fast” countries developed large cumulative debts, sometimes at the government level, sometimes private debts, both of which have been exposed as unaffordable by the global slowdown since the 2007-08 financial crisis.
- The random acceptance of Greece in the euro in 2001, as well as the waiving of certain Maastricht criteria in the admission of Portugal and Italy at the start, have exacerbated the debt problem in Med-Europe
- The focus by Germany on government deficits, both in the 1998 Stability and Growth Pact and in the recent pact to rescue the Eurozone, addresses neither the sources of the current crisis nor the fundamental design faults of the Eurozone – for example, the German government deficit was above the Eurozone average in the run-up to the 2007-08 crisis, while Spain and Ireland were in budget surplus.
- In parallel to the divergences, the growth of “true” competitiveness, output per hour worked and value received for a given volume of product (“terms of trade”), has worsened sharply in the apparently stronger, Dutch and German

economies. The euro, by making them excessively cost competitive vis-à-vis “soft” Med-Europe EMU rivals, may have reduced the pressure on their businesses to control costs.

- The fall in wage and salary incomes caused by both lower growth and a lesser labour-income share in GDP has made the financially strong economies unduly dependent on exports and associated business investment for growth
- The build-up of trade surpluses has been falsely hailed as an “investment” in future decades when the labour force is expected to be smaller, with more old people to support, arguing for surpluses now to generate income then
- As well as being a misconceived argument, this strategy is weakened by the poor investment of surpluses in US sub-prime mortgage paper, Greek government bonds, etc., at a loss
- For the euro to be sustainable in future, these surpluses will have to be given to Med-Europe countries as unrequited transfers, not lent with the expectation of interest and repayment. And revival of the Med-Europe economies by growth will only be possible if The Netherlands and Germany accept much higher inflation than the ECB’s Eurozone target.

The analysis of the divergences and imbalances of inflation and real interest rates within the Eurozone will concentrate on the period to 2007 in which policy-makers and financial markets were largely unaware of the build-up of problems being created. Since 2007, awareness has grown – though major pockets of denial (and/or bluff) remain. One effect has been that the divergence of growth has been reversed – Med-Europe and Ireland have crashed. So far the picture is much more mixed as regards divergent inflation, but it is being put right in some countries, and has become less acute in all of them. Divergent inflation is the most easily understood source of imbalances, so it is convenient to start there.

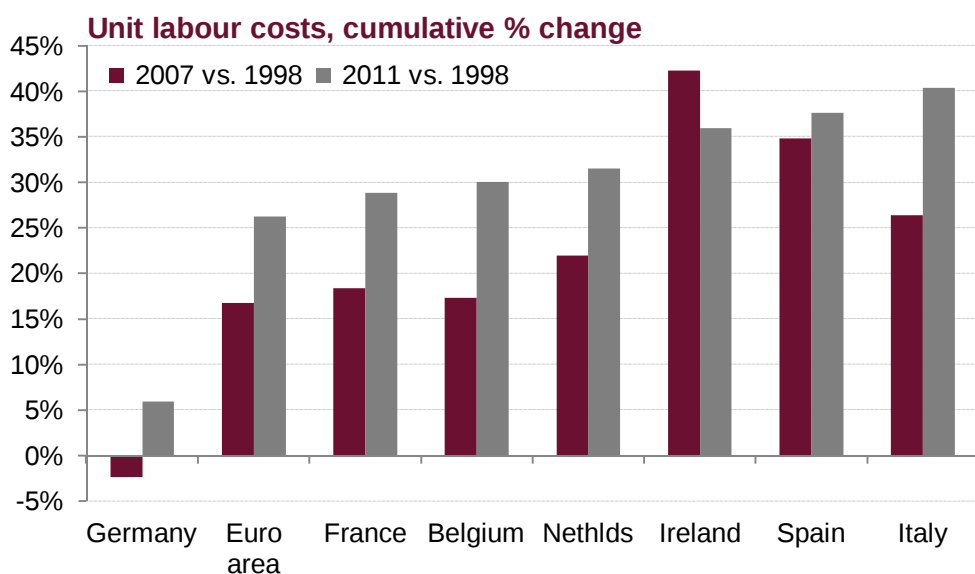
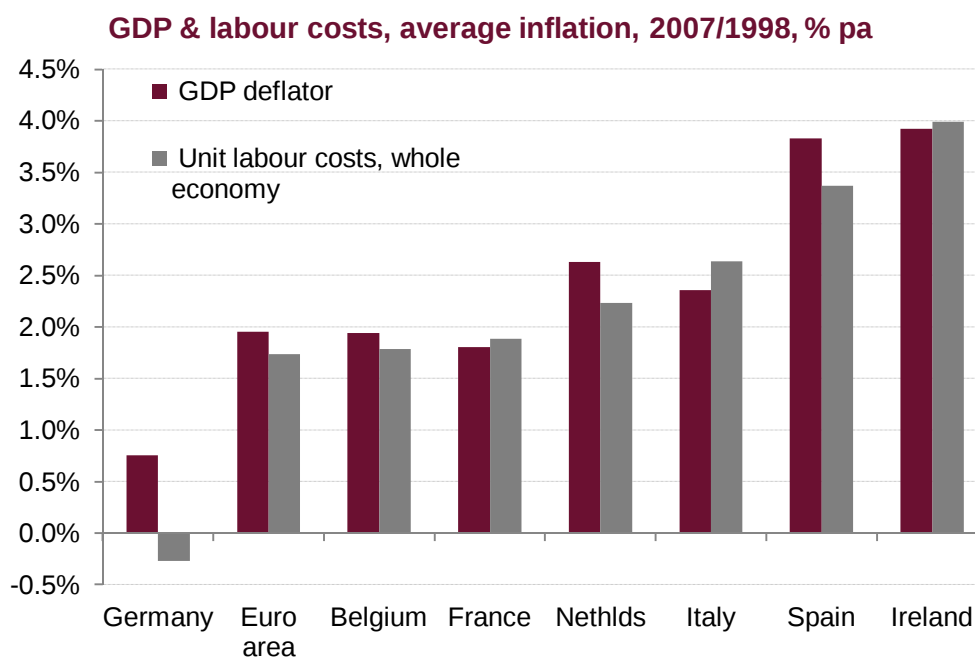
Inflation divergence



The most widely understood measure of inflation is the consumer price index (CPI). Some aspects of inflation, especially its recent trend, are better measured by the so-called “core” CPI, which simply excludes food and energy, whose movements are highly volatile and generally have little to do with inflationary behaviour within a particular country (especially in Europe). Consumers respond to inflation, sometimes by shifting to purchases of less inflationary goods and services, so the actual inflation suffered in overall consumer spending is measured by changes in the consumer spending “deflator”. In the chart above, countries are shown in ascending order of consumer spending deflator inflation, using the average annual rate between 1998 (the last pre-euro year) and 2007, when the debt crisis became evident. Interestingly, the differences in the chart below accumulate over the nine years in question to only about 15-20% between Germany/France and Spain, and 10% between them and Italy. This is a lesser divergence than domestic cost pressures would suggest (see below) reflecting the fact that in a relatively efficient single market for products and services, major price divergence is to a degree ironed out – businesses have to price into the market.

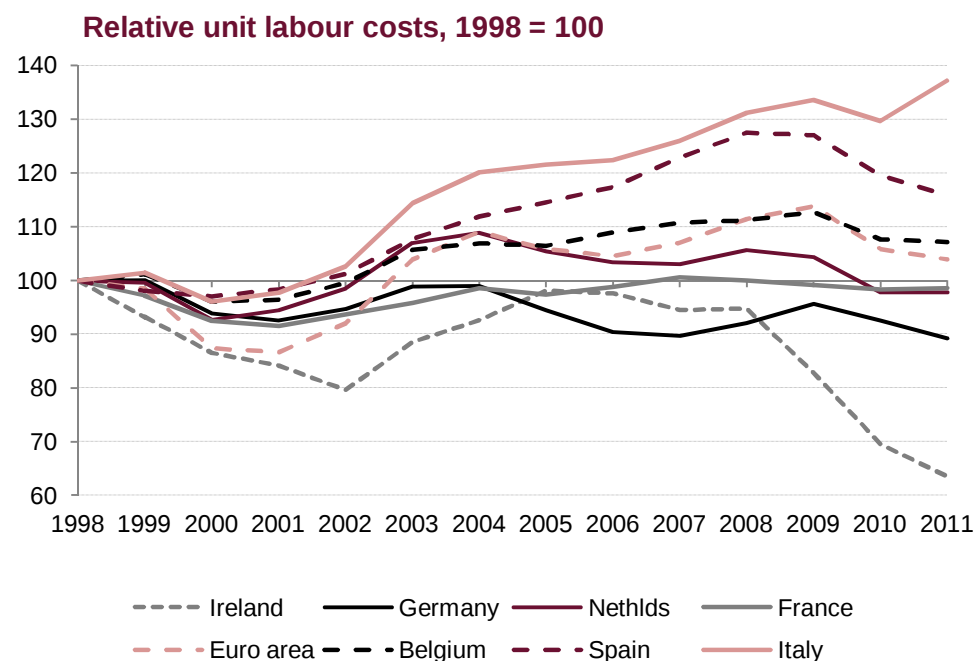
When it comes to relative cost competitiveness, the better measures are differences in the inflation of the GDP price index – thus minimising the influence of import prices – and of unit labour costs, which is the growth of total hourly wages and salaries (plus “fringe” labour costs) less the change of productivity (output per hour worked). This more fundamental measure of cost competitiveness shows a much larger divergence between countries than consumer price inflation. (Greece, which on earlier measures showed much higher labour cost inflation even than Italy, Spain and Ireland, is excluded partly because the OECD has ceased to try to represent its unit labour costs, presumably not trusting the Greek statistics, and partly because it joined EMU late, in 2001 and should clearly not have been allowed in under any criteria. The Greek case is treated separately below.) Leaving

aside Ireland, being small and flexible, German unit labour cost growth undershot Italy's for nine years by about 3% a year, and Spain's by about 3½% a year. Cumulatively, over nine years the divergence was very large. In fact, the chart below clearly indicates that Germany is the “odd man out” when it comes to Eurozone labour cost inflation, a point that has major consequences, to be analysed below. The Netherlands, France, and Belgium had unit labour cost inflation close to the Eurozone average.

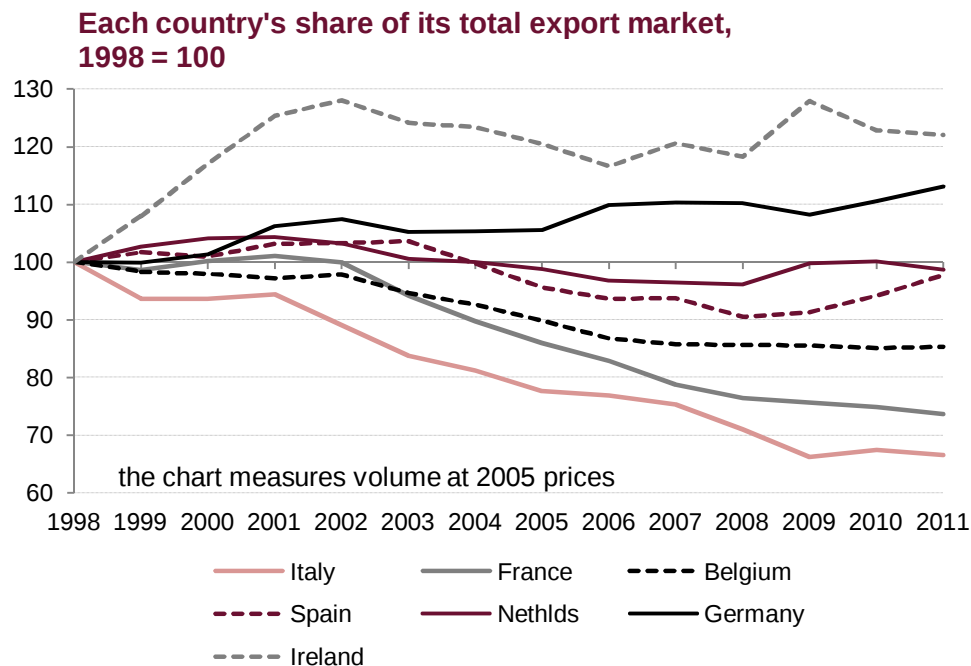


This chart shows the cumulative change in unit labour costs between 1998 and both 2007 and 2011. The weakness of activity since 2007 has increased these costs significantly (Ireland excepted) between 2007 and 2011, as the chart shows: lesser output means that costs have to be spread over a smaller “denominator”.

For Germany this effect is less than most, owing to output having recovered just above its early-2008 peak. In Spain, employment has crashed far more than GDP – though Spanish real GDP data are open to question – so unit labour costs have only gone up a little since 2007, despite continued rising wages. In Ireland, wages and jobs have been hammered in that flexible, small economy that entered the crisis first, so that unit labour costs are now lower than in 2007.



The chart above shows the shift of unit labour costs for each country relative to the average of its trading partners, each partner's weight being its share in the country's exports and imports combined. The effects of divergent inflation of labour costs thus partly depend on geography and trade distribution. (For trading partners outside the Eurozone, the change in relative unit labour costs is a compound of the relative cost change in home currency and the shift of the bilateral exchange rate.) Italy, having very close trade links with Germany, suffers particularly badly in relative cost owing to the divergence of its costs from its most important export market, Germany. The Netherlands, with extremely high ratios to GDP of exports and imports, is virtually bound not to diverge much in costs, and benefited from the labour cost inflation in Britain (an important cross-channel trading partner) being somewhat higher than in the Eurozone, partially offsetting very close links with Germany. Hence, although its unit labour costs have risen faster than the Eurozone average, its relative unit labour costs have risen less. In stricken Spain and Ireland, relative unit labour costs have gone down strongly since 2008.



Relative costs are not the only factor affecting a country's export performance. A mix of qualitative factors such as product quality and image, delivery efficiency, etc., are also important. Also relevant is whether a country entered the euro at the "right rate" in 1999. The chart above shows the yearly index of each country's share of its export markets (all measured in "real" terms, ie, at 2005 prices, and weighted according to their share of its exports). It is widely asserted that Germany was overvalued at euro-entry and Spain undervalued. As regards Germany, the chart does not support this view. Its export market share has risen consistently, both in 1999-2001 and since, despite the fact that the export market share for the OECD, the euro area, and advanced countries in general, has fallen quite sharply, owing to the meteoric ascent of China's world market share. (Over the 13 years 1999-2011 China's share of world markets by volume rose nearly four times, largely accounting for the OECD's being down some 11%.) It follows that Germany was not as uncompetitive as was widely supposed in the late 1990s: its products were preferred (or price-insensitive).

Two other countries, The Netherlands and Spain, have kept a larger proportion of their 1998 export market share than labour-cost developments alone would have suggested. In the Dutch case, market share has been maintained, and relative unit labour costs are also little changed, but the background point – large market share gains by China, and corresponding losses by advanced economies – means this is a better-than-peer-group performance, probably reflecting the qualitative factors referred to above.

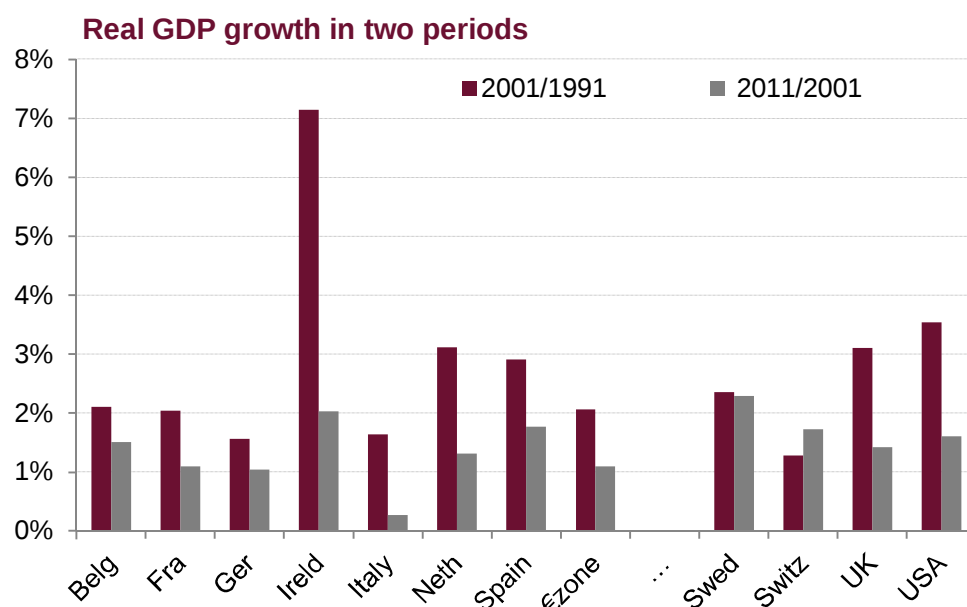
In Spain's case, market share gains from 1999 to 2003 followed by decline until 2008, and then some recovery, suggests Spain was indeed undervalued at the start of the euro, and then suffered from its high cost-inflation until the crisis, after which its rapid cuts in unit labour costs seem to have brought market share recovery. While this all seems logically connected to cost changes, the overall

maintenance of market share over 13 years in the face of a net loss of cost competitiveness and the overall loss of share by advanced countries as a whole, suggests some favourable element of product quality or other non-cost effectiveness at work for Spain.

On the negative side lie France and Italy. With Italy, it is hardly necessary to look far beyond costs, which have got far out of line over 13 years, with no reversion to mean even after the crisis. Its export market share has slumped by one third since 1998. With France, this is not true. Despite little change for better or for worse in its relative unit labour costs, its market share has fallen by a quarter over 13 years, versus an advanced country average of one ninth. This must clearly be attributed either to unfavourable geography – too great a concentration in slow markets – or poor products, etc.

The importance of these results is that on competitiveness grounds – including both costs, geography and qualitative issues – not only is Italy hobbled for the indefinite future if it stays in the euro (as we shall see when examining growth) but France has also performed badly even with the euro's exchange rate held down by the competitive “dead-weight” of Med-Europe. If Italy were to leave the euro, for whatever reason but fundamentally through lack of cost-competitiveness, then the single currency would rise quickly to a level at which France could be in severe difficulties, considering how far its market share has fallen even without a significant cost disadvantage.

Growth divergence



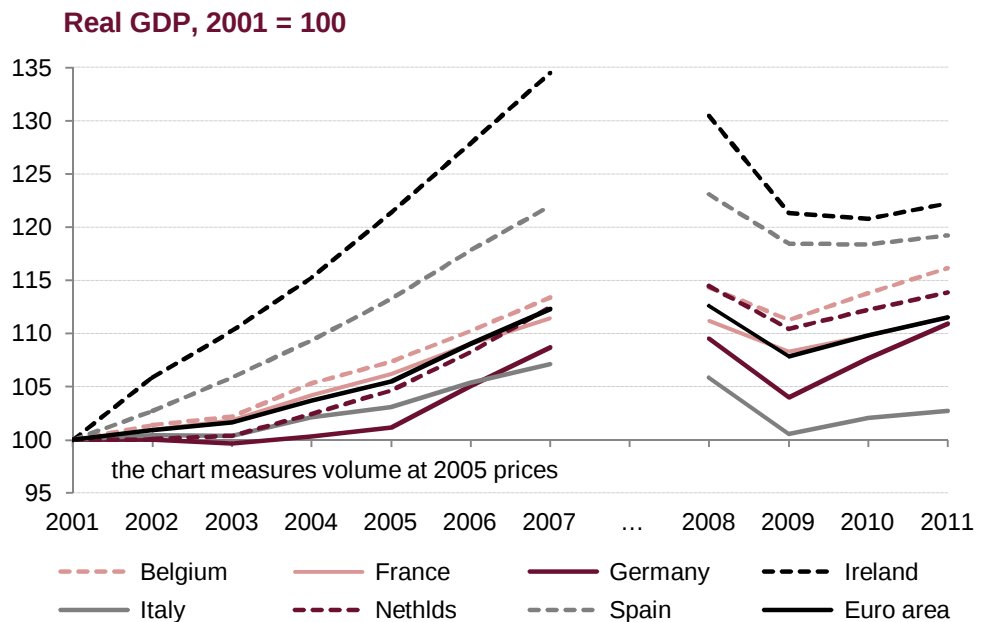
The growth of Eurozone countries was little affected by adopting the euro in 1999 and early 2000, when the US-centred hi-tech boom drove the world economy up – and then down when the stock market bubble burst from mid-2000, provoking a 2001 Eurozone slowdown, as the US suffered a mild recession. Over those first

three years, the divergences between countries had not progressed far, and had little effect on the growth outcome. But the recovery after 2001 saw major divergences emerge, partly because of different potential for catch-up growth (Spain and Greece) or attraction of greater capital and labour resources (Ireland), partly because of the perverse effects of the “one size fits none” monetary policy, and partly because of a severe fiscal deflation in Germany to address alleged cost excesses and labour market rigidity. So we compare the ten years 2001-2011 with 1991-2001.

It is immediately apparent that all the economies of the Eurozone suffered a large drop in growth in the latest decade compared to the previous one. But so did the US and the UK. The significance of this is, however, that the US and UK were what Mrs Merkel and others in Germany refer to as the “sinners”, who actually provoked the 2007-08 crisis. When we look at other European countries that were not in the euro, such as Sweden and Switzerland, we find their performance in 2001-11 no worse than in 1991-2001 – quite a bit better in the Swiss case, despite the problems of the UBS, a strong currency, etc.

So why did the non-sinners, the “saints” such as Germany and The Netherlands, suffer such a reduction of growth? The answer, as will become apparent, is that their rapidly increasing dependence on exports for growth, and inadequacy of domestic demand, meant that the surplus economies came to depend just as much on the run-up of debt in the deficit economies as did the “sinners” themselves. In Europe, as in the world at large, the flood of cash from the surplus-seeking savings-glut economies was the fuel for the explosion of debt in the deficit economies – the artificial cost-competitiveness arising from suppression of wages and salaries, especially in Germany, was as much the cause of imbalances, the financial crisis, and the collapse of growth, as the excessive borrowing of Med-Europe and Ireland (and the US and UK).

The chart below shows the level of GDP, based on 2001 = 100, and splits the past ten years into two periods, up to and after 2007, the year when the financial crisis broke. It is clear that German growth in the good years of the cycle – less than 9% over six years 2002-07 – was feeble for a supposedly strong economy. Italy was even feebler, but Italy can be seen to be completely hobbled in the euro context (of which more below, p.22). The rogue element in the six-year run-up to the 2007-08 crisis was German weakness. As the chart shows, the chief problem was that Germany did not grow at all for the first four years of world recovery, 2002-05. Those were the years in which a vicious fiscal squeeze kept Germany stagnant while wages and salaries were cut by threats to shift jobs to Hungary, etc. As a result, German GDP rose by half as much as the US in 2002-07, and was even further behind Britain, let alone the artificially booming Spain and Ireland shown in the chart below.

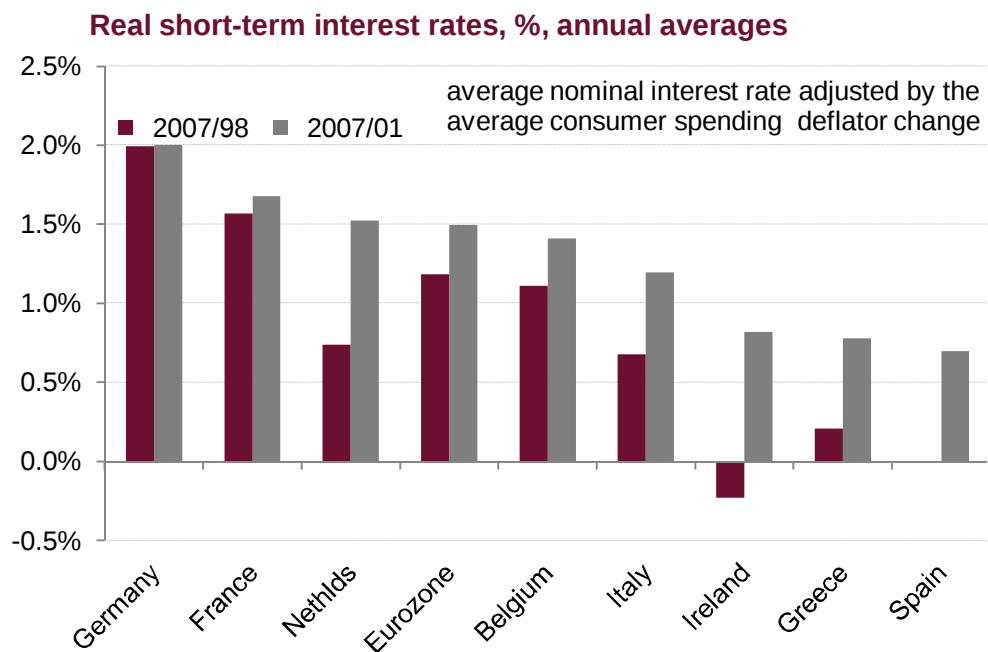


Germany's beggar-my-neighbour policy therefore was two-pronged. Aggressive suppression of wages and salaries led to greater cost competitiveness within the fixed-exchange-rate Eurozone, boosting its exports at the expense of euro "partners". But the same policy, based on repression of output growth, ensured minimal expansion of the German market for other countries goods and services, adding to the financial imbalances between them. It follows that the failure of Germany, and its associated countries like The Netherlands, to grow much in the 2001-11 period – in contrast to other financial strong north-central European countries like Switzerland and Sweden – is a result of their pursuit of export-led growth at all costs, by taking advantage within the euro of the inflationary habits in Med-Europe. The damage this has done to Med-Europe countries is profound, and will not be glossed over here – but the cardinal point, as we shall see, is that it has also severely damaged The Netherlands and Germany.

"One size fits none" monetary policy

It was in the crucial six-year, 2002-07 run-up to the crisis that the damage from the single currency's common short-term interest rate was concentrated. That period is isolated in the chart below.

On top of Germany's unsurprising and deliberate suppression of wages and salaries came the perverse impact of the common short-term interest rate in the Eurozone. As is plain from the below chart, Germany, with slow growth and low inflation, had the highest real interest rate, acting as a natural deterrent to consumption and incentive to save more. Meanwhile Ireland, Greece and Spain, where both growth and inflation were much stronger, had much lower real interest rates, exacerbating the frenzied surge of borrowing just at the time when they needed high real and nominal rates to curb the excesses.



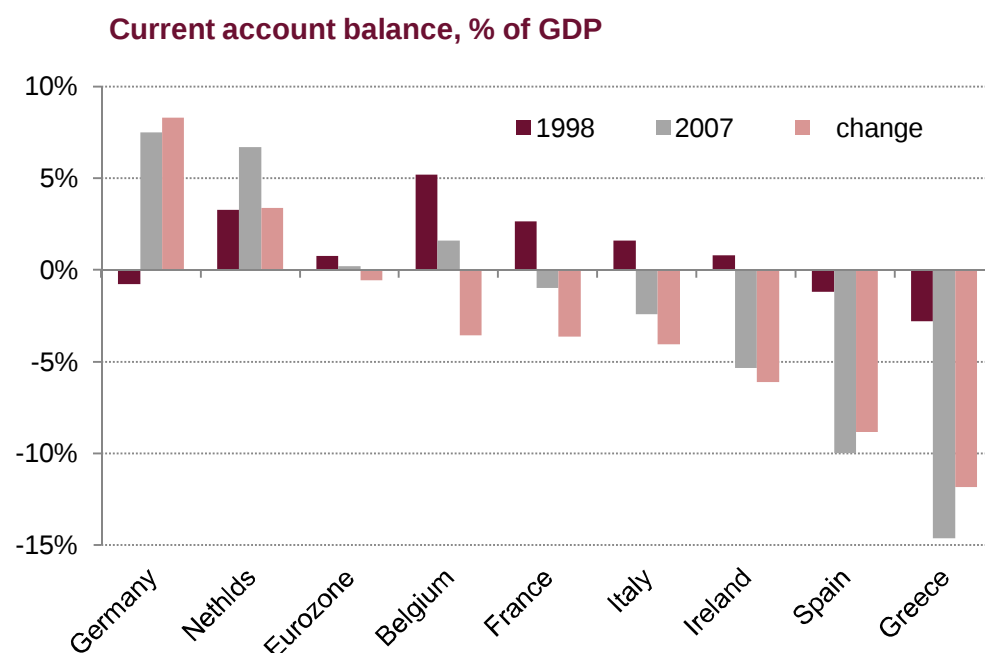
The “one-size-fits-none” monetary policy thus complements the distortions of relative inflation. Lower relative inflation biases Germany towards net export growth, and higher relative inflation biases Spain against net export growth. Higher real interest rates in Germany – because of its lower inflation – biases it away from domestic credit growth and spending, while lower real interest rates in Spain – because of its higher inflation – biases it toward domestic credit and spending expansion. The two effects together were a powerful engine leading to imbalances and disequilibrium.

Possibly more important was the distortion introduced in capital markets. The point here is that relative to housing and real estate prices, and to some extent stock prices, the disparity of interest rates was dramatically larger. Once the relatively low cost of debt enhanced growth of housing and real estate prices in Spain and Ireland, the continued flow of funds from the “savings-glut” surplus countries held down what should have been a rising cost of borrowing, and thus reinforced the boom into a bubble. If these countries had had their own currencies and interest rates, both would have risen, in nominal and real terms, and the boom would have been choked off much earlier, with much less damaging consequences. This wealth effect from the “one-size-fits-none” interest rate structure then knocked on to reinforce gains of consumption in Spain and Ireland, and its sluggishness in The Netherlands and Germany.

Euro crisis is a balance of payments crisis

The result of these trends was that the run-up to 2007 saw what had been declared impossible by the advocates of monetary union: a balance of payments crisis. That was what all the stricken countries had in common. The counterpart to a balance of payments deficit is necessarily borrowing within the national economy, and this varied between countries. In Greece and Italy, the government did the bulk of the

borrowing, making them the two most immediately vulnerable countries in the current euro-crisis, focussed on government debt levels. Spain, Portugal and Ireland all had, and have, greater overall debt than Italy and Greece, counting both the public and private sector. This was concentrated in business borrowing in Spain and Portugal, and in both business and household debt in Ireland.



It is no surprise that the balance of payments was the chief indicator of the problem (and not the government deficit), as a balance of payments deficit can easily result from either excessive inflation or very rapid growth (sucking in imports). Likewise, both slow growth and low inflation will tend to put a country in balance of payments surplus. As the structure of the Eurozone encouraged divergence by mostly the same groups of countries on both these counts, it was virtually bound to lead to imbalances of payments. Least favoured in this respect were Italy and Portugal, which had both high inflation and low growth. In effect, they were both incompetent to enter the EMU on fundamental supply-side grounds.

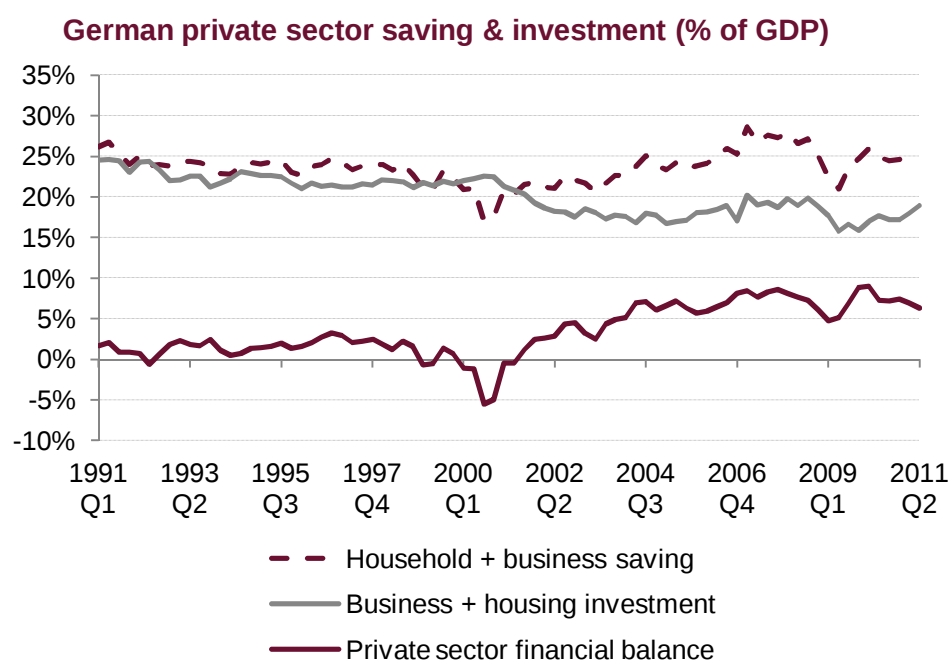
If the Eurozone were serious about avoiding a future debt crisis, it would treat government deficits as the largely unrelated issue they are, and focus instead on limits to the current account imbalances that should be permitted without countervailing action. This would involve symmetry between actions of the excess saver countries and the excess borrowers, as it can be seen that the Eurozone as a whole is roughly in balance: the imbalances between the countries are as much caused by the surplus countries as the deficit countries, for all the reasons analysed above. However, limits on balance of payments surpluses have been strenuously opposed by Germany, which refuses to take any responsibility for the euro crisis, even though German policies are an inherent cause of it.

There is a long history to this point. In Keynes's original conception of the Bretton Woods post-WWII fixed exchange rate system it was conceived that "fundamental

disequilibrium” that would justify an exchange rate change could as well be undervaluation requiring up-valuation, rather than overvaluation requiring devaluation. His proposal was for a world currency (the “bancor”) against which moves in either direction could be mandatory. But it was not possible to draft suitable sanctions for countries that hung onto unduly low exchange rates with mercantilist, “beggar-my-neighbour” intent. In the event the system was dominated by the US, which had (and has) a pro-growth bias. When Bretton Woods broke down in the early 1970s, the US was able to confront the structurally surplus nations (Japan and Germany) with inflation if they hung onto low exchange rates. Germany did not, and came through the 1974-75 oil crisis far better than Japan, which had resisted currency appreciation.

The danger in the Eurozone context is that the system is dominated by Germany, which is instinctively conservative and punitive in approach. The entire burden of adjustment is being forced onto Ireland and the Med-Europe countries with too much debt, with a complete refusal on Germany's part to reciprocate by stimulating its consumption growth. One trick that is pulled to propagate this approach is to divert the policy focus from the actual imbalances onto the largely irrelevant topic of government deficits.

The role of excessive savings in fuelling debt



Behind all this lies Germany's denial of its role in creating the debt problem. The problem arises because the private sector in Germany saves some 8% of GDP more than it invests. The reasons for this are partly demographic. The largest German baby-boomer generation was born in the early 1960s, and is now around the age of fifty, which is the time of life when a person typically saves the most – kids out of school, mortgage much reduced, mounting worries about adequacy of pensions, etc. At the same time, the peaking, and soon declining population means

the need for capital spending is less. So savings mount and investment recedes, leading to a large financial surplus in the private sector (ie, households plus business).

The problem with saving more than you can usefully invest is that some home is needed for the funds. When that surplus occurs in the entire private sector of a nation, the only possible outlets are either financing a government deficit, or foreign investment. In Germany, the dogma insisting on balanced budgets means that foreign investment is the only answer – ie, a current-account surplus, largely in goods and services trade. But Germany's problem is matched by an (in aggregate) equal current-account surplus in its surrounding countries – Benelux, Nordics, Switzerland and Austria. And to the surpluses in those countries seeking a home must be added the corresponding surpluses, representing even more extravagant savings rates, in China, Japan and the Asian Tigers. To their combined huge surpluses there must – necessarily, in sheer arithmetic – correspond current-account and trade deficits. These have been located in the US and Britain, and, within the Eurozone, in Med-Europe and Ireland.

Conceptually, the surpluses in Pacific Asia correspond to the deficits in North America, those in German-centred north-central Europe to Med-Europe and Ireland. The driving force across the Pacific was China's tenaciously defended manipulation of the yuan-dollar exchange rate, with "soft peg" shadowing elsewhere in emerging Pacific Asia, though no longer (since the crisis) in Japan. The deficits in Med-Europe, corresponding to the surpluses in north-central Europe, were likewise driven by the exchange rate fix embodied in the euro. The surpluses, in other words, both globally and within Europe are as much the fundamental cause of the deficits as the other way round. More so, in fact, because the prevalence of low and falling real rates of interest throughout the run-up to the financial crisis **proves** that it was excess supply of funds driving irresponsible borrowing, rather than the huge escalation of financial activity being a borrower-driven bubble. Had it been the latter, real interest rates would have risen sharply, and the borrowing would have been cut back.

This background means that the Eurozone imbalances require not just austerity in the deficit countries of Med-Europe, but a major offsetting stimulus programme in north-central Europe. Given German private-sector appetite for surpluses, this can only be achieved by a substantial shift into government deficits, offsetting the private surpluses domestically rather than by current-account/trade surpluses and foreign investment. Also clearly, given the assumption of the euro continuing with all its current members, and assuming the ECB sticks to and achieves a 2% inflation target, the requirement that over time the costs in Med-Europe should come back into line with German-centred Europe means Med-Europe inflation of well below 2% and German inflation above it.

German policy-makers make not the slightest admission of any culpability for the current euro-mess. Their revulsion from both budget deficits of any kind and inflation means there is not the slightest chance of a growth policy being adopted within the current euro context to avoid a Med-Europe depression arising from the

ever-tougher, self-defeating austerity programmes that we analyse in Chapter B below.

Government deficits largely irrelevant

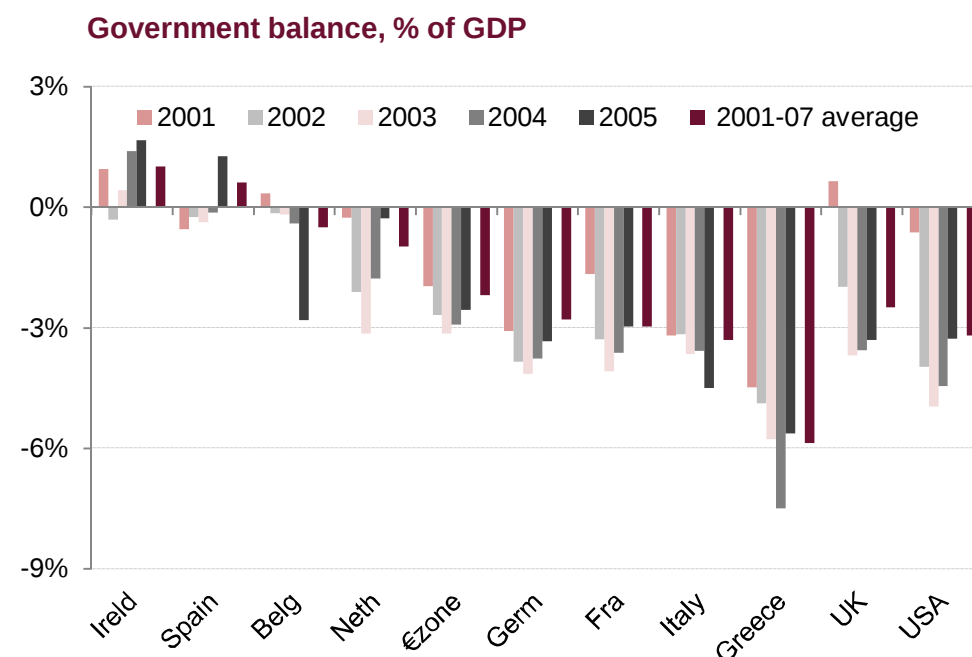
Germany's obsession with balanced budgets expressed itself as long ago as 1998, with its insistence on the Stability and Growth Pact (SGP) the original version of the view that budgets should be close to balance in normal times, and never more than 3% in deficit. There is no clear economic reason for balancing the budget. For example, if it were always balanced, then economic growth would tend to reduce the government debt ratio to GDP over time, no matter what level it started from. It follows that the balanced-budget rule has entirely arbitrary consequences from the stand-point of the national debt, depending on the rates of growth and inflation.

More importantly, a balanced budget is also arbitrary and potentially destructive, because of other of financial flows within the economy. For a variety of reasons, many of them demographic, the German private sector (households and businesses combined) saves in a normal year approximately 8% of GDP more than it invests. Its finances are therefore in surplus to that extent. If the government is in balance, this necessarily results in a current account surplus of 8% of GDP. (All flows in the economy add up to nil – one person lending necessarily means another person has borrowed that amount.) This current-account surplus means that such a “normal year” can only occur if another country is ready and able to run the corresponding current-account deficit. In The Netherlands, the private sector's natural rate of surplus has recently been even higher – about 10% of GDP. The result of a budget balance is even more extreme in the Dutch case.

Who is appointed to run the current-account deficits that these policies entail? The answer is nobody. On the balanced-budget theory, which put crudely requires every country to be run like Germany, the whole world would be in surplus – presumably with Mars. Sadly, the Martian economy does not exist. Taking the Eurozone alone, the private sector's financial surplus is running at about 4% of GDP, less than Germany and Holland, but still large. For the advanced countries as a whole – the bulk of the world economy, taking in Western Europe, North America, Japan and Australasia – the number is 6% of GDP. The remainder of the world's economy consists of China, emerging Pacific Asia, Latin America, India, Russia, OPEC, etc. Much of this group is in current-account surplus (large for China, Asian Tigers and oil exporters). The whole concept of every country aiming for a balanced budget, at a time when private sectors are way out of financial balance, now and for several years in the direction of surplus, is simply mathematically impossible.

So what lies behind this dangerous fallacy that everybody needs balanced budgets? The answer is suggested by the German phrase for the government budget: “öffentliche haushalt”, which literally translates as the public household. But of course the government is not a household. Even a strict interpretation of a real household's finances ought to include the possibility of buying a house with a mortgage loan, and possibly even a car on some form of credit. In other words,

even a well run German household could reasonably finance a major long-term capital purchase with borrowing. So the analogy with a household's finance is doubly false, as even a household should not expect to avoid borrowing – and a nation is most certainly not a household, as any householder could only too easily explain.



The chart above shows that the attempt to pretend that deviations from budget balance – or deficits of more than 3% of GDP – are the explanation of current Eurozone problems is clearly nonsense. The blithe confidence with which the SGP was agreed to in 1998 merely reflected the strength of the world economy at that time, led forward by the US hi-tech boom. When the tech bubble burst in 2000, a mild recession in 2001 was enough to puncture illusions. Germany and Italy tipped over the 3% deficit limit immediately, followed by France in 2002. Germany's budget deficit exceeded 3% of GDP for five successive years, and its 2001-07 average deficit was 2.8%. As well as being only just below the 3% limit, this was larger than the Eurozone average. None of this prevented Germany being the strong man of Europe after the 2007 crisis. The reason, of course, is obvious: its huge flow of private surpluses (of saving over investment) meant that the budget deficits were heavily outweighed, the difference being large German current-account surpluses.

Equally clearly and more importantly, budget surpluses in 2001-07 did not prevent Spain and Ireland from being in financial trouble after the crisis. Again the reason is obvious: their private sectors were running large deficits – excesses of investment compared to saving. These private deficits heavily outweighed their (quite small) budget surpluses to require a large inflow of overseas cash, largely in the form of debt rather than equity. As shall be seen below, Spain and Ireland have major potential debt problems that have already caused their economies and employment levels to crash, and at least in the Spanish case may tip the economy into

depression. The limits on budget deficits recently trumpeted as the means of avoiding Eurozone crisis have little to offer in terms of the actual debt and deficit problems that caused the crisis in those two countries, though they are relevant in Italy and Greece.

The simple reality is that a fixed rule for government balance without regard to the behaviour and needs of a country's private sector is bad economics. What is true is that a country with an existing large stock of government debt outstanding, and relatively uncompetitive labour costs, has every chance of drifting into an upward spiral of that debt that can only be stopped by devaluation or depression. This is clearly the case for Greece, and probably for Italy. The Maastricht criteria for entry into the euro were breached to a degree by a number of countries, but were established with the clear if unstated intent of excluding Italy, which did and could not comply, with a net government debt at 106% of GDP in 1998 – the Maastricht limit being 60% – and a history of high government deficits, inflation and devaluation. Italy's admission to the EMU at the start in 1999 was an explicitly political decision by German Chancellor Helmut Kohl.

The admission of Greece in 2001 was even more destructive to the possibility of a successful monetary union, as its deficit was nearly 4% of GDP in 2000, and higher than that every year since, including the good years 2004-07. Its net debt was 90% of GDP in 2000 (and gross debt, the Maastricht criterion, over 100%) and has now mounted to the 135%, with gross debt of 168% of GDP. Even more than Italy, Greece has a private sector that tends to be in deficit – if only because it was growing faster – so the country was one where government budgets needed to be kept lean

An important conclusion to be drawn from this chapter, contrary to the claims of (for instance) former Bundesbank President Axel Weber, is that **the current European financial crisis is largely the result of adoption of the euro.**

Chapter B: Consequences of debt in Med-Europe & Ireland

Greek debt out of control

If Greece does not leave the euro, and assuming the euro does not destroy Greek democracy, the debt write-off now being negotiated with private investors – 50% off the principal and a low interest rate on the remainder – is just the start of a long process, even if it is successful and implemented. The eventual write-off, if Greece stays in, is likely to be 100% of all current debt, and with continuing subsidies needed.

The Greek crisis first loomed in late-2009, and intensified in early 2010 until it was put temporarily in abeyance by an austerity programme adopted in May, 2010, with financial support offered by other Eurozone members. This programme was based on a false premise, and with grossly over-optimistic assumptions. As a result, the programme has actually made the Greek deficit larger, in euros, but especially as a percent of GDP. The intervention to bail out Greece means that its creditors will now collect fewer cents from each euro of Greek debt, if any, than they would have otherwise. In the process, Greece's economy is being destroyed, quite possibly to be followed by its society and political stability.

The false premise in the Eurozone's programme for Greece was that a grossly overvalued country in a fixed-exchange-rate zone can improve its budget deficit by a huge margin purely by means of demand deflation. It is not by accident that the typical IMF programme for a country in Greece's type of debt crisis consists of "devalue and tighten your belt". It works. But it only works if the country devalues, as well as tightening its belt. Austerity with an overvalued currency spells contraction of spending, income and output, resulting in falling tax revenue that offsets, and may well outweigh (as in this case – see below) the reduction of the government's 'structural' or 'policy' deficit.

In 2011, the government debt rose to €360 billion. This was put by the OECD at 167% of GDP. Because of the savage austerity programme, Greece's 2011 real GDP (ie, adjusted for inflation) was down nearly 7%; modest inflation meant its nominal GDP was down 5½%.

The austerity measures intended to reduce the deficit are also cutting GDP sharply, and this reduced flow of spending and income is in turn harming tax revenue, outweighing the increases of coverage and rates in the austerity programme. The initially estimated deficit is up 1% in euros in 2011. Because GDP is down, its ratio could be up from 10.8% of 2010's GDP to 11½% in 2011. Yet as recently as December, Greek government ministers and various international and European officials were saying the 2011 deficit would be 9% of GDP, already an upward revision from the 7½% target that was set as part of the previous deal under which Greece got foreign financial help. Slippage in the deficit on this scale, especially

from 9% to 11½% in a couple of months, means none of the estimates produced by the various participants can or should be taken too seriously.

Last year's Greek recession and worsening deficit took place in a relatively healthy world and European growth context. This year and next the outlook is less favourable. Germany's GDP fell in 2011 Q4, and could be down again in 2012 Q1. The rest of Europe is engaged in fierce budgetary deflation and likely to do worse than Germany – even France, though it still grew a little in 2011 Q4, as its budget tightening is a fierce 2% of GDP. Greece meanwhile, is embarking on another round of austerity measures, because its official foreign creditors believe it did not carry out its commitments last time. Maybe not – but the austerity it did adopt was enough to cut real GDP nearly 7%. This year's recession could be as large.

The “primary” budget deficit, ie excluding interest payments, was little changed as a percent of GDP last year, the latest two quarters, seasonally adjusted, averaging 5% of GDP. It is unlikely to fall much this year, as the tax base is shrinking too fast, and massive wage cuts will slash demand, income and spending further. The chief weakness of the current planned 50% debt write-off is extremely optimistic projections of the improvement of the primary balance. Already in 2011 the reduction from 5.1% to 2.3% indicated by the IMF data is likely to have been missed by 2% of GDP – the final number for 2011 is unlikely to be below 4%. The IMF goes on to project a slight primary surplus in 2012, rising to 4½% of GDP by 2014. In the current European economic climate, and with violent deflation slashing Greek spending and incomes, this seems massively over-optimistic.

Greek debt may be cut in the near term by the private-investor “voluntary” write-downs now being negotiated. But after that it could mount again indefinitely. Not only is GDP falling in real terms, but income deflation is needed to restore minimal competitiveness if Greece is to stay within the euro. This will shrink the GDP denominator of the various ratios even further. Austerity is making the deficit worse, not better, and the debt ratio to GDP a lot worse.

The reality is that unless Greece leaves the euro and can return to growth, its debt is not worth one cent in the euro. The Irish may have been able to deflate their economy by 20% and finally see the possibility of getting their debt situation under control. But the Irish were 25% richer than the Germans, French and British in 2007, so they have merely fallen back to join their peers. Their government debt was negligible then, and the budget in surplus. Their labour costs were, and are, undervalued, not grossly overvalued like Greece's. And exports are 100% of GDP, so that cost competitiveness translates quickly into a major demand boost relative to GDP. Greece's exports are surprisingly low, less than a quarter of GDP. So only a massive devaluation can save the economy from the risk of implosion.

Negotiations are close to completion to write the current private-sector holdings of Greek debt down by €100 billion. These negotiations involve simultaneous receipt by the private investors of some immediate cash back, acceptance of the written-down debt being replaced by 30 (plus) year bonds at a very low interest rate, and acceptance of the write-down by at least 75-80% of existing Greek creditors. Yet

payment of the cash-back part of this deal depends on approval by the Eurozone authorities (etc) of the €130 billion financial-support payment to Greece, and this in turn depends on each country's Parliament approving its share of the payment. As the Eurozone countries manoeuvre with the Greeks over this, the private investors' willingness may erode, making the phasing of this deal unusually complex. So it is entirely possible the "voluntary" write-down plan will not attract enough support. In that case, Greece would probably default on March 20th, when a €15 billion principal-plus-interest payment is due at the maturity of a €14.4 billion bond.

Greek default on this basis would not be an immediately expensive event for The Netherlands, whose direct exposure to Greek debt is small. The ECB's holdings of Greek (and other) Med-Europe debt are not disclosed, but together with the EFSF the amount spent is probably less than €50 billion. The Dutch share of this would be only about €3 billion, as the ECB would need fresh capital. Greece in the euro would need a bridging loan to keep going, and its ongoing primary deficit might remain at current levels of about €10 billion a year, of which the Dutch share would be €1 billion. Much more probably than not, default would be followed by euro-exit. If not, the "All stay in" scenario with Greece in default could quickly devolve into a politically dangerous scenario, as the Eurozone authorities would have to take virtual control of the country's finances – the move suggested in a recent German background paper that provoked a major outcry in Greece. The dangers to The Netherlands, political and financial, arising from political instability, and risks to Greek democracy, are large, but beyond the scope of this study to estimate.

If the "voluntary" debt write-down is achieved, the assumption is that about €100 billion is taken off the value of current private creditors' claims. But recapitalisation of Greek banks (who own much of the debt) and other adjustments mean the debt will only be reduced to some €325 billion from €360 billion. Of this only €100 billion will be the amount still owed to the current creditors being written down, the remaining €225 billion being mostly owed to the bail-out group, ECB, etc. On the €100 billion the interest will be perhaps €3 billion, and on the remainder the interest is likely to approach €10 billion (4-5%) for a total of €13 billion. Added to the primary deficit of approximately €10 billion, this amounts to a cash flow subsidy of €23 billion a year, 12% of GDP, with a €2.3 billion Dutch share.

But this scenario leaves outstanding the €325 billion of Greek debt, €100 billion to existing investors and €225 billion to mostly official lenders, when its debt capacity is nil. All experience of previous debt crises (which are quite common) suggests that the longer old debts are left outstanding the larger the actual ultimate liability becomes. So, on the €225 billion the Neuro group has the option of playing for time, paying the interest, and probably having a larger write-off later, or accepting the write-off now, the Dutch share being €22 billion. Whereas playing for time would involve only a relatively small, annual cost to The Netherlands, the economic cost would be least if the full €22 billion were written off now. In the real world, this point could assert itself at any time, probably quite soon given the likely clear failure of Greece to meet its targets and obligations.

For cash-flow calculations below, the €225 billion will be assumed written off over the three years 2012-14, given the uncertainty about when Neuro group members, keeping Greece in the euro, will realise they are committed to this liability and that it is more economic to accept it sooner than later. (The cash-flow tables in this chapter all assume all current Eurozone members stay in.) On the €100 billion remaining amount owed to existing investors, the interest would have to be funded for the life of the new bonds, probably 30 years, and then the Neuro group would be liable for the principal redemption, as the Eurozone is pledged to permit no more bankruptcies. But while the Dutch €10 billion share of this liability will be on the national balance sheet from 2012, in cash-flow terms its occurrence is not for 30 years.

Greek projections

	2011	2012	2013	2014	2015	2016
GDP, €bn	215.3	204.5	200.4	200.4	206.5	212.7
Gross gov't. debt, € bn *	325.0	349.5	288.6	213.1	112.3	110.4
Total budget balance, € bn	-24.8	-24.5	-22.3	-18.7	-12.3	-10.4
- % of GDP:						
Gross gov't. debt *	151.0%	170.9%	144.0%	106.3%	54.4%	51.9%
Primary budget balance	-4.0%	-4.5%	-5.0%	-5.0%	-4.0%	-3.0%
Interest on gov't. debt	7.5%	7.5%	6.1%	4.3%	1.9%	1.9%
Total budget balance, € bn	-11.5%	-12.0%	-11.1%	-9.3%	-5.9%	-4.9%
Maturing debt **		83.2	94.3	113.1	12.3	10.4
Total required aid Eurozone		83.2	94.3	113.1	12.3	10.4

*2011 debt of €360bn, 167% of GDP, less "voluntary" write-off being negotiated now

**Assumed write-down of remaining debt not written down in "voluntary" write-off

The crisis could revive quickly. Greece's financial support from other Eurozone countries is currently awarded quarterly on the basis of agreed-on budget deficit targets. The target for 2011 is already clearly and massively breached, like all the others before it. The forecasting process of the squadrons of Euro- and IMF "experts" that pore over the Greek data and produce the targets are consistently too optimistic, without which, of course, maintenance of Greece within the euro would not have been justifiable for at least the past two years. The targets keep getting missed exactly because Greece should not and probably cannot be maintained within the euro. All Eurozone countries have to agree unanimously each quarter to continue supporting Greek public finances, which would collapse without official external inflows. The likelihood has to be that some country will quite soon refuse to go along with this support for Greece, which will then leave the euro, with an inevitably messy but probably negotiated exit involving a bridging loan from the ECB.

In effect, the recent request that private holders of Greek government debt take a "haircut" (voluntary write-off) of 50-60% of their holdings is simply another example

of Eurozone policies being “too little, too late”. The “voluntary haircuts” demanded of the Greek government’s private-sector creditors have shifted from just over 20% last July to 50% in October, and an effective close-to-70% now. But the truth is that the correct write-off for Greek government debt is 100%. As long as Greece is in the euro the paper is not worth anything, and can never be repaid without equal subsidy from other Eurozone members.

The case of “solvent” Italy

Whereas most of the content of the early-December EU summit was an inconsequential re-assertion of the SGP, giving it a set of false teeth (in a colleague’s memorable phrase), one real policy change was the concession of Germany to France that Greece would not be a precedent for write-downs on government debt obligations anywhere else in the Eurozone. This is tough on Portugal (analysed here with Spain, below, as its chief debt problems is business, not government debt). Portugal is unlucky to be denied the possibility of a write-off, as it is poorer than Greece, but Greece got the “first-mover advantage” before France lowered the bar on write-offs. Portugal will probably be out of the EMU quickly if Greece goes, and this will bring the focus onto the two large Med-Europe countries, Italy and Spain, of which Italy will probably be “next up”. The debt crises of Ireland, Portugal and Spain (in order of overall debt/GDP ratio, all of them with a higher ratio than Greece or Italy) lie in the private sector, and are therefore “slow-burn”.

In Italy, government net debt was 100% of GDP at end-2011 (128% for gross debt) exactly the same ratio as in 1999 in its first year in the euro. Needless to say, official forecasts envisage this ratio declining in future, as they have for the past 13 years. The question is whether to believe them.

If Italy’s net debt ratio has stayed at 100% over the past 12-13 years, what will it take to ensure it does not go higher in future? When debt is 100% of GDP, the answer is simple: the budget deficit must be equal to or less than the nominal GDP growth rate. Under that condition, the increase of debt is equal to or less than the increase of GDP. Italy’s nominal GDP in 2011 had increased at a 2.9% annual average over the 13 years from 1998, exactly the same as its average government deficit over the years 1999-2011 – hence its unchanged debt ratio. The 2.9% past average nominal growth breaks down into average real growth of 0.7%, and GDP inflation of 2.1%, with 0.1% of “rounding and compounding” adjustment.

Italy’s real growth trend has worsened through its euro membership. In 1999-2001, having entered the euro at roughly the “right rate”, it grew much as before. But over the 10 years to the latest quarterly data (2011 Q3) cumulative real growth has been 2.7%, so annual average growth has been about ¼%, significantly less than the 13-year average since 1998. This collapse in growth reflects the fact that Italy has been crushed by euro-membership – no longer able to devalue by way of adjustment for its above-average inflation. So real future growth will probably be less than, or at best equal to, the past ten years – ie, effectively zero.

Only with accelerating inflation, therefore, could Italy match the 2.9% nominal growth rate of the 13 euro-years to date. But the scale of its uncompetitiveness after the crisis means that Italy's inflation will in reality have to go the other way: downward toward zero, if not actual deflation. Merely to remain at its current level of uncompetitiveness with Germany would require Italian inflation falling into the 1-2% region.

If Italian inflation is to be at most 1-2% and growth roughly zero, then nominal growth will be at most 1-2%, which becomes the upper limit for future budget deficits as a percent of GDP, if the debt ratio is not to escalate in the Greek style. Italy, after all, is not to be allowed to write off any of its debt – and nor should it, being a rich country (and with most of the debt owed to its own citizens). Italian interest payments on its government debt were 4½% of GDP in 2011 and are forecast to be 5% in 2012. With new debt costing as much as 7%, this ratio is only likely to increase in future – unless Italy is explicitly and massively subsidised by other euro countries, including The Netherlands. So a deficit ratio of 1-2% of GDP implies “primary” surpluses (ie, the balance before interest payments) of at least 3-4% of GDP.

The primary balance for 2011 is (optimistically) put by the OECD at just under 1% of GDP, though a number close to zero is more likely to be recorded, as OECD forecasts are usually rose-tinted and, in particular, 2011 Q4 has seen recession in Europe that it did not foresee. To improve this primary balance to plus 3-4% is the goal of the new, technocrat/caretaker Prime Minister, Mario Monti. He has decreed a fiscal tightening, ie budgetary deflation, of 4% of GDP over two years, three quarters of it in the form of tax increases.

Unfortunately, the Monti programme is being imposed on an Italian economy that moved into recession in 2011 Q3, was down 0.7% in Q4 and can only be expected to see recession deepen in 2012. Italy is heading, full steam ahead, into the Greek trap. Its GDP is likely to be hammered by the budgetary deflation – particularly with weak prospects for the world at large in 2012, and especially German-centred north-central Europe, on which Italy depends economically as well as financially. The tax increases will be offset, possibly even outweighed, by a shrinking tax base (ie, income and expenditure that are liable to taxation). So Italy is likely to see little shrinkage of its deficit, but major shrinkage of its economy. (In Italy as in Greece, some migration of activity into the “black” economy is likely.) During 2012-13, the Italian economy could even see falling nominal GDP, and net government debt climbing up to five percentage points a year towards 110% of GDP.

Given the lack of improvement in Italy's debt over the long term, and the poor immediate prospects, the most reasonable assumption is that subsidies from the rest of the Eurozone will have to support Italian finances at the rate of at least 5% of GDP. The assumption here is that the relegation of private lenders to subordinated status will cause Italy to rely increasingly on financial support from other Eurozone countries to keep the average net interest rate on its net debt at 5% of GDP or a little over, and that the primary budget balance remains at best

marginally positive. 5% of Italy's GDP is about €80 billion, which is about 1¼% of the GDP of the Eurozone countries, if we exclude Med-Europe.

It cannot be assumed that roll-over of existing debt as it matures can be done with private lenders, as in the past. Italy has virtually zero real growth, and interest rates that, at 6% or so, are 4-5% ahead of likely future inflation. A government debt burden well over 100% of GDP in a country whose real interest rate exceeds its real growth rate by 4% or more is theoretically unsustainable. The debt ratio is almost certain to mount indefinitely. In this context, it is realistic to analyse a scenario in which financial markets conclude that Italy has slipped into the “Greek trap”. In that case, official Eurozone financing will be needed not just for the budget deficit, but to refinance maturing debt as well. This would be a major added burden, as Italy's maturities are €305 billion in 2012, €175 billion in 2013, and €140 billion in 2014 and 2015, before falling below €100 billion a year. In this scenario, financing Italy within the Eurozone could quadruple in cost to a five-year average of €250 billion a year.

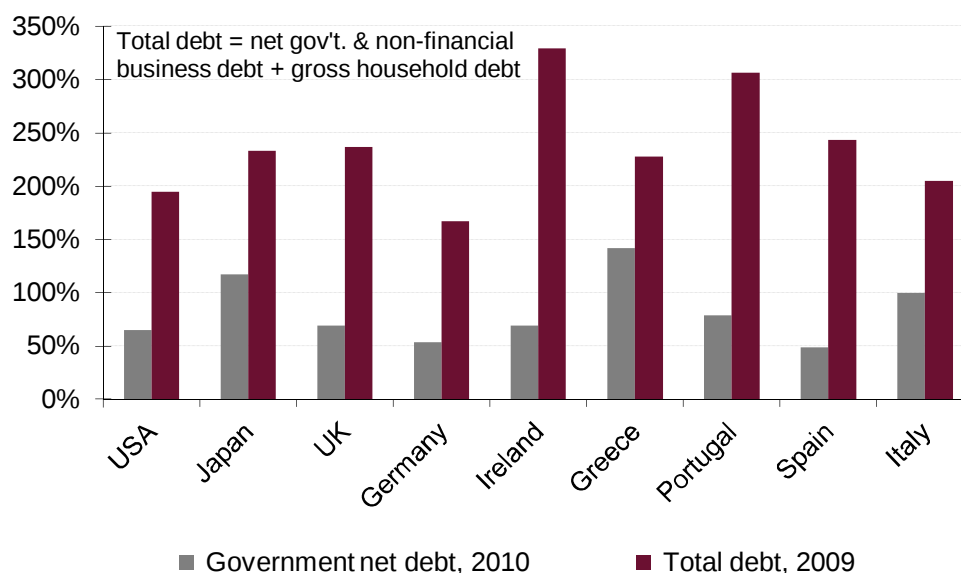
Italian projections

	2011	2012	2013	2014	2015
GDP, €bn	1578	1546	1516	1516	1538
Gross gov't. debt, € bn	2026	2107	2202	2286	2358
Total budget balance, € bn	63	81	95	84	72
- % of GDP:					
Gross gov't. debt	128%	136%	145%	151%	153%
Primary budget balance	0.5%	0.0%	0.0%	1.0%	2.0%
Interest on gov't. debt	4.5%	5.2%	6.3%	6.5%	6.7%
Total budget balance	-4.0%	-5.2%	-6.3%	-5.5%	-4.7%
Maturing debt		305	175	140	142
Total support from Eurozone					
- optimistic		81	95	84	72
- pessimistic		386	270	224	214

All of the above highlights the risk that Italy's debt will increase its net ratio to GDP from 100%. But the SGP, Maastricht criteria, and recent pact to “save” the euro, all require that Italy reduce its gross debt ratio to 60% of GDP or less. Clearly there is not the slightest chance of this within decades, unless Italy quits the euro and inflation rises. The setting of this target is fantasy – the 60% number is arbitrary, relating to no rational (or achievable) objective, though for Italy in the euro, with negligible potential nominal growth, the sustainable limit of government debt is clearly far below the current level.

The major role of private debt – the Irish crisis

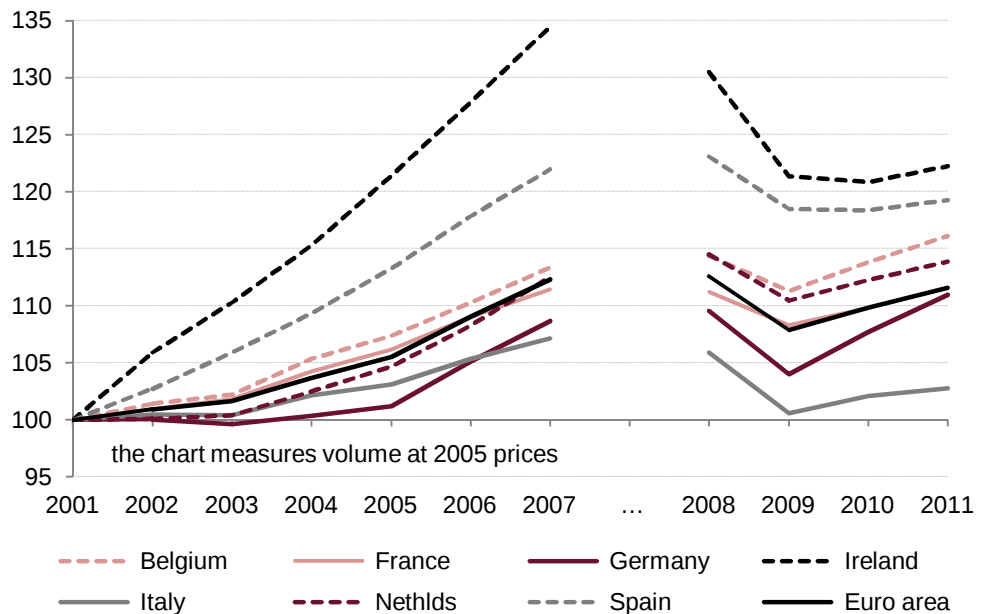
Gov't. debt, 2010, & total debt, 2009, % of GDP



The chart above introduces the problem of Ireland, Portugal and Spain, listed in descending order as that is their order of total indebtedness relative to GDP. Total indebtedness is defined here to include net government debt, net non-financial business debt and gross household debt. The arguments for taking government and business debt net are complex, but the ranking of countries would be little affected by using gross data. (Financial sector debt is excluded as it is mostly a pass-through, relating to financial assets of equal amount. Only where such assets collapse in value, as in the crisis of 2007-08, does financial debt become a major issue in itself. But such a collapse is only likely where the non-financial borrowers from the banking system have a debt crisis, which was exactly what happened in 2007-08. So it is in non-financial debt that the key analysis resides.)

As may be seen from the chart above, Italy's total debt on this basis, at 200% of GDP, is not dramatically higher than that of Germany, France or America, and is well below Japan and the UK, and, within the Eurozone, Spain, Portugal and Ireland. The latter two have debt of more than 300% on this measure. The necessity of financial support packages for Ireland and Portugal, and the upswing of Spanish government bonds yields followed by savage fiscal deflation, imply that the private-sector debt problems of these countries are potentially as important as the more obvious government debt issues facing Italy and Greece.

Real GDP, 2001 = 100



To understand the gratuitous and unnecessary scale of the damage that has been done to Ireland it is worth repeating the growth chart above from Chapter A. Measured quarterly, Ireland's 2011 Q3 GDP was down 12% in real terms from its end-2007 peak, more than twice the recession of the US and Germany, and with no significant recovery yet. Owing to violent deflation, nominal GDP (ie, at current prices) is down 20% over the same period. Without doubt, Ireland's pre-2007 growth was biased towards an excessive dependence on debt – and on construction and real estate development – to a great degree by the perverse incentives of the “one size fits none” Eurozone monetary policy. (Note how the comparable British boom was moderated by the rise of the pound into overvaluation, driven by high interest rates.) But even if Ireland's growth was both distorted and somewhat exaggerated by euro membership, it was rapid anyhow – 7% a year in real terms in the ten years before 2001. Its collapse since the crisis, so that 2011 real GDP is only up about 2% a year from 2001, means a huge volume of output and income has been lost forever as a result of the euro's distorting effect on its previously healthy growth.

Unlike the Med-Europe countries (see above and below) Ireland can probably survive within the euro, despite this unnecessary sacrifice to the shibboleth of “stability”. Reasons include:

- Ireland's GDP per capita at comparable purchasing power was 22-30% above the UK/France/Germany level in 2007 – the loss of output and income since has narrowed that gap, but still left Ireland relatively rich
- Its high CPI inflation throughout the euro period reflects buoyant profitability – unit labour costs have been at 1998 levels or cheaper vis-à-vis its trading partners ever since, and have become extremely cheap and competitive since the crisis (see chart in Chapter A above) in sharp contrast to Med-Europe. This shows the benefit of a small flexible economy

with a mobile labour force accustomed to both inward and outward migration and willing to accept nominal wage cuts.

- Exports are more than 100% of GDP, so that half the economy is foreign demand and only half domestic, likewise foreign supply (imports) and GDP: this means that cost competitiveness can lead quite quickly to a significant favourable shift in net exports (exports minus imports) that is much larger relative to GDP than in an economy less trade-orientated
- Though the banking system had run up huge debts that are the source of Ireland's current problems, the government in 2007, as the crisis broke, had net debt that was actually negative – its interest bearing assets slightly exceeded its gross debt (both being then about 29% of GDP) – so that the government started with a “clean slate” in taking on liability for the banking system

Ireland's problems were set in concrete in early October, 2008, when it responded to the deepening post-Lehman panic by guaranteeing the entire liabilities of its banking system, whose assets and liabilities were the largest among advanced countries relative to its GDP (possibly excepting Iceland). This reflected not only the extremely high private-sector debt level shown above, but also those banks' rash adventures in global financial markets. It might have been better to have seen if non-deposit, or at least non-senior, liabilities could have been left out in the cold before extending this guarantee, but in the rush of events that sort of pause for thought was neglected. A comparable guarantee was quickly extended by Germany and the UK, taken for granted in France, and activated in practice in The Netherlands and Belgium, where the Fortis takeover of ABN/Amro's domestic Dutch assets had left them both effectively insolvent.

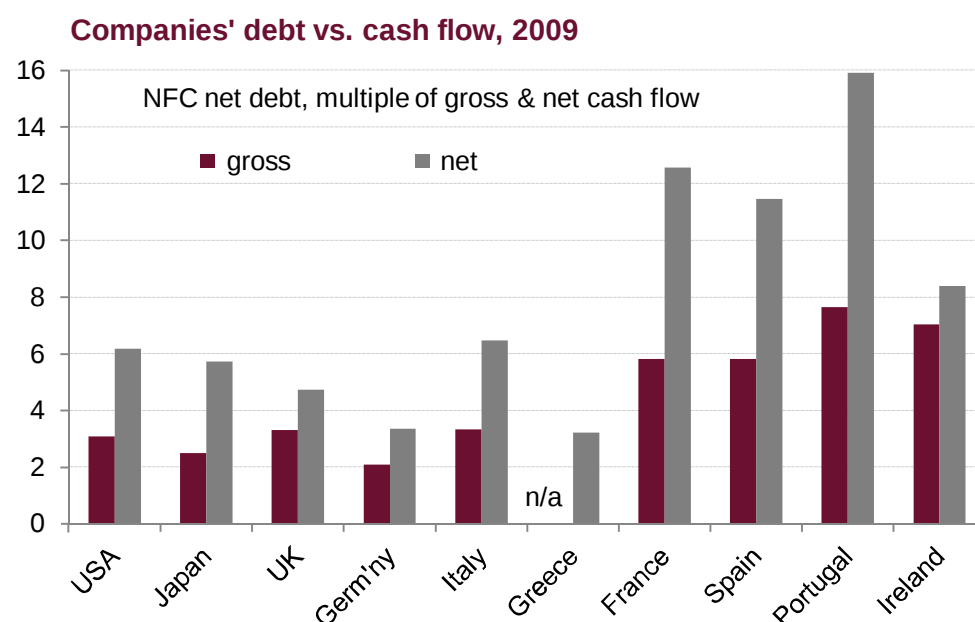
Ireland's banks had a major problem with loans to non-financial companies (NFCs) – especially the real estate and construction extravaganza – as we shall see below, and these would have brought them down in short order. But the total NFC debt in Ireland was well below the ratio to GDP of Spain and Portugal, where it is likely to prove crippling, as we shall see. Nonetheless, after applying major help to its banks over their NFC loans, Ireland's net government debt by end-2011 was estimated at 65% of GDP, with gross debt at 113%, a sad escalation from 2007's zero and 29%, respectively, in a mere four years. And yet that still leaves the household debt issue to be tackled. Whereas the level of household debt needed to provoke America's subprime crisis was “only” 120% of gross disposable income, Ireland's 200% ratio was, and is, more than half as large again.

Ireland's household debt problem is latent rather than active, owing to its banks' access to ECB funding at essentially the same rate as German and Dutch banks – though the ECB's ability to extend such facilities depends entirely on the credit of the stronger nations. The result is that, with the ECB repo rate at 1%, Irish mortgages, nearly all of them floating rate, cost about 3-3½%, far below the rates being charged US households in 2006-07. But if Irish households had to pay similar rates to the Irish government's 7%, and more than that until recently, they would quickly default, and the banking system would require another huge capital input from the government – and a further major drop in real income and spending

by the population. This ECB support, therefore, is the chief route down which Ireland is subsidised by the financially stronger Eurozone economies.

The Irish experience is therefore that the euro has done lasting damage to people's income and welfare, though not posing an insoluble problem, as it has for Greece and probably Italy, (and, as we shall see, for Portugal and Spain in a longer-term form). Ireland has huge resources of land – with a population less than 200 years ago – and potential employment growth, as large numbers of people round the world want to live there. It provided a natural and hospitable resort for international capital, providing the funds for its development. No doubt the 7% growth of the 1990s had to slow, as development based on capital-intensive industries attracted by low corporate taxes showed diminishing returns. But the euro-induced boom-bust leading to violent recession, from which it can only recover at best gradually and with a much reduced growth rate, are an indictment of the euro system.

Iberian & French businesses heavily in hock



A frequent definition of a junk bond is when debt is five times gross cash flow (ie, before depreciation). But whereas an individual company can use depreciation cash flow for debt service for a while, stretching the use of old equipment, etc., an economy needs to replace its capital, so the relevant ratio is to net cash flow (ie, after depreciation). The smaller denominator makes debt of ten times net cash flow approximately equivalent to five times gross cash flow, so that is a reasonable basis for judging the affordability of a country's non-financial business debt. By this criterion, Portugal is in desperate trouble – well beyond rescue, with business net debts at 16 times net cash flow – and Spain, and possibly France, in serious trouble: their ratios of around 12 times net cash flow being about that of Japan in 1996 that was followed by six years of zero growth. The analysis here will focus on Spain, its grim conclusions simply being grimmer for Portugal. French risks will be seen to be less.

Spain's NFC debt ratio may be similar to Japan's in 1996, and Japan's experience after that was depressing enough, but Japan at that time had several advantages not now enjoyed by Spain, including:

- **A currency.** Devaluation, as well as “tightening the belt”, is a normal remedy for a country with excessive debt. Japan's real exchange rate went down 20% in the six zero-growth years between 1996 and 2002. Without that effective devaluation, its experience would have been much worse. Spain is cut off from this resort by euro membership.
- **A monetary policy.** Having a currency means a country has monetary freedom, in Japan's case meaning zero interest rates for most of the period from 1998 to the present day. Spain's interest rates and monetary policy are set in Frankfurt from the standpoint of the entire Eurozone, not Spain's particular needs.
- **A fiscal policy.** Unconstrained by prejudices concerning budget balances, Japan ran large fiscal deficits from 1998 onward to accommodate the large private-sector, particularly corporate, financial surpluses (of saving over investment) needed to achieve debt pay-down.
- **Wage and salary flexibility.** Japan's nominal wages fell at an average of 1¼% a year from 1997 to 2004, and have been falling since, though more slowly. This contributed mightily to adjustment. This is obviously not something the euro prevents Spain from copying – quite the contrary – but as it happens Spain has one of the most rigid labour markets in the world, with a large measure of wage indexation.
- **A buoyant world economy.** Japan's long adjustment to excessive business debt was against the backdrop of a relatively fast-growth world economy, in contrast to Spain's likely environment in the next few years

The Spanish government has actively pursued a tighter fiscal stance, in line with the current Eurozone insistence on austerity. It is likely to prove counter-productive. Unemployment has already mounted from 8% in late 2007 to over 20%. The government's GDP estimates have ceased to be credible, registering a real decline of just under 5% in the recession, with negligible recovery since. It is highly improbable that such a recession, less than that of the US, Germany or Britain, would lead to a 12 percentage-point rise in unemployment, even with the lay-off of masses of low-productivity casual construction labour, much of it migrants from eastern Europe. But, as elsewhere, denial followed by bluff has been the standard Eurozone response to critics throughout the crisis. Almost certainly, the true fall in GDP has been much greater.

To compound this actual and potentially long-term economic weakness with fiscal deflation, when the private sector desperately needs a financial surplus to achieve debt pay-down, is courting disaster. Only with careful nursing can the corporate sector gradually lighten its debt burden. Shock therapy is the reverse of what is needed. The slowdown likely in Europe generally this year and next makes it hard for Spain to expect any relief from export growth, despite its relatively good competitiveness and performance relative to market. Spain had a 4.5% current-

account deficit in 2010, with a 9.3% government deficit, implying a private surplus of 4.8%. This is almost certainly not enough – household debt is considerable if not excessive (see earlier chart), and the combined private-sector surpluses (household plus business) in the US and UK are much larger than this.

Yet already OECD projections suggest the current account deficit narrowed to 4% of GDP in 2011, less than the narrowing of the government deficit to a projected 8% (according to the incoming government after recent elections) implying the private-sector surplus was reduced to 4% in 2011. Given the parlous state of business finances, this is enough already to ensure that spending on fixed investment and inventory could be slashed in 2012, with exports also weak. Yet the incoming government is proposing an even more savage fiscal squeeze than Italy's, cutting 4% of GDP out of domestic demand. It is also asking banks to write down their asset values to market, especially in real estate and housing, where realisable prices are well down. These measures could shift the economy from mild to severe recession, and much reduced business cash flow. That in turn will raise, not lower, the ratio of debt to net cash flow – by the toxic route of mercilessly squeezing the cash-flow denominator. Spain's business finances, in the context of austerity, are caught in the same vice as Italy's government finances. As long as they stay in the Euro, austerity is worsening, not reducing, the debt problem. The only solution to these debt problems is growth, and that is precisely what the Berlin-Brussels-Paris political élite is ensuring will not happen.

The risk, obviously, is to the Spanish banking system. Even after Japan's six-year "drying-out" period, its banks had to undergo a substantial debt write-down in early 2003 (8% of GDP) before economic recovery became sound. In Spain, it is unlikely that exaggerated asset values – especially in real estate, but also in business generally – can withstand the coming economic downswing. Once they start to tumble, the call on the government to bail out the banks could cause its debt to soar. This is like Ireland a couple of years ago, when it dealt with the business debt problem, so that government debt, which has soared, now accommodates the business debt excesses of the boom. A recession in Spain now probably implies serious debt service problems in business, asset liquidation leading to falling asset prices, and major bank write-offs requiring government recapitalisation. There is a major danger that current austerity policies will lead straight to depression.

Spanish projections

	2011	2012	2013	2014	2015
GDP, €bn	1096	1074	1053	1053	1068
Gross gov't. debt, € bn	796	890	994	1100	1202
Total budget balance, € bn	-86	-94	-104	-106	-102
- % of GDP:					
Gross gov't. debt	73%	83%	94%	104%	112%
Primary budget balance	-6.4%	-6.5%	-7.1%	-6.7%	-5.6%
Interest on gov't. debt	1.5%	2.2%	2.8%	3.4%	3.9%
Total budget balance	-7.8%	-8.7%	-9.9%	-10.0%	-9.5%
Maturing debt		145	98	83	57
Total support from Eurozone					
- optimistic		94	104	106	102
- pessimistic		239	202	189	159

In the above table the total support lines simply use the government deficit projection as the optimistic scenario, and add in the maturing debt for the pessimistic view. No extra provision is made in the table for the risk of a banking crisis requiring Neuro group support, though such a crisis is the likely trigger for downside scenarios of Spanish financial difficulties.

In Portugal, where the chief export market is potentially recessionary Spain, where cost competitiveness is worse than Spain, and the business debt burden much higher at 16 times net cash flow, as is government debt relative to GDP, the private sector is actually still in deficit – the current-account deficit is larger than the budget deficit. It is almost impossible to see how Portugal can avoid a crash. It is a poorer country than Greece, so the Franco-German decision to insist on no further government debt write-offs after Greece means the country is likely to be returned to penury – having in any case had very little growth since it joined the euro at its inception.

In this projection of Portuguese financial needs, the assumption is that coping with the extremity of business debt ratios creates a crisis that requires the write-off of existing debt over three years, as in Greece above. The projected government debt of zero in 2015 is therefore fictitious in the sense that the existing debt will have been replaced by a large volume of government debt to finance a banking recapitalisation. This could be substantially larger than Ireland's 2010 31% of GDP, as Portugal's business debt is larger than Ireland's was. Portugal's future debt capacity will be extremely low, as it has negligible potential growth and, assuming it stays in the euro, no inflation either – yet market interest rates are likely to be quite high.

Portuguese projections

	2011	2012	2013	2014	2015
GDP, €bn	172.0	167.7	163.5	163.5	166.8
Gross gov't. debt, € bn **	192.5	205.1	145.6	79.1	0.0
Total budget balance, € bn	-10.1	-12.6	-10.4	-5.5	0.0
- % of GDP:					
Gross gov't. debt	112%	122%	89%	48%	0%
Primary budget balance	-1.7%	-1.8%	-1.8%	-0.9%	0.0%
Interest on gov't. debt	4.2%	5.7%	4.5%	2.5%	0.0%
Total budget balance	-5.9%	-7.5%	-6.4%	-3.4%	0.0%
Maturing debt & write-offs *		70.0	72.0	79.1	0.0
Total required aid from Eurozone		70.0	72.0	79.1	0.0

**assumes 3-year write-off of current & accruing debt*

***assumes write-off in footnote above, and excludes large expected bank recapitalisation*

France's business debt problem is about the same size as Spain's – as measured by Eurostat data on national financial flows and balance sheets (themselves derived from French official sources). But its economy is in other respects not so unbalanced, and other “bottom-up” data sources on business debt ratios give a much more benign story for France, while confirming the bleak numbers for Spain and Portugal. Household debt is no problem at all, which it is in Spain if to a lesser degree than in Ireland (and the UK). The danger is that a large business debt burden falls on an economy that has been generating slower growth of productivity than The Netherlands and Germany. And although France has not suffered Spain's inflation of unit labour costs, its export performance in terms of share of markets is distinctly worse than Spain's, as observed above. One clear French advantage is that it did not share Spain's grossly excessive real estate and construction boom, with resulting high prices that a slowdown could undermine to create a crisis of banking collateral. Nonetheless, France is engaged on a fiscal deflation of 2% of GDP between 2011 and 2012, an election year, and the risks to its banking system from falling non-financial profits and therefore non-performing business loans could easily become serious.

Austerity + subsidy – not a cure

The recession and possible depression that is engulfing Med-Europe is the logical result of the underlying denial by surplus countries with excess saving of any responsibility for the global and European financial crisis. The emotional root of the problem is the moralistic view that saving is “good” and borrowing “bad” – exemplified by references to countries with too much debt as “sinners”. Eurozone policy is orientated toward punishment of perceived transgression, rather than solving the problem of too much debt. Examples of this include:

- Debt ratios can be reduced either by cutting deficits and debts, or raising the income denominator, typically GDP, but in the case of households

personal disposable income, and in the case of businesses net cash flow. As we have seen, attempts to punish “sinners” with austerity will not work in a world in which they cannot devalue and the rest of the world economy is weak, so that export demand does not make up for the growth lost through the domestic demand cut that is intrinsic to the austerity.

- Not only is real growth hobbled as a means of cutting the debt ratio, but inflation is rejected too. Commentators argue that lenders who foolishly financed the debt run-up must absorb some of the pain. The most effective way of achieving this is inflation, which raises the nominal-income denominator of any debt ratio, and reduces the value of that debt’s interest and principal payments. Devaluation from the standpoint of a lender to the devaluing country can simply be a large one-shot dose of inflation, if the debt is denominated in the devaluing country’s currency (as could mostly be the case, for instance, if Greece devalued).
- Instead of the “salve” of inflation, Eurozone leaders for a while preferred the outright punishment of lenders by partial default. The concern is to avoid “moral hazard” – ie, rewarding mistakes. But the primary purpose of the economy is not to achieve justice – it is to increase real incomes over time, provide jobs, and so forth. In the interest of not causing “another Lehman” the German government has been persuaded by the French to abandon the idea of debt write-downs. But without either write-downs or the salve of inflation, the only means left for coping with the debt problems is reinforced austerity, which is, as we have seen, likely to be self-defeating.
- In summary terms, curing a country’s excessive debt problem requires one (or more) of the three ‘de’s: devaluation, default or deflation. The Eurozone has ruled out the first two – and adopting the third seems likely to achieve a fourth ‘de’: depression.
- **With unchanged Eurozone membership, the only method of adjusting costs and prices in Med-Europe to be competitive without extreme and constantly reinforced austerity, leading to depression, would be stimulation of rapid inflation in The Netherlands and Germany for a decade or two; and acceptance over that adjustment period of large fiscal subsidy payments to the deficit countries – not loans to be repaid later, but unrequited transfers. Such transfers are already happening through banking systems being subsidised by access to the ECB’s repo “window” to finance themselves at interest rates well below those paid by their own governments**

The danger for The Netherlands is that the potential for subsidy needed by Med-Europe is open-ended. All official scenarios are based on a rapid reversion to recovery, both in Eurozone economies and financial markets. Official scenarios never anticipate recession or financial crisis. This is part of the problem. The imbalances that are poisoning the Eurozone economies

cannot be acknowledged because their cure, once they are acknowledged, clearly requires major exits from the euro, or its disbandment. Unacknowledged, they remain unaddressed, so continued financial deterioration is likely, unless the core Eurozone countries step in and provide the continuing subsidies outlined above.

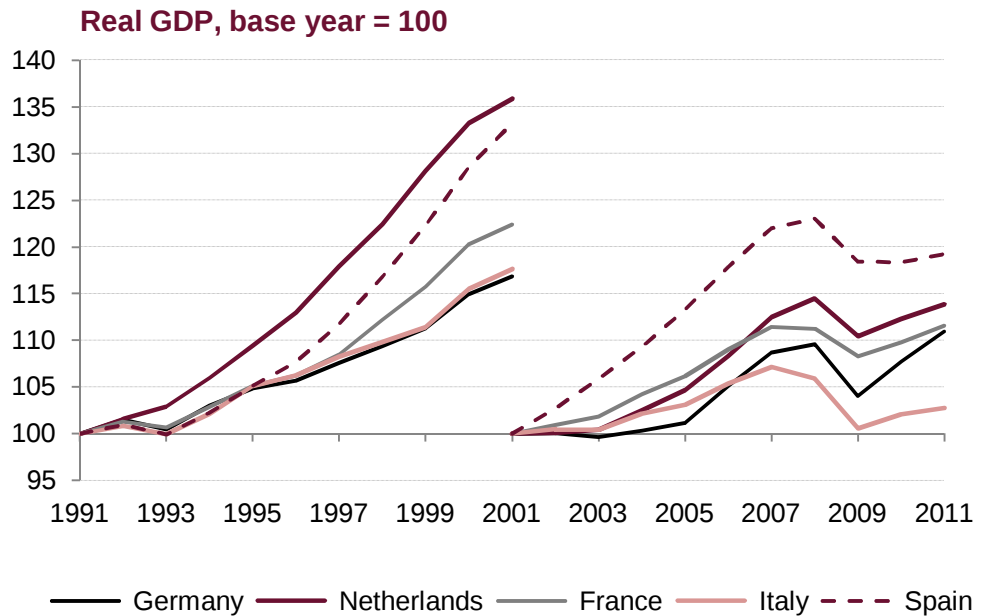
Summary – aggregate potential costs of current EMU membership

Potential cash support needed by Med-Europe, € billion

	2012	2013	2014	2015
Greece	83	94	113	12
Portugal	70	72	79.1	0
Italy - optimistic	81	95	84	72
Italy - pessimistic	386	270	224	214
Spain - optimistic	94	104	106	102
Spain - pessimistic	239	202	189	159
Total - optimistic	328	365	382	186
Total - pessimistic	778	638	605	385
Potential Dutch share @ 10%:				
Optimistic	33	37	38	19
Pessimistic	78	64	60	39
Potential Dutch saving, immediate unilateral €-exit:				
Optimistic	24	37	38	19
Pessimistic	69	64	60	39

The table above summarises the large potential cost of keeping together all current members of EMU. Including the realistic step of writing off Greek and Portuguese debt per three years, the 2012-2014 amounts are some 6% of Neuro (and therefore Dutch) GDP each year, falling to 3% thereafter.

Chapter C: Austerity and waste in The Netherlands and Germany



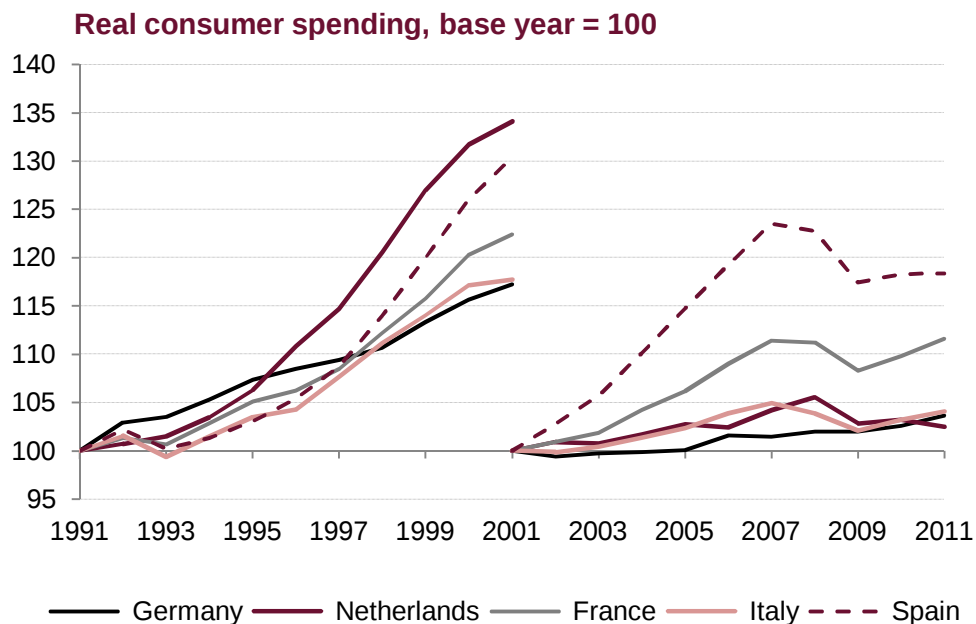
The chart above gives a measure of how Germany and The Netherlands have fared since the euro, compared with France and Italy, which came into the euro on a comparable real income level, and Spain which had considerable catch-up potential (then as now). In Germany, the 1990s yielded much better growth than the past decade, 17% over the decade versus 11%. Yet the baseline of 1991 was a boom year and the end-point, 2001, a mild recession, whereas over the past decade the end-point, 2011, was moderately strong, versus the mild recession at the 2001 baseline. The underlying slowdown was therefore greater than the 17%/11% comparison suggests.

The Western world at large had a slower pace of growth in the past decade, mostly because of the “Great Recession”, but the whole point of Germany’s vaunted “competitiveness”, high savings and sound finances is that it is supposed to be largely immune to slower growth elsewhere. In reality, of course, excessive saving and the deliberate crushing of wage growth has meant that Germany became heavily dependent on export demand, via the artificial cost competitiveness resulting from the euro structure. It made itself as dependent on the excessive borrowing in deficit countries as were those deficit countries themselves. When that had to stop, German growth suffered badly – its recession was even worse than in the US and Britain. Recovery since then has been brisk, but remains largely dependent, as before, on export growth, ie, other countries’ willingness to run deficits. As that is about to falter drastically, Germany faces meagre growth in future.

France too suffered a sharp growth slowdown after the introduction of the euro, but the countries worst affected of the five above were Italy, Spain and The Netherlands. In the Italian case, mere entry into the euro seems to have been enough to eliminate any growth potential. The crippling uncompetitiveness of Italy was discussed in connection with divergent costs and export performance in Chapter A above. The 20 years to the early 2000s saw the Dutch economy grow consistently at about 3% a year, much more strongly than Germany or France. But by 2011 the ten-year average growth rate had come down to 1¼%, admittedly still better than Germany (1.0%), France (1.1%) or Italy (0.3%).

Of course, the US and UK, having both grown about as fast or faster than The Netherlands in the 1990s, and especially through to 2007 as the Dutch economy slowed, also fell sharply in 2008-09, with 10-year growth only a little better than The Netherlands in 2001-11. But the difference is that the “Anglo-Saxons” were the ones crippled by debt. And they both had large financial sectors heavily engaged in activities instrumental in causing the financial crisis, and which are shrinking substantially over several years that started in 2007. In the US case, this has also been true of construction and real estate. In Britain, a surge in the GDP share of government spending also slowed the average productivity growth of the economy. A much more valid comparison for The Netherlands is with Switzerland and Sweden, comparable north-central European surplus countries. Sweden’s GDP grew as fast in 2001-11 as in 1991-2001, while Switzerland’s grew faster. The distortions imposed on The Netherlands by the euro have clearly cost it significant growth over the past ten years.

The welfare damage from this slowdown is larger than the slump of growth itself. The economy is there to support jobs and income growth. By this criterion, Germany and The Netherlands have failed. Gaining competitive advantage by holding down wages rendered other countries debt-laden and in crisis – and landed Germany and The Netherlands with a raft of investments bought with trade surpluses and now standing at a loss, while the welfare of their consumers has been blighted for a decade. The natural result of low wage and salary growth has been slow growth of real consumer incomes. And the debt crisis which their excessive and artificially won competitiveness has imposed on deficit nations has left Germany and The Netherlands with minimal growth prospects for several years at least – assuming the euro persists in its current form. Wage and salary earners sacrifice will have been in vain: they will do as badly or worse over the next decade as they have over the last.



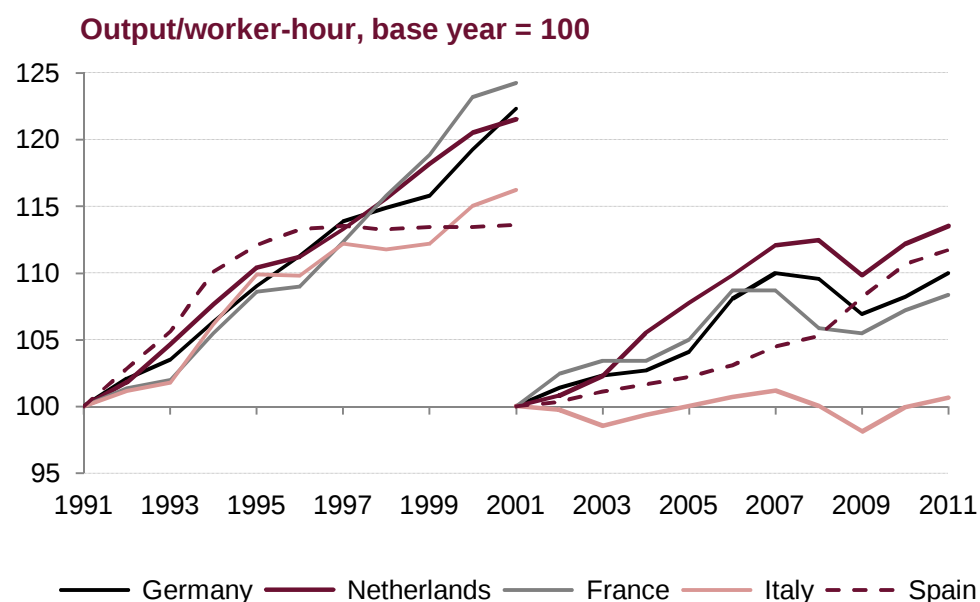
The chart above illustrates the ironic reality. In France, with a relatively balanced economy – neither undervalued nor overvalued – real consumer spending grew as fast as GDP over the past ten years, though much slower than in the 1990s. But in Germany and The Netherlands real consumer spending has grown more slowly than Italy's – and dramatically less than in the 1990s. Not only did Dutch real consumer spending rise more slowly even than Germany's, but also the population gain of 0.4% a year, versus Germany's 0.1% annual decline, means Dutch consumer spending per head has actually fallen in the past ten years.

Of course, the picture since the crisis in 2007-08 has been coloured by the "Great Recession". In The Netherlands and Germany, as in other countries, government spending has risen relative to GDP, so in a sense total consumption has lost less. But in volume, ie real terms, government consumption was also restrained and the government share of GDP was falling slightly from 1999 until 2006 in The Netherlands, and significantly in Germany, where its growth has continued to be minimal since 2007 as well. Dutch real government consumption jumped a remarkable 10% in 2007, after being heavily restrained until then. And it has continued upward since in response to the crisis. But this sudden, belated focus on citizens' welfare, though welcome even if "collective" rather than individual, came too late to prevent the divergences and imbalances that were major causes of the crisis. Budget spending is likely to be falling in future, now that the emphasis is on budget balance, implying cuts, and further wage and salary restraint could be needed as export markets founder. So focus on real growth of consumer spending alone is not a distortion: it was in the 2002-07 period that the major divergences in the Eurozone were established.

In effect, all those euros earned by Germany and The Netherlands through cost-competitiveness arising from wage and salary restraint have been invested abroad and have ended up financing no-growth Italy's consumption growth at a faster rate than their own. It is small wonder that the Dutch and German electorates are

hostile to overt subsidies to the Greek government, etc. They have already in effect been subsidising them since the euro started. **When it comes to the scale of the cut in growth over the past decade, The Netherlands' has been the most dramatic, not only for GDP but even more so for real consumer spending.**

To put numbers on the amounts lost by Dutch people, the lowest estimate would take the difference of consumer spending in 2011 if real consumer spending growth had matched real GDP growth since 2001, as it did in the past. The difference in their growth was 1.1% p.a., which has accumulated to a shortfall in consumer spending in 2011 from what it ought to have been of €30 billion, €1,800 per head of population. If Dutch GDP had grown as well as that of Sweden and Switzerland (though less than its own pre-2001 growth) the addition to 2011 consumer spending would have been half as much again, making the shortfall last year some €45 billion, or €2,700 per Dutch person.



Why has growth slowed so much? We know why consumer spending in Germany and the Netherlands has been slower than GDP – the crushing of wages and salaries for the false security of cost-competitiveness explains that. But the slowdown of growth is harder to fathom. For the US and Britain, GDP growth far exceeded The Netherlands and Germany until 2007, and even after the recession those two countries are still ahead in 2001-11, though the points cited above account for their poor average growth rate compared with previous decades. But in Germany and The Netherlands, these considerations do not apply. There was no excess devotion of resources to housing and real estate, to finance, or even to government spending, to explain the drastic fall in growth – a fall that was not shared by the otherwise comparable economies of Sweden and Switzerland.

It may be that cost-cutting by suppression of wages and salaries, leading in the euro context to excessive cost-competitiveness, has taken away the “stick” with which the competitive market punishes firms that do not raise their productivity.

When exchange rates were floating, acceptance of wage and salary restraint by docile labour forces did not reduce the incentive to raise productivity, because the rising exchange rate rewarded the labour force, ie, consumers, for their restraint, and kept up the pressure on firms for productivity improvement. But the easier business conditions for Germany, The Netherlands and to some extent France in the euro (with no more devaluation of the lira, etc., that was much-hated by companies), may have led firms to become complacent. So the effect of the euro may be a double-whammy against ordinary people: the underlying growth of GDP is harmed by slower productivity growth, and the labour share of it has been reduced in pursuit of a self-defeating cost-competitiveness.

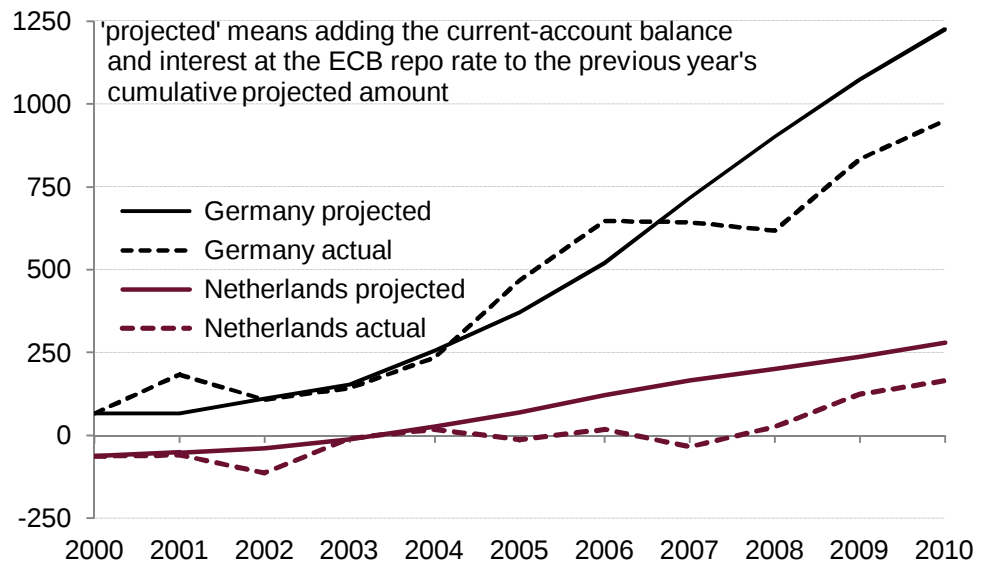
This complacency effect is obviously not the only source of the blight on continental productivity growth. Italy clearly has major supply-side problems to compound the inherent demand deficiency that has help down its growth over the past ten years. French productivity slowed more than German, and Dutch productivity less. But the combined average annual productivity growth for these three has been cut by more than half, in a decade when the hi-tech revolution was still helping to generate rapid improvement in cost and inventory control.

The waste of savings in The Netherlands and Germany

The sacrifice of living standards by Dutch and German wage and salary earners was supposed to build up surpluses invested abroad to yield income in future. It is assumed that the decline of population, especially of working age, will require that domestically generated income will in future need to be supplemented. The problem is that the surpluses, built up by the artificial cost competitiveness arising from an undervalued exchange rate, are only there because other countries are borrowing money and running up debts in the course of running the corresponding deficits. Those countries, led by the US at the global level, but mostly Med-Europe within the Eurozone, now have debt crises. Almost inevitably, the assets The Netherlands and Germany have built up with their surpluses are the very debts of these deficit countries – debts that the latter are not able to repay in full.

The proof of the matter lies in the chart below. The solid line for each of The Netherlands and Germany shows what would have happened to net foreign assets if the current account surpluses had simply been invested at the ECB's repo rate. The dotted line shows the actual path of net foreign assets for each country. The shortfall over the past ten years was €115 billion for The Netherlands and €274 billion for Germany, amounting to €6,900 for each Netherlander, and €3,400 for each German. In effect, the dynamics of the artificially low real exchange rate achieved by means of the euro required losses on the resulting surpluses through purchases of American sub-prime mortgage paper, Greek government bonds, etc. Only through the acceptance of such "investments" could net exports be generated. In effect, the wage and salary sacrifice of ordinary Dutch and German people was invested in junk.

Dutch & German net foreign assets, € billion



What makes this outcome particularly sad is that the theory it is based on is flimsy. The presumed decline in the labour force has not materialised, despite the fall in the “working-age” population (either the 16-64 age group or the 20-64s). Over the past ten years, the Dutch labour force has grown at 0.5% a year, and employment likewise. Germany’s has grown more slowly, but is still well ahead. The reason is a combination of rising participation of the supposed working-age population in the labour force with a rising tendency for people to work at age 65 and later. The better health and rising life expectancy that are increasing the over-65 population as a percent of the total are also causing those older people to be both capable and keen to work. Playing golf can pale after a while, so working life, at least on a part-time basis, now stretches much later.

Not only are alarming future projections of a huge burden of old and sick dependent people exaggerated, but also the generation of surpluses is hampered by poor net income flows on overseas assets. The investments made with the surpluses, aside from failing to appreciate in value (the simple growth in net foreign assets being less than the cumulative value of surpluses), also are not generating net income to The Netherlands: the net income account, part of the current account balance, has averaged a deficit over the past five years.

German/Dutch growth in 2012-13 and subsequently

The Eurozone economy depends for the foreseeable future, if all current members remain in the euro, on growth of export demand in north-central Europe, centred on the German export machine. In all countries budgets are being tightened to reduce deficits. This ensures that domestic consumption will at best follow growth elsewhere in the economy, and certainly not lead it. This is not only true of government spending itself, and consumer spending, but also capital spending, which will not grow significantly unless capacity usage is being stretched.

Export demand in north-central Europe is prospectively weak for the next two years, through to the end of 2013. First, much of it comes from Med-Europe, where fiscal deflation of demand is savage, and elsewhere in Europe, such as France and Britain, where fiscal deflation is severe. Markets outside Western Europe take about half German exports, though less of Dutch, for whom Germany itself is the largest market. The prospects for the US, China and emerging Pacific Asia (the “Tigers”), commodity countries and developing economies generally are described in Appendix A. They are not good, from the standpoint of north-central European countries’ exports. Specifically:

- The United States has achieved a significant reduction in its relative labour costs owing to Chinese and other countries’ inflation and the weakness of the dollar
- The import share of the US market could therefore be falling for several years
- Scheduled US budget tightening is substantial this year at 1¼% of GDP, and much larger in 2013, about 2½% of GDP
- US domestic demand is likely to grow slowly at best during 2012-13 as a result, and such a US demand slowdown would cut imports significantly in normal times – more so now, given the new US cost competitiveness
- China could find its exports (30% of GDP) expand much less fast than in the past, and GDP growth is generally expected to be slower in future
- Slower Chinese growth will mean a falling share of capital spending in GDP, doubly reducing its growth of capital goods imports, a prime German speciality
- Much the same considerations apply to the rest of the Asian Tigers
- Energy and metal prices are dominated by the US and this China/Tigers group: a sharp slowdown in all of them, and increased domestic oil output in the US itself, means countries dependent on energy and metal exports are likely to grow much more slowly in future
- This most obviously affects Russia, the Middle East and Australia, but its effects will be widespread
- In aggregate this all means Germany’s non-European exports markets could be flat or declining in 2012-13, and then growing much more slowly than in the recent past

Effectively, the growth engine of continental Europe is stalling. Paradoxically, this means that Germany and The Netherlands will have to struggle all the harder for cost competitiveness, to hold onto world market share. This suggests further suppression of wages, and therefore consumer spending. Such downward pressure on labour income will be aided by competition for jobs from the sizeable number of immigrants to be expected in the two countries from Med-Europe, where unemployment is high and rising. The stalling of world export markets could thus knock on to a weakening of German and Dutch consumer spending.

It goes without saying that government spending will not be a source of growth, as all countries are tightening their budgetary stance, in pursuit of balanced budgets. In this context, capital spending could stop growing too – a slow economy lowers both capacity utilisation and profits – and could well fall. The Netherlands and

Germany could see flat or modestly lower real GDP in 2012, with recession already started for both countries – in Q3 and Q4, respectively. In 2013, with the US and China both freer to take tough decisions after elections/government changes, world trade could be just as disrupted, and recovery prospects poor. Only from 2014 might a gradual recovery start.

Conclusion

This Chapter has been concerned with the damage the single currency has done to the productive economy and prospects of even the financially strong Eurozone economies. It turns out that their financial strength is largely a function of weak economic growth, and a major deterioration from pre-euro growth of GDP and consumer welfare. The intended compensation, a build-up of saving for the future, has to a great extent been wasted. But in future, if the euro is to persist with its current membership, it will not be a matter of investing such surpluses, but effectively giving them away, as the deficit countries will remain in deficit and have already exceeded their debt capacity. The euro has damaged severely the growth rate of financial healthy economies like The Netherlands and Germany, which have sacrificed in vain the welfare of their citizens.

Chapter D: Netherlands/Germany v. Switzerland/Sweden

It is self-evident that any projections of future growth-rate and other changes for aspects of the Dutch economy outside the euro would be largely arbitrary. Rather than attempt to argue for some particular potential growth rate change for the various key economic variables, this analysis will look at how The Netherlands and Germany have done by comparison with what can be called the “Dutch comparators”, Sweden, Switzerland and Denmark, three economies of comparable size and character that have had floating exchange rates. This comparative analysis will help determine how The Netherlands might fare outside the euro, leaving aside the avoidance of the financial penalties of Med-Europe subsidy that have already been detailed.

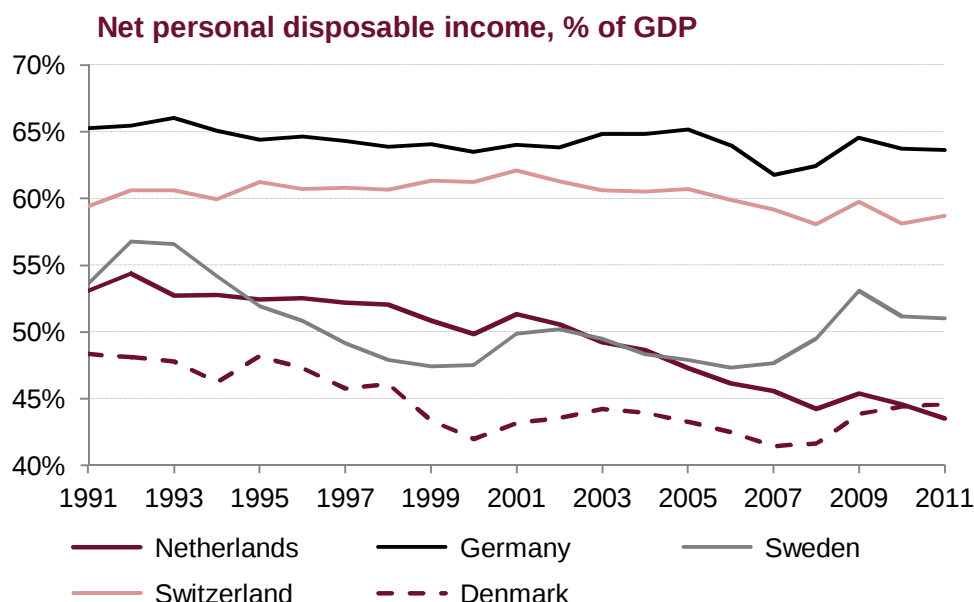
A key point of principle is that The Netherlands outside the euro has the freedom to adopt the policy stance it wants. (This variable alone prevents a convincing long-term forecast of the effects of leaving the euro.) For example, while insistence by The Netherlands and Germany on budget balance within the euro probably can only be achieved at the expense of Med-Europe depression (and large, continuing government deficits in those countries) Dutch exit makes a balanced-budget policy much more feasible. Interest rates could have to be zero, and quantitative monetary easing might be needed. The offset to ultra-tight fiscal policies, with the Dutch private sector currently running a financial surplus of 12% of GDP, might have to be very easy money. Such a policy stance would tend to hold down any tendency of the “new guilder” (henceforth NG) to rise – easing one of the chief fears (undue currency appreciation) that might be raised at such a unilateral Dutch EMU-exit.

Putting the point another way round, The Netherlands might choose to shadow the euro, losing some policy freedom, but probably in current and foreseeable conditions able, assuming the government continues with the aim of budget balance, to enjoy lower interest rates at all maturities than if it were in EMU. Denmark’s shadowing of the euro gave it exchange rate stability, but at the expense of higher interest rates, but in current circumstances The Netherlands outside the euro could attract capital inflows, and has a large current account surplus as well. Shadowing the euro would imply lower Dutch rates than the ECB’s, and lower bond yields than Germany’s. This reflects the fact that The Netherlands outside the euro would be likely to retain its AAA bond rating, whereas Germany, and The Netherlands if it stays in the euro, are likely to be down-graded, owing to taking on liability for the debt-laden economies of Med-Europe.

Switzerland, with a truly floating exchange rate until recently, has enjoyed very low interest rates, and, as we shall see below, better real GDP growth than The Netherlands and Germany, and far greater consumer welfare. It is likely that The Netherlands outside the euro in current circumstances could get “the best of both worlds” – some currency appreciation, accompanied by low interest rates and a balanced budget, while the economy would be better balanced: consumers could

enjoy the fruits of their productivity growth, with the economy less entirely dependent on exports for growth.

Naturally, major Dutch dependence on exports is not going to disappear, so the issue of export competitiveness and dependence cannot be dismissed. The danger that Europhiles will emphasise in a unilateral Dutch euro-exit is that a sharp rise in the nominal and real exchange rate will do sufficient damage to net exports that very low interest rates cannot compensate for it. But several factors argue against this risk. First, a sharp rise in the NG would rapidly lower inflation, probably below zero, sharply raising the real value of consumer incomes. In an extreme case, a one-shot appreciation of 10%, given that Dutch “supply” consists of a 43% import share of total demand (and GDP 57%), ought to lower final prices by 4.3% in its initial impact, assuming unchanged margins. With Dutch inflation currently well below this rate, the implication is rapidly growing real incomes – and therefore consumer demand (as well as welfare).



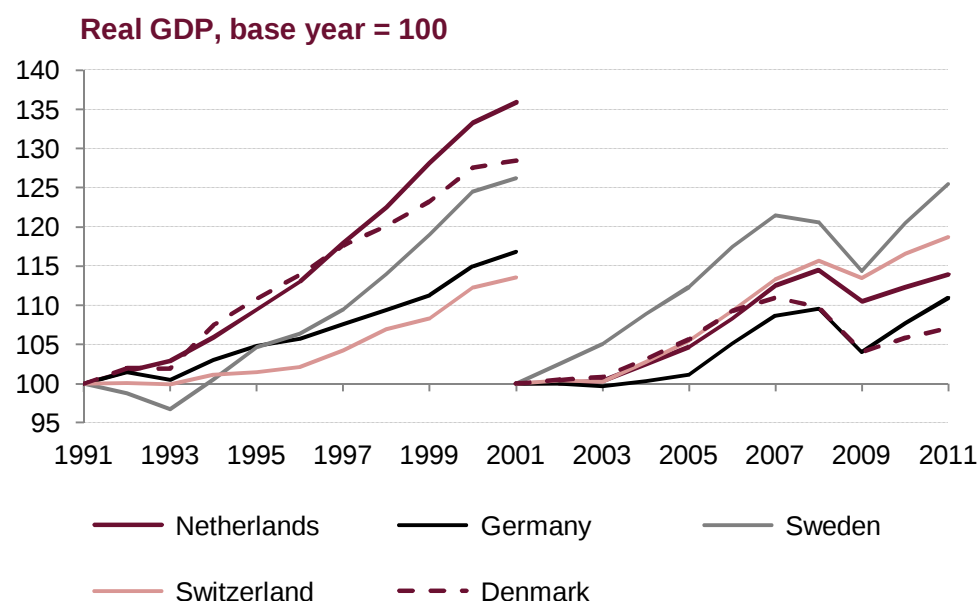
The second point derives directly from this: the consumer share of GDP needs to rise. The chart above shows the scale of the loss of income by consumers over the past decade, with the repression of wages and salaries. A rise in the real exchange rate is badly needed to rectify the balance of incomes in favour of consumers. The feared loss of competitiveness need not arise: profit margins can take the strain, pending a positive productivity response, leaving price competitiveness intact. It is in this context that major Dutch firms’ enthusiasm for the euro can be understood: it has held down relative labour costs at the expense of ordinary people’s wages and salaries, yielding effort-free profitability.

The third point is that Germany is easily the largest Dutch export market, and it would clearly be an easier, because smaller, adjustment to existence outside the euro if the exit were made with Germany, rather than “flying solo”. Whereas the German real exchange rate has fallen significantly during the euro years, the Dutch

has stayed largely unchanged, as The Netherlands' extremely open economy relatively quickly "reverts to mean". For Germany and The Netherlands to leave the euro together would cut the favourable impact in terms of policy freedom, but likewise the risks. As for real consumer incomes, a significant rise in the new deutschemark (NDM) would take the NG part of the way along with it, lowering import prices in general, though not (of course) of German goods.

Lastly, however, it must be observed that of the three country comparators that we are about to compare with The Netherlands and Germany, Sweden and Switzerland have fared far better economically in most respects, particularly Switzerland despite its experience of soaring exchange rates being the most acute. Denmark has done better on many counts, with its main problems arising from its shadowing of the euro. So the likelihood is that The Netherlands could be best off leaving the euro by itself and adopting an unfettered policy, though leaving with Germany would continue the longstanding alignment of their exchange rates, as well as reducing both the upside and the risks.

GDP growth

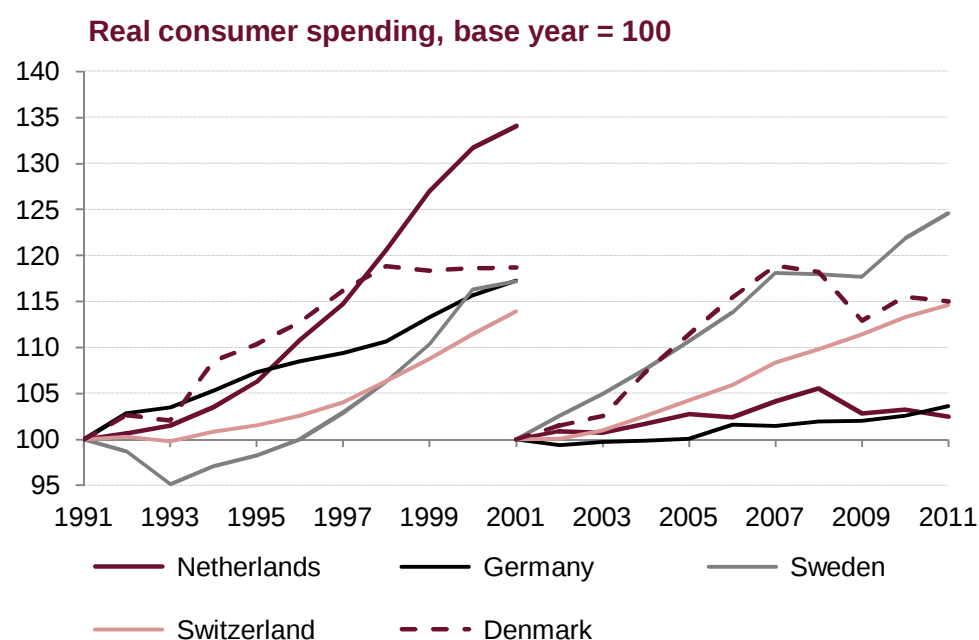


GDP growth is compared between 1991-2001 and 2001-11, as in Chapter 2. Sweden was seriously out of balance in 1991, and saw GDP declines in both 1992 and 1993, but then rallied on the back of structural reform, budget tightening and devaluation, to secure ten-year growth of more than 25%, well ahead of Germany and Switzerland, a little behind Denmark and well behind The Netherlands. In the latest ten years, Sweden's growth is little changed, avoiding the slowdown affecting most others, whether surplus or deficit countries. Switzerland grew relatively slowly in the 1990s, only up 13½% in the ten years to 2001, but has actually improved its performance in the latest ten years, up just under 19%. This is in very sharp contrast to The Netherlands and Germany, where growth was down drastically and seriously, respectively. Denmark, on the other hand, has had a terrible decade

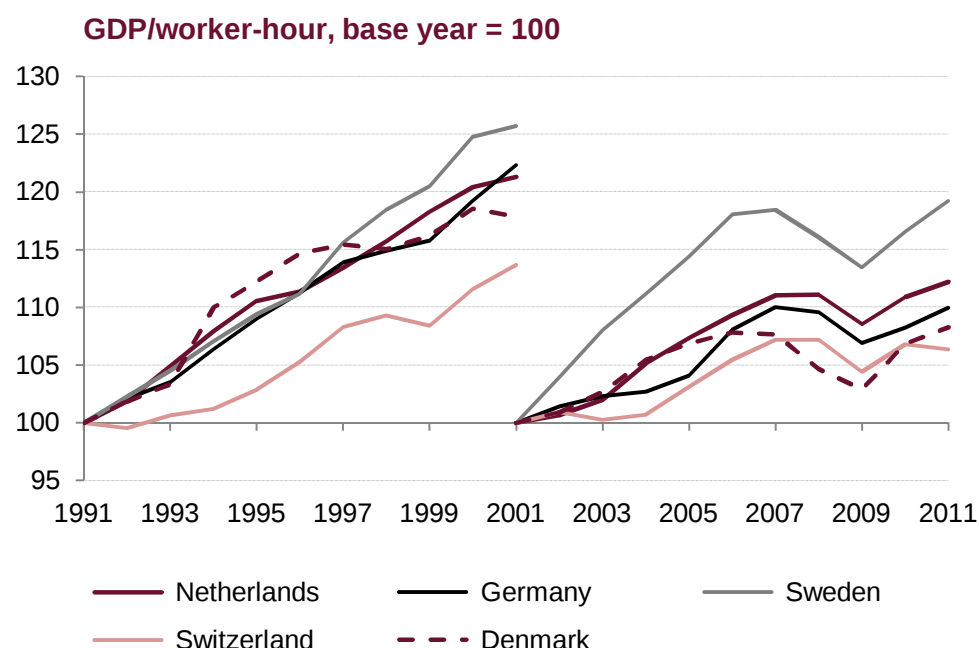
since 2001, with ten-year growth coming down from 28.5% to 7%, even worse than the dismal German performance and only half the Dutch 14%. But the Danish experience is not comparable with Sweden's and Switzerland's, as it kept its krone shadowing the euro. In that sense its performance corresponds to that of a country in the euro, with a more violent correction since 2008 owing to having got overvalued when shadowing the euro.

Consumer spending

The full cost of euro membership has been felt in consumer spending. Sweden had consumer spending growth well short of its GDP growth in 1991-2001, as it dealt with the early-1990s economic crisis. But in the last ten years its consumer spending growth has matched GDP almost precisely, with 25% growth. Switzerland had consumer spending growth equal to its rather weak GDP in 1991-2001, and only a little behind it in the latest ten, stronger years. In Denmark, consumer spending growth was behind that of GDP in the fast-growth 1990s and more than double it in the last ten years. Growth of consumer spending in The Netherlands and Germany collapsed close to nil in the last ten years, having roughly matched that of GDP in the 1991-2001 period.



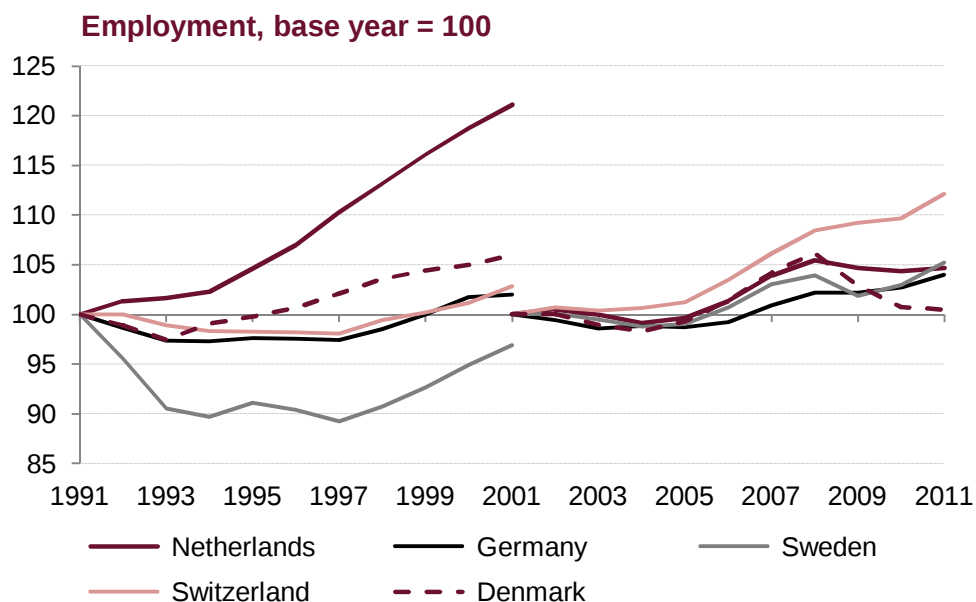
Productivity growth



When it comes to GDP/worker-hour, a more fundamental measure of competitiveness than relative costs, all five countries have been slower in the last ten years than the previous ten. Sweden comes out best, with the fastest growth in both periods, and the smallest decline between them. The Netherlands and Germany grew faster on this measure in the 1990s than Denmark and Switzerland, and again in the last ten years, though their outperformance was much lesser. The poor Swiss number, however, must be considered in the light of ...

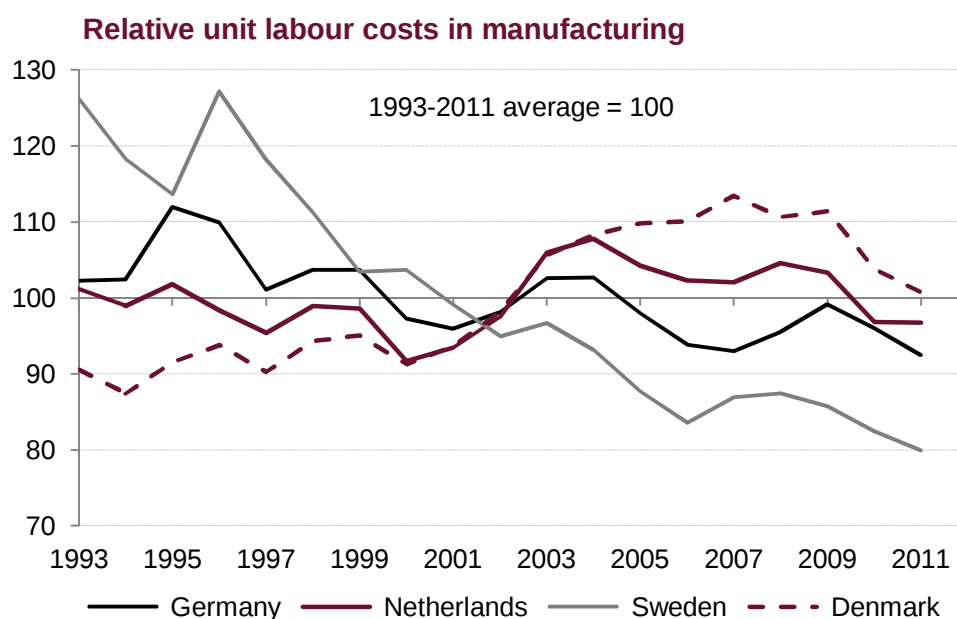
Employment growth

... far superior Swiss job creation. The penalty suffered by Denmark for its policy of shadowing the euro but running up deficits is shown in the chart below: a severe loss of jobs since 2008. The Swedish example gives an interesting insight into the plight of Spain. Sweden was suffering from excessive debt and an overvalued exchange rate in 1991, and had to put its economy through the wringer in the early 1990s, as did Canada and Britain. In each case, the combination of a relatively strong world economy and the ability to devalue was crucial to stabilisation and recovery. Since then Sweden, like Canada and Britain, has prospered, and grown much faster than The Netherlands and Germany, in jobs as well as GDP. Spain today has neither a buoyant world economy, nor the ability to devalue – so it will soon be in crisis again.



The buoyancy of Swiss job creation – its labour force growth over the past five years has been an extremely rapid 1½% a year – suggests that a two-way cause and effect was operating: a strong economy was boosting the inflow of both labour and capital, raising the nominal and real exchange rate, as much as the strong real exchange rate was damping what could otherwise have been inflationary growth. This example should act to still Dutch fears about a higher real exchange rate if it leaves the euro unilaterally. It is unreasonable to suggest the formidable Dutch business sector cannot match the Swiss.

Cost competitiveness – real exchange rate



Switzerland is excluded from the chart above, because the OECD does not include it in these data. The chart only goes back to 1993, as Sweden had a huge devaluation between 1991 and 1993, making the pattern for other countries hard to discern in the chart. The chart measures, for each country, the change in its relative unit labour costs (ie, the compound of changes in hourly pay and productivity) vis-à-vis its trading partners – using for each country the weights of all foreign countries in its foreign trade to gauge their importance.

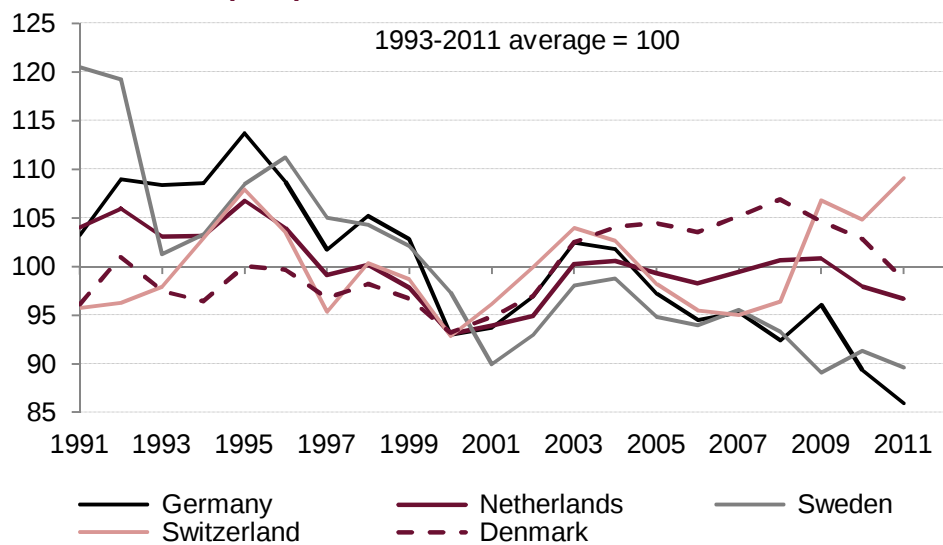
Sweden's relative unit labour costs, or real effective exchange rate (reer), has declined throughout the period since 1993, when it had already had a large devaluation. This probably reflected its success in keeping up growth in the face of a slowing world: such a favourable deviation from the bulk of countries implies more rapid growth of imports than exports, so that to offset this and keep overseas trade in balance requires real effective devaluation. Putting the matter another way, if Sweden had joined the euro, its growth and consumer spending would have been much less, or it would have joined what are now the deficit countries in crisis – Med-Europe and Ireland – as, to some degree, did Denmark.

Germany's reer has also declined steadily over the past couple of decades (the decline going back to the late 1980s). In Germany's case, cause and effect lie the other way round from Sweden. Its repression of wages and consumption have necessitated a falling reer to generate some net export growth and offset what would otherwise have been an even more drastic deficiency of demand than the shortfall that actually occurred. Denmark's sharp rise in reer in the 2000-07 period reflect its shadowing of the euro, combined with faster wage growth than Germany, its largest trading partner by far. This higher reer probably accounts for Denmark's poor growth over the past decade, and the fact that consumer spending did not slow nearly as sharply as GDP. Denmark by linking its crown to the euro became like a little Italy, effectively slowed by loss of competitiveness, but with its excessive wage costs helping to sustain consumer spending at a considerably faster growth rate than that of The Netherlands and Germany.

The Netherlands has enjoyed consistent stability in its reer. This is no great surprise. Exports are 83% of GDP, and imports 75%, so the country simply cannot get far out of line in its costs with major trading partners, conspicuously Germany. This is likely to remain true in future, whether inside or out of the euro.

To bring the important case of Switzerland into the picture, it is helpful to look at relative export prices. Here we observe roughly the same pattern for the other four countries as with reer, except that Germany's relative prices dropped faster than its reer – implying a loss of purchasing power for labour income (one cause of weak consumer spending). The Dutch trend in relative export prices was also somewhat weaker than in reer, implicitly lowering the buying power of Dutch citizens – importantly so, given the huge importance of foreign trade in the Dutch economy and the greater impact on real incomes, therefore, of any given shift in export prices.

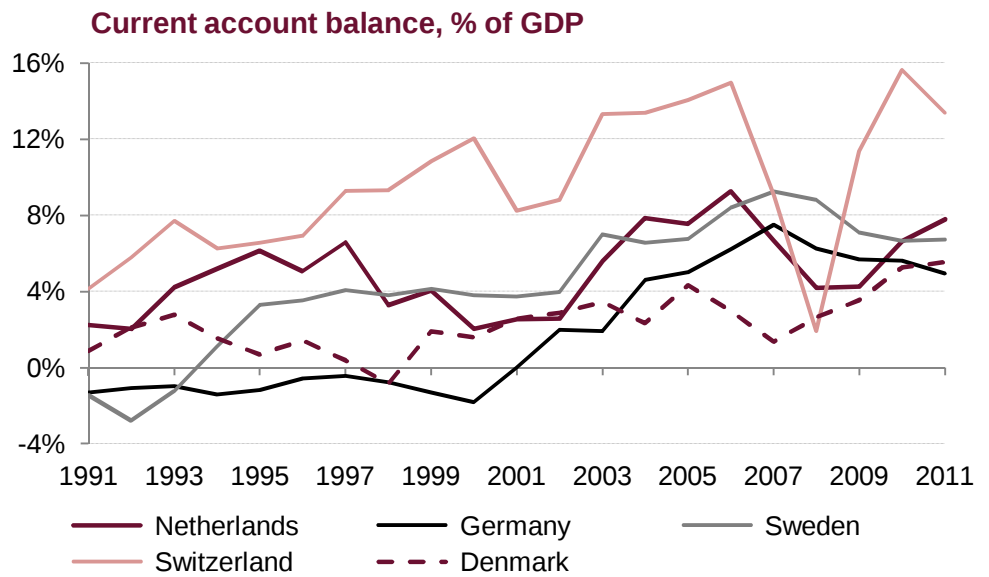
Relative export prices



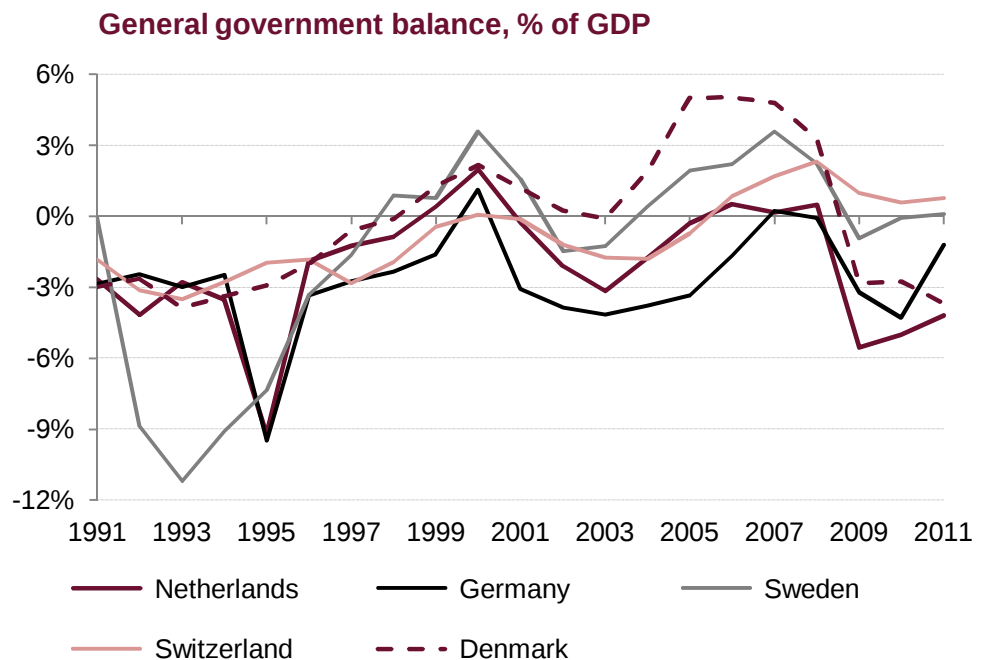
When it comes to Switzerland, it can be seen that for all the famous volatility and “safe-haven role” of the Swiss franc its relative export prices have not fluctuated any more violently than those of the other four countries, without any clear upward or downward long-term trend, though they have shifted upward post-crisis. For Sweden and Denmark, the relative export price picture is close to that of reer. The smaller countries do not seem to have had greater fluctuations than big-league Germany in their relative costs, whether tied to Germany in the euro (Netherlands and effectively Denmark until 2007) or not (Sweden and Switzerland). Implicitly, therefore, worries about exchange rate changes destabilising The Netherlands, should it leave the euro, should be discounted.

Current-account and budget balance

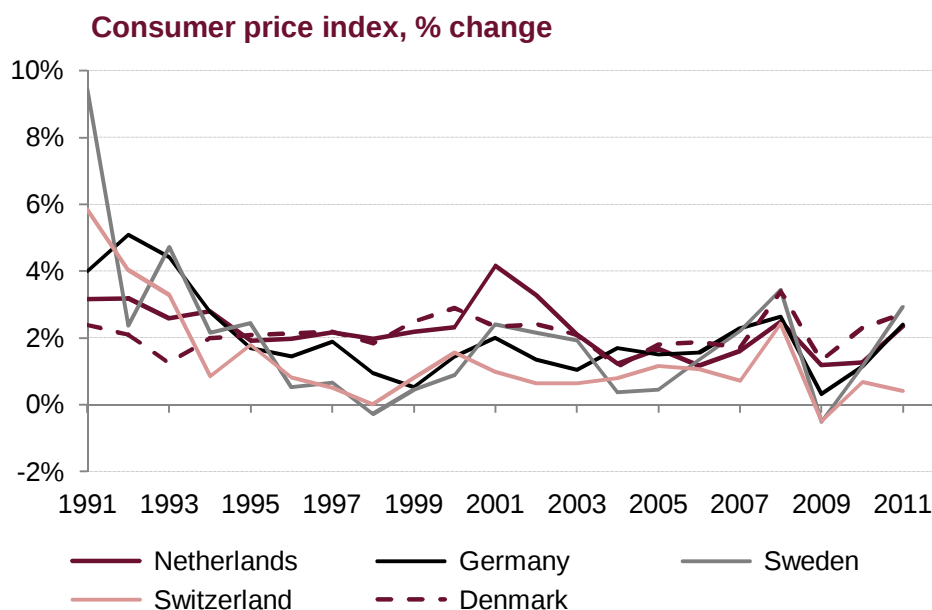
All the countries in this particular universe have been in large current-account surplus for the entire period since the 2001 recession. This reflects their general tendency to save far more than they can profitably invest, combined with a belief in budget balance. There is little difference in their current-account performance (taken by itself) between those in the euro and those not. The huge Swiss surplus reflects its slow growth in the 1990s. In the past ten years Switzerland has managed to grow faster than all but Sweden, with a modestly slower rate of growth of consumer spending than GDP, though much faster than The Netherlands and Germany, while continuing to run a huge current-account surplus. Clearly it has had a far better combination of growth, support for its citizens’ welfare, and financial stability than either of the two members of this group inside the euro.



When it comes to budget balance (see chart below) Sweden and Switzerland have also achieved balance more successfully than Germany and The Netherlands, though Denmark has paid the price for shadowing the euro in its recent lurch into deficit. Interestingly, on this measure, Switzerland has a much more stable pattern over the past 20 years than the others (though Germany's spike into surplus in 2000 was caused by its G-3 mobile wave-band auction).



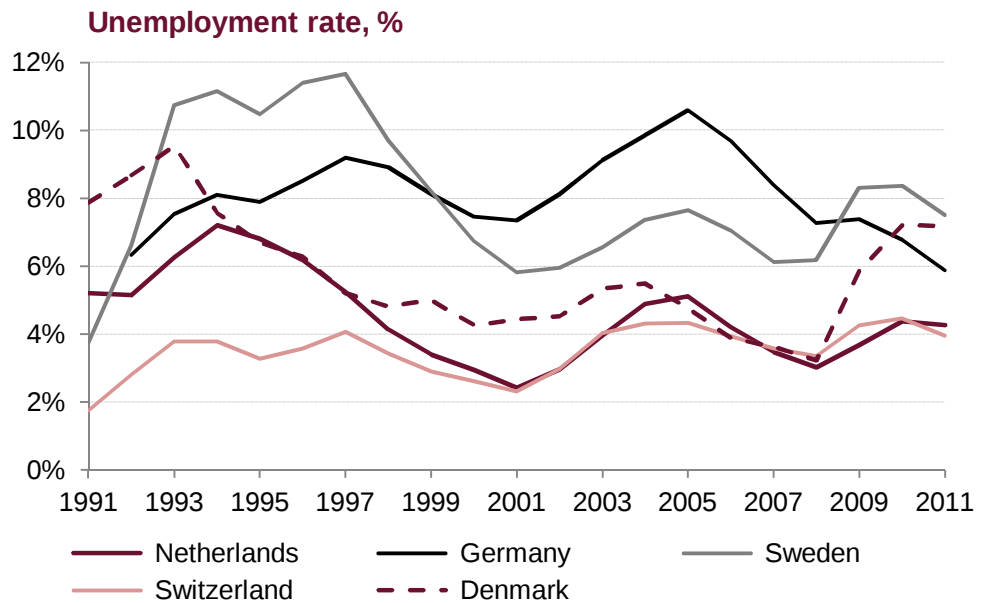
Inflation



All of these five countries had inflation well under control by the early 2000s, even The Netherlands by 2004. The effects of being undervalued in global terms, as well as within Europe vis-à-vis Med-Europe, began to show themselves with overheating at the peak of the boom in 2007-08, when inflation exceeded the commonly accepted modern target of 2%. While this inflation naturally dissipated in the recession, in the recovery it has returned quite quickly, except for Switzerland, where a currency truly free of constraint has kept inflation low. It is inherent to the euro structure that only with continued recession, probably depression, in Med-Europe can inflation in Germany and surrounding countries within the euro remain low – including those partly shadowing it like Denmark, or even trending downwards like Sweden. If the Eurozone as a whole achieves on-trend growth, Germany and The Netherlands for sure, and probably Denmark and Sweden, will see inflation move well above 2% and stay there.

Unemployment

When it comes to unemployment, Switzerland and The Netherlands have held it down most successfully, with the German rate improving in recent years after a severe upswing in the mid-2000s as the economy was sharply deflated. Germany's performance is qualified by the absence of much labour force growth in the past five years, whereas it has been huge in Switzerland – 1½% a year – with the Dutch ½% annual labour force growth also significant. The two Scandinavian countries in our group have suffered worse from unemployment after the recession for differing reasons. Sweden has had rapid labour force growth of 1% a year: the recession has meant growth could not fully utilise it. Denmark, with labour force growth of ½%, has not been able to cope with the problems arising from shadowing the euro without a doubling of unemployment.



Conclusions

The long-term conclusion that is most important from this analysis is that The Netherlands has nothing to fear from leaving the euro unilaterally. On balance, growth is likely to be higher, and certainly not lower, as a result of leaving. The likelihood of achieving, rather than just talking about, budget balance is greater. Inflation should be lower. And, most important, the economy should re-orientate toward its primary purpose: the welfare of citizens.

The fine performance of Switzerland over the past ten years reinforces the message of the early 1970s, when the collapse of the dollar and the build-up of Dutch North Sea gas led to major real and nominal exchange rate appreciation, and coincided with post-WWII records in Dutch and German growth. Switzerland has far outperformed The Netherlands and Germany in growth of GDP and jobs, while its citizens have had the benefit of a rising currency, strong real consumer spending growth and lower inflation. Yet its finances – measured by budget and current account balances – have been stronger. There is no reason why The Netherlands outside the euro should do worse. Leaving the euro with Germany would be the safety-play, therefore, but leaving unilaterally – or, if both leave, engaging in a true currency float – would probably lead to the best results overall for the nation.

Chapter E: Near-term prospects and euro break-up

Cash-flow costs by country and total at the end of Chapter B above give the price Neuro countries must pay in future years to keep the euro intact. But within the euro most of the debts will never ultimately be repaid and subsidies will need to continue, year in and year out. Indeed the euro can only survive if it becomes a fiscal transfer union with national sovereign debt subsumed in Eurozone bonds. Moreover structural change must not be confined to crisis-stricken economies. Given the need for domestic austerity and lower relative wages in Med-Europe, growth can only be enjoyed in the Eurozone as a whole if the surplus countries, notably The Netherlands and Germany, accept the need for consumption growth faster than GDP, probably breaching the Stability and Growth Pact in the process, and higher inflation than the Eurozone average, presumably at least 3-4% – as well as accepting 10-20 years of outright subsidy of Med-Europe. Failing this, Neuros will be condemned to waste their savings on worthless assets, and Med-Europe to depression.

Our view is that, assuming The Netherlands stays in EMU for the time being, the dawning of realism about Greece will cause it to make a negotiated exit – willed, if regretted, on both sides – later this year. And that Portugal will have to leave shortly thereafter. The political thought behind this is that loss of Med-Europe countries from the euro is most problematic for France of the Neuro countries, its competitive position being much weaker than The Netherlands and Germany. So a Greek exit before the French elections are over is unlikely (unless arising from April's Greek election outcome.). But Germany has major elections in autumn, 2013, and would like a "clean run" for the previous year. That means settling the "Greek problem" for once and for all. However, as we have demonstrated, the Greek problem will not go away as long as it remains in the euro. So it will have to go – and will be glad to go, given the virulence of the recession.

Once Greece goes, with severe recession meanwhile sapping Portuguese business and banks, the full force of the financial markets' perfectly proper scepticism will drive Portugal out in short order. At that point, if not before, attention will turn to Spain and Italy, both likely by then to be much weakened by the savage austerity programmes now being implemented. At that point, the Neuro countries will actually be forced to make the decisions they have ducked in the two-year crisis so far. The Netherlands and Germany, if they wish to preserve the euro with Italy and Spain in it, will have to accept deficit budgeting and relatively high inflation for the foreseeable future, as well as indefinite subsidies of Italy and Spain via fiscal union and Eurobonds. The alternatives will be exit, either by Italy and Spain, or by Germany and The Netherlands in tandem. The former would create the Neuro, the latter would mean a return to the rationality of floating exchange rates.

At any stage in the above possible course of events, it would be open to The Netherlands to leave the euro unilaterally – on the upside, so to speak. Such a decision would clearly be more profitable the earlier it is taken.

Break-up scenarios for the euro

- (a) only Greece and Portugal leave
- (b) "contagion" then forces Italy and Spain to exit, leaving behind the "Neuro", centred round Germany, France, Benelux and Austria
- (c) "contagion" after Greece and Portugal leave creates such large prospective subsidies to Med-Europe that The Netherlands and Germany decide to quit EMU, effectively returning Europe to floating exchange rates
- (d) The Netherlands leaves alone

Only Greece and Portugal leave

Aside from the technicalities of treatment for each category of euro obligation vis-à-vis Greece, its exit would involve a bridging loan to the central bank to get the new currency started, presumably (as with IMF-type financing) senior to all existing loans. It is only reasonable to assume this would eventually be repaid if much of the remainder of existing Greek debts, including those now mostly to official institutions, were both written down and denominated in new drachma. This could be expected to fall drastically, though not the 80% assumed in some quarters. So for practical purposes, the financial impact of Greek exit later in 2012 would be little different from the cash flows shown above in connection with keeping it in EMU, an unchanged negligible present value of the existing debt, but with a more immediate write-down. This is simply the price of having accepted Greece into EMU in 2001 and then treating its galloping imbalances with complacency for eight years.

Portugal's gross government debt would probably not be a complete write-off if it leaves EMU this year. The risks from its huge business debt would have to be kept under some form of control by denomination in new escudos, as with government debt, at least for that portion owed to Portuguese banks. But a banking crisis is still likely to require major recapitalisation at government expense. The relatively small primary deficit means a devaluation could yield primary surplus quite quickly. Government debt capacity would certainly not be more than half GDP, however, and half of that might be taken up with bank recapitalisation. In order of magnitude, Portugal's near-€200billion debt, would be cut by three quarters, and then subject to whatever devaluation proved necessary for the new escudo, probably in the 25-40% region. That would only leave €30 billion out of the original €200 billion, but most of that would be borne by existing holders, not Neuro countries. So its exit would be much less costly than keeping Portugal in.

This scenario of Greek and Portuguese exit could become more costly in relation to Italy and Spain, however: financial contagion as exit from the euro becomes demonstrably feasible. At the least this could bring forward the date at which Neuro countries would have to finance the gross borrowing requirements of these two countries, including refinancing of maturing debt. **This is one factor behind current Eurozone policy paralysis.**

Spain and Italy leave

In this scenario, the Greek and Portuguese exit costs are the same as in the previous one. Italy and Spain suffer acute contagion and exit the euro. Sizeable bridge loans to facilitate exit would be needed. Nonetheless, if implemented quickly, Italian and Spanish exit from the euro would offer major savings compared to keeping them in – especially after Greek exit. Italy's exit would be more easily managed than Spain's, as its overall debt ratio is not high, only its government debt. In Spain, exit involves the double problem of a higher budget deficit and the danger from a banking crisis induced by huge company debts.

To estimate the cost savings from Italian and Spanish exit is hazardous, as they get rapidly greater the longer the exit is delayed. It is not realistic, in the current condition of European politics to expect either country to take a Greek exit later in 2012 as a signal to get out. The whole tenor of recent policy discussion and action has been to treat Greece as an exception – which it is, in that its problems are more acute. If a Greek exit is followed by these two countries “hanging on”, the cost of supporting them rapidly escalates to the upper end of the ranges presented above for their finances. Continuing for some years, followed by “throwing in the towel” and exit, this would become a very expensive scenario, as the badly injured economies would need to be nursed back to health at major Neuro expense.

Immediate Italian exit would not be very expensive. Foreign banks and other institutions owning Italian government bonds would lose money as the new lira descended, and might need some bail-out by the governments. Euro institutions that have recently loaded up with Italian paper to try to fix the market would lose some money. But with currency freedom, Italy would quickly enhance its primary surplus, return to moderate growth, and regain debt servicing capacity, if at the expense of ongoing inflation and devaluation – back to the old days, in fact, and very welcome for that compared to the past 10-11 years.

Immediate Spanish exit would be more problematic. Its primary government deficit is nearly 7% of GDP, reflecting the private sector's need for a huge financial surplus to permit deleverage after the debt orgy in the run-up to 2007. A major devaluation might put things right, given good export performance in recent years. Spain needs a large current account surplus (= foreigners' deficit) to provide its private sector with financial surplus without the government having to run the offsetting deficit. But Spain is highly internationally connected and a major devaluation could worsen the banks' difficulties with their assets – ie, the excessive debt load of business. Clearly the sooner Spain exits the better, as going into severe recession without leaving the euro would bring on a bank crisis anyhow, without the possibility of putting right the primary budget deficit.

For all these advantages of early exit, which would minimise the cost of Italy and Spain leaving the euro, this remains improbable, so a high-cost, long-drawn-out struggle would be likely before the simple realities of recession and massive unemployment forced exit. This prospect gives rise to the alternative scenario ...

The Netherlands and Germany leave

Here again, the sooner the better in terms of total cost. Realistically, at the earliest it could be reactive to Greece and Portugal having left later this year, and the massive contagion in financial markets threatening to raise sharply the cost of keeping Italy and Spain in the Eurozone. Given the German electoral calendar, however, and the absence of scepticism about the euro in any major German political party, it is hard to imagine this option being undertaken this side of autumn 2013 elections – even though it would be popular.

In this scenario, the costs for launching independent currencies and monetary systems in Italy and Spain could be the same, but incurred earlier, much reducing the total costs, given the large potential annual fiscal support for those two countries.

The chief point of this scenario is that it amounts to a return to floating exchange rates. In no way would it be likely that France, Italy and Spain would wish to maintain a common currency. The German and Dutch exchange rates, whether fixed together or floating separately, the new French franc might be little changed against the dollar, while the Med-Europe currencies would fall sharply.

For The Netherlands, this would involve the equivalent of strong-euro experience before the world moved on from the subprime crisis to the Greek start of the euro-crisis. Relative to the dollar, the Dutch currency would be up, but also relative to much of former Eurozone, France and possibly Belgium included. In trading terms, Dutch firms would feel a (possibly badly needed) stiff breeze. In price terms, consumers would benefit.

When it comes to net Dutch foreign assets, the dissolution of the euro would require a legacy currency, and a role for the ECB in managing it and maintaining markets and liquidity. Pension funds, with net equity positions abroad, could suffer losses. But such losses would be qualified by the shifts in stock markets, which tend to offset currency movements. Given the major gains to consumers' real incomes arising from cheaper imports, the government would need to consider some form of value added tax increase, or other comparable revenue, to offset pension funds for losses incurred by a policy serving the general good.

The Netherlands quits EMU unilaterally

To the extent The Netherlands stays in the euro before drawing the conclusion it ought to leave, it will incur costs, most likely under the "All stay in" scenario. Further exit costs could also arise if, by the time of Dutch exit, formal commitments to meet long-term Med-Europe financing needs have been made under the intended ESM agreement, currently intended for later this year. This timetable argues for early action if this policy option is preferred. Aside from representing action to deal with a threat to Dutch finances, it more generally gives The Netherlands freedom of action in economic policy.

No more than anywhere else can The Netherlands independently set inconsistent targets for the three chief demand-management policies: budget balance, interest-rates/monetary, and exchange rate. The risk that most observers would probably emphasise is a rising new guilder (NG). But it must first be observed that previous episodes of Dutch real exchange rate strength have not taken it out of a fairly narrow band of +/- 10%. Nor is this likely to happen in future. The sheer open-ness of the Dutch economy argues against it. While this is clearly not the equivalent of the euro rising 10% (to \$1.45, say) as that would take up other EMU countries too, the relatively recent experience of the euro at \$1.60, leaving the Dutch economy unscathed – unlike Med-Europe – suggests little threat. And a 10% rise is the extremity of past experience, not the norm: it would almost certainly settle down again – with Dutch consumers gaining all the way through, of course.

Should The Netherlands, at least at the start of unilateral euro-exit, shadow the euro? With insistence on budget balance and shadowing the euro, monetary policy will be forced, not freely determined. If inflows threatened to make the NG strong, that means interest rates at or close to zero (no great sacrifice perhaps) and possibly quantitative easing too (buyback of existing securities in the market, eg Dutch government bonds, financed by, in effect, "printing money"). This policy choice seems reasonably manageable.

Dutch foreign assets & liabilities

In this scenario as in leaving with Germany, the valuation of foreign assets would be an issue. If the New Guilder (NG) appreciates or depreciates against the Euro, then the Dutch exit from the Euro will yield losses or gains respectively on net Dutch foreign assets. The policy freedom that The Netherlands would gain by leaving the Euro includes the option of shadowing the Euro, at least to start with. It follows that costs or benefits on net foreign assets cannot be specified without major assumptions as to future economic and foreign exchange policy.

If the Dutch policy were to benefit consumers by permitting some appreciation of the NG the maximum move that would be likely on past experience would be 10%. This means that at the worst the problem would be little different from having the euro shift to \$1.45, well within recent experience. (The bulk of Dutch foreign assets and liabilities are outside the Eurozone, so that for them, as opposed to the economy as a whole, the experience of the NG at \$1.45, or at most \$1.50, is the relevant criterion, not some higher number as mentioned above.) The possible losses on net equity assets would be largely offset by valuation shifts. In this case the cost to Dutch net foreign assets would be approximately €75 billion, assuming Dutch stocks only appreciate a portion of that 10% in Euro terms.

The Netherlands has a large balance sheet with the rest of the world, with total assets of just over €5.3 billion, and liabilities of €5.1 billion, for a net-asset total of just over €200 billion (as of 2011 Q3). These have been subject over the years to the vicissitudes of foreign exchange rate movements, generally outweighed by movements in the prices of the assets and liabilities themselves.

An exchange rate change tends to be offset over time by contra-moves (“negative feedback”) in costs and prices: eg a rising exchange rate lowers the cost of imports, and thus the cost of living and in due course wages and salary gains, and vice versa with a falling exchange rate. With a purely accommodative fiscal and monetary policy this can wipe out the impact of the exchange rate change quite quickly. But where a fundamental disequilibrium is being rectified by an exchange rate move, policy will normally shift to sustain the move. Thus a needed devaluation is normally accompanied by tight monetary policy in the country devaluing, holding back any reaction toward higher inflation and preserving the lower cost basis that was needed to correct the fundamental disequilibrium (in this case overvaluation, as in Med-Europe today). Conversely, a needed appreciation is normally accompanied by easy monetary policy to offset deflation.

The largest sharp appreciation to have occurred in the real Dutch exchange rate since floating rates were introduced in the early 1970s has been 10½% between 1970 and 1974, and 17½% between 2000 and 2004. But the latter period followed a sharp dip in 2000 from 1999, as the euro slumped after its introduction. The rise from 1999 to 2004 was 9%.

It is normal for a larger, less open country to have bigger swings in its real exchange rate, as the smaller role of trade in its demand and supply means the impact of a given percentage exchange-rate change is smaller. The more open the economy, the smaller the swing in the real exchange rate before domestic demand and supply, and domestic costs and prices, shift to offset it.

These points suggest that if The Netherlands leaves the euro by itself, the maximum rise in the real exchange rate, assuming it did not take the Danish option of shadowing the euro, would be 10%, the outer range of prior experience. The assumption in the calculations of the cost of this change to net overseas assets is that such a 10% real rise in the new guilder (NG) would be offset by an 8-9% drop in stock prices in NG terms, ie a 1-2% rise in foreign-currency terms (including euros).

The 17½% gain in the Dutch real effective exchange rate between 2000 and 2004 reflected the revival of the euro against the dollar and yen, plus most other currencies, after its initial slump, though not against sterling (the UK being the Eurozone's largest trading partner). That period is reassuring. The four-year current-account surplus in 2001-04 accumulated to €88 billion and net Dutch foreign assets went up by €82 billion: less than the cumulative surplus, of course, but about the same rate of shortfall as has been habitual for the past ten years, as discussed in Chapter C above. So the impact of real appreciation on net foreign assets then was roughly nil. The appreciation of the euro started in earnest in spring 2002, and so was greatest between 2002 and 2003. But that year also saw the long bear market in stocks give way to the “Baghdad bounce” during and after the Iraq War. So instead of the upset to Dutch net foreign assets that might have been expected, their weighting towards equities (including foreign direct investment) led to a large annual gain in 2003. In general, this is a reminder that the static analysis attempted in this Chapter is an academic or accounting exercise,

rather than a forecast. Other movements in major financial markets are likely to be much more important – in this case stock market gains, as the distortions and imbalances imposed by the euro are reduced, even eliminated.

Dutch assets and liabilities at 2011 Q3 were (in € billion):

Foreign direct investment, equities

	<i>Assets</i>	2,058
	<i>Liabilities</i>	1,754
	<i>Net</i>	305
<i>Equity securities</i>	<i>Assets</i>	440
	<i>Liabilities</i>	290
	<i>Net</i>	151
Total equity	<i>Assets</i>	2,499
	<i>Liabilities</i>	2,044
	<i>Net</i>	455
Total non-equity	<i>Assets</i>	2,320
	<i>Liabilities</i>	2,621
	<i>Of which: government</i>	240
	<i>Net</i>	-301
	<i>Of which: non-government</i>	-61
<i>Other, net</i>		52
Grand total, net		206

If The Netherlands leaves the euro, it is assumed that existing government debt is converted into NG, to facilitate debt management and monetary policy – though it might be more immediately profitable to leave it in euros.

Growth, jobs, export industries, banks

Unilateral floating of the NG would raise broader policy issues than accounting for net foreign assets. People could be legitimately concerned that a rising NG would threaten exports, growth and jobs at a time when real GDP has fallen for the latest two quarters. Given the disruption that an exit from the euro would inevitably entail, there is a strong case for suggesting that this threat should be dealt with by shadowing the euro for a transitional period, to gain expertise in its management and that of an independent monetary policy. The aim should be to float in due course, like Sweden and Switzerland, rather than remain constant for years like Denmark, which has been notably less successful than the other two. Transitional shadowing of the euro would also remove the threat described above of losses on net foreign assets.

The Dutch current account surplus, 10% of GDP, and its known financial strength relative to the Eurozone average, would argue for appreciation being the most

likely result of no exchange rate objective, ie, “clean” floating. Shadowing the euro should not be done with a view to accumulating FX reserves, if that can be avoided. Rather, the first line of defence against appreciation should be zero short-term interest rates, followed (as probably necessary) by strong quantitative easing: in the first instance the Nederlandsche Bank (NB) buying back longer-dated Dutch government bonds on the public market. This would bring down the longer-dated rate of interest, lowering the fixed-rate mortgage interest rates that are the norm for Dutch households. It would also flood the NG money market with liquidity, with a view to “drowning” those that sought to drive up the NG with purchases. Lastly, it would raise sharply the broad money supply, stimulating assets prices and demand in the economy, probably helping growth. This is simply one illustration of how an attempted capital inflow by foreign investors would be fundamentally stimulative for the Dutch economy. (Different routes for such stimulus would occur in the event the Dutch authorities allowed the exchange rate to rise.)

In this scenario of shadowing the euro to prevent NG appreciation, exports would be unscathed, growth would be stimulated by lower interest rates and by a larger money supply with asset price strength, households would have access to cheaper mortgages, jobs would grow along with the economy, and banks would thrive in the declining interest rate environment. In the current depressed European economic context, inflation risks would be minimal. If the world and Europe were to enter a stronger patch, of course, a release of the NG to rise and offset inflationary pressure would be both likely and desirable.

If the pressure of events led to downward pressure on the NG, in the current recessionary environment, the argument for shadowing the euro would be weaker. With unemployment on the high side, a downward float would aid exporters and growth, helping to reverse some of the damage from the current ongoing recession. Interest rates, however, would probably rise – but so they would anyhow, if it were desired to shadow the euro and prevent NG weakness. In the recessionary conditions, inflationary pressure would not be great. It must be said that the huge current account surplus argues against this scenario, as would the detachment of The Netherlands from the problems of the Eurozone.

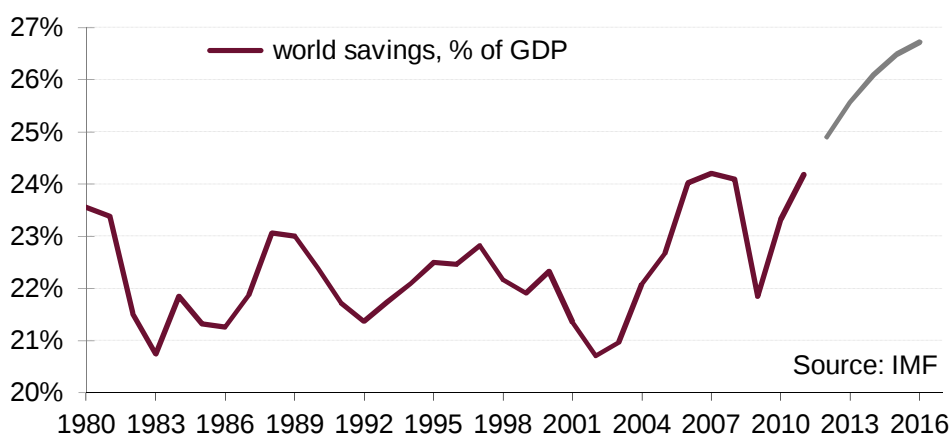
In general, if these options seem surprisingly benign, that is because the conduct of economic policy within the Eurozone has been so damaging, so that escaping it provides immediate good results. In a recession, stimulus is needed, and stimulus generally involves popular policies!

Appendix A: The grim global 2012-13 context

The strong deflationary bias in the world's economic policy and behaviour will, if anything, intensify over the next two years. In Europe this is made ideology by referring to deficit nations as “sinners” – as if Germany could be in surplus without someone else being in deficit. But China too among the surplus nations often calls for the US, in particular, to remove its deficits. Only the Japanese are experienced enough to know this is drastically self-destructive. They may not register that the world savings rate is already at an all-time high, and increasingly unable to be matched by profitable investment, without which deficient demand will drag the world economy down into recession. But after two decades of excessive private-sector saving – that they do not have any policies to reduce – the ‘surplus countries’ know the effects of a world-trade downswing induced by a slowing United States.

The deficit countries of the advanced economies, notably the US, UK, and Med-Europe (Italy, Spain, Greece and Portugal) are all engaged in vigorous, often savage, fiscal tightening. So are the others. In Europe, relatively balanced countries like France and Belgium have fiscal packages cutting demand in 2012 by more than 1% of GDP. Even surplus “saints”, Germany and The Netherlands, are engaged in significant fiscal tightening. Of the major advanced economies only Japan, dealing with the aftermath of last March's triple disasters, has a modest fiscal stimulus scheduled. For the advanced world in aggregate, the scheduled fiscal tightening is well over 1% of GDP. Because the US has elections this year, its chief tightening is postponed until 2013 – hence the intensification of global fiscal deflation over the next two years, the US actions being the most important.

World gross saving, % of GDP



China has an inflation problem so that it too has had its foot on the brake pedal. With quite a modest credit and monetary tightening has started to expose the fragility of its internal finances. This is another case where politics, in China's case the big ten-year changeover in government jobs this coming autumn, means the chief pain is being held over for 2013.

The world savings rate was at an all-time high in 2007, the year that triggered the financial crisis, and was back to 2007's rate again in 2011. In 2007, once the US

subprime crisis stopped its households' ability of dis-save, the absence of a spending offset to the excessive saving caused a Keynesian downswing, later aggravated but by no means solely caused by the financial crisis. The return to 2007's world savings rate in 2011 is bad omen enough.

Scheduled cuts in fiscal deficits – i.e. in public-sector “dis-saving” – will raise the world savings rate into new record territory in 2012 and again in 2013. Or would, if all goes well. But people with a smattering of economic education (a class that appears to exclude most political leaders) know that in the world in aggregate investment equals saving. Saving can actually only go up if investment goes up. But of course world investment is already at an all-time high (as it equals saving) with quite ludicrous levels in China, 49% of GDP in 2010 and probably more in 2011. Why it should go up from 2011's level in China – to more than half GDP – or in the advanced nations, where policy is strongly deflationary, is not explained by the rosy-hued optimists in the world financial “commentariat”.

The reason why it is not explained is that it is not going to happen. The proposition that is accepted (officially) by major international forecasters is that strongly deflationary fiscal policies will cause investment to boom. This is “nonsense on stilts”. The only place where investment may boom is China, where government-mandated capital spending is not subject to the burden of being economically viable, i.e. profitable in a broad social sense. China may well reverse its deflationary engines soon in this year of sensitive government changeover. But that, of course, is the point: it is increased public spending, in this case Chinese, that is likely to stimulate demand in the world, not cuts. In the US too, the fiscal deflation previously scheduled of some 2% of GDP or more has been eased back to somewhat over 1% of GDP. But it is still major deflation, just less severe than previously legislated. The likelihood of a fresh burst of investment in advanced market economies in these conditions is negligible. So the projected gains in saving (and reductions in budget deficits) will probably be thwarted by a growth slowdown induced by the global fiscal tightening.

While this foreshadows a grim 2012, 2013 could be much worse. In that year, with its elections out of the way, US public finances are currently scheduled to be tightened by 2½-3% of GDP, much more than this year, even with the assumption that the “Bush” tax cuts due to expire at end-2012 will largely be kept in place. China, its leadership changeover completed, will be forced to address its spectacular domestic imbalances, almost certainly with strongly deflationary consequences. Europe, with no attention to the need for growth beyond a few fatuous and ineffective supply-side gestures, is likely to continue in recession and quite possibly sink into depression. Emerging market “decoupling” will be seen for the fiction it is: export-led strategies everywhere will be hammered alongside oil and metal prices.

What follows is a likely timeline for this grisly scenario.

With Europe already in recession in late 2011 and early 2012, US import demand is crucial for all the export-dependent economies of the world, i.e. most of it. The

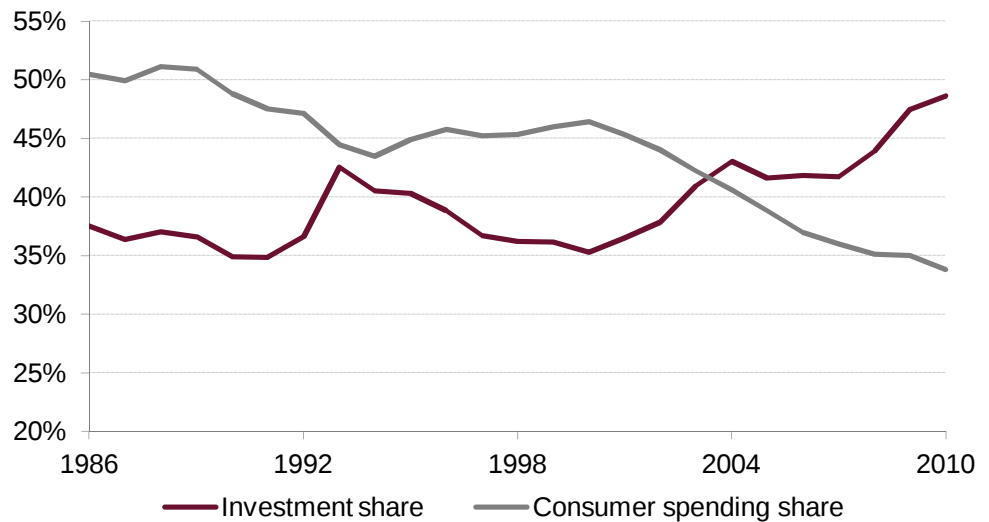
US grew well in the second half of 2011, led by cap-ex and car demand. Sadly, much of this buoyancy is caused by a tax break for cap-ex in 2011 only that has pulled spending forward from 2012. This means a natural drop in Q1 spending on cap-ex, cars and computers as the premium spending in late-2011 drops away and spending that would normally occur now does not, as it has already happened in late-2011. Meanwhile, real incomes are hardly rising and consumer spending is inhibited by a sharp drop in the savings rate in the second half of 2011.

Government spending is being cut back hard, so domestic final demand in early 2012 should be down. GDP could be at best unchanged in Q1 from 2011 Q4. In later 2012 quarters, a modest recovery may start, but growth could be well below trend, which itself may now be down to a lowly 2%. In early 2013, a major payroll tax hike is due, plus the start of the fallback cuts in federal spending resulting from the failure of last autumn's super-committee to agree on a bi-partisan fiscal programme. (We assume that the Republicans ultimately agree to Mr. Obama's payroll tax cut extension but only on the proviso of deeper spending cuts in 2013 and beyond.) With this further heavy fiscal deflation there is a major danger of fresh recession in 2013. The detail of this US scenario is on p.65 below.

China's tightening is the natural response to formerly accelerating inflation and the continued sloshing around of the huge flow of liquidity poured into the financial markets in the recovery programme of early 2009. The problem is that its economy and financial system is fragile, owing to its distorted pattern of development over the past decade or more. The combination of a naturally cautious population that saves about a third of its disposable income, and the rake-off by the corporate-state ruling elite (various levels of government, state-owned banks and enterprises, and the major exporters) of up to 50% of GDP, gives rise to a savings rate of more than 50% of GDP – grotesquely more than can be profitably invested, and far above any previously known such ratio in any country. Whereas the on-lending of this surplus saving to the US and elsewhere up to 2007 was a primary cause of the crisis, the outlet for it since has increasingly had to be domestic, though a net export surplus remains and has benefited the US Treasury.

China's investment ratio is now 49% of GDP, far larger than (for example) Japan in the early 1970s, where/when the ratio was 36-38% and also proved to be excessive. This means that the equivalent of the waste involved in force-feeding US borrowers in 2004-07 is now force-feeding China's domestic capital stock – only more so, as the saving rate is higher now than then. The result is stratospheric housing prices, relative to incomes, diminishing returns on capital, and bidding up of labour costs, i.e. wages, to service that capital. But the flow of cheap labour from rural China is slowing, and the bidding up of labour costs has made its industries much less competitive vis-à-vis the US – by about 20% in terms of relative unit labour costs over the past two years. This is an effective real appreciation, even if the nominal gains in the yuan have been small. This pressure on profit margins is compounded by the downward pressure on the return to capital of an excessive supply of savings.

China's investment and household consumption share, % of GDP



These factors are coming together in a dangerous way, though Beijing can probably postpone real trouble until 2013. Excessive savings may drive up asset values to start with (lowering the return to capital by raising the denominator) but once too many waves of borrowing and physical investment have been added, the flow of income from capital starts to be eroded. That point seems to have been passed in China, though data are scarce. So the monetary squeeze, to get rid of the inflation that itself results from a deliberately undervalued exchange rate, may start the downward tumble of asset prices that becomes self-reinforcing as it slows the economy and shrinks profit incomes even further. A relatively high bank debt-to-GDP ratio makes this poisonous cocktail worse.

By the end of last year China's relatively mild reduction of credit and money growth had been producing surprisingly voluble squawks of distress from various quarters – high-end housing, businesses with rapidly rising labour costs and substantial debt (often at high rates from non-bank sources), and so forth. The US scenario above, combined with Europe in desperate trouble and the sharp rise in relative labour costs affecting cost competitiveness, means Chinese exports could dip seriously in early 2012, having already fallen 1½% in real terms in 2011 Q4 from Q3. As a result, we expect a new Chinese domestic stimulus programme quite soon in 2012.

The basic problem is that such a new programme is unlikely to involve much consumer spending, as the savings rate is not suddenly going to fall, and achieving rising consumer spending via rising consumer incomes means accepting higher wages and salaries and a lower share in GDP of the corporate state. The problem is that large volumes of debt, as well as asset values, are predicated on the flow of profit income – whose reduction, therefore, could have the dangerous financial consequences outlined above. The much more likely route for stimulus is the conventional one, capital spending. This would help keep the economy afloat through politically sensitive 2012 at the expense of an even more distorted

relationship between the capital stock and the income from it, aggravated by a probable revival of labour cost inflation – possibly price inflation too, though this may be held down by the weakness of the rest of the world's economy.

The basic point is that the US is entering a period in which its budget deficit (including federal, state and local budgets) has to come down from last year's 10% of GDP to about 4%. This is what will be needed to stabilise net public-sector (federal, state and local) debt at or below the 100% of GDP that it is rapidly approaching and is the current level in Italy (for example). Such a correction of fiscal imbalance implies poor demand growth for several years – front-ended in our forecast because of the severity of the proposals for 2012 and 2013, but not ending then. Meanwhile, the new cost competitiveness of the US because of Chinese and other Pacific Asian inflation means this weak demand will be exaggerated at the level of imports by import substitution. So the Pacific Asian export-led development strategy, which has served the region well for fifty years, is being invalidated. The additional point for China is that a much slower growth rate in future means a drastic cut in the 49% share of investment in GDP. With exports only growing slowly, if at all, and investment needing to fall, while consumer spending is hard to stimulate, China has a very turbulent time ahead of it economically.

But if China and the Tigers are to grow much more slowly in future, now that the US can no longer be treated as the market of first resort, two consequences follow: tough times for commodity prices and producers, and for the German export machine, which is the supplier of choice for capital goods and cars. As the German export expansion of the past 2-3 years has been to emerging markets generally, not just China and the Tigers, the afflictions of the commodity countries will have further negative knock-on effects on core Eurozone. In this report the article on oil and metal prices outlines how this could affect them. The results pervade the relevant country coverages. For Europe, this means that the violent deflation being imposed by Germany on Med-Europe could be reinforced by very poor results for Germany itself for several years, taking away continental Europe's main hope of growth. The chances of Europe sinking into a depression are substantially increased by the global back-drop against which the Eurozone crisis is being worked out.

Appendix B: The ECB – the last chance saloon

Commercial banks, by their very nature, are at risk of creditor runs. Because the central bank is the monopoly supplier of so-called 'base money' (i.e. notes, coins and the reserve accounts of commercial banks), it is in a unique position to provide an 'outside' asset to which investors can flee in a panic. By 'outside' asset, we mean a safe store-of-value that does not represent a claim on anybody else in the market. Historically, central banks have fulfilled this role by lending emergency funds, i.e. short-term, to illiquid, but solvent, financial institutions against high-quality collateral at a penalty rate. As this crisis has evolved, central banks across the developed world have amended the means by which they act as lender-of-last-resort (LOLR). The lines between emergency liquidity support and ongoing funding of banks has become blurred at times. Generally speaking, however, central banks remain unwilling to extend credit to their respective banking systems that is either long-term or against risky collateral. Even as central banks have looked to find more unconventional ways to ease monetary conditions, e.g. via asset purchases directly from investors, they have tended not to stray too far from low risk securities¹. Both the Federal Reserve and Bank of England have been reluctant to purchase anything other than government-issued or government-guaranteed debt.

This is not true of the ECB. Although its asset purchase programme has been limited in scale, it has chosen to focus its purchases of government paper on the troubled periphery economies, i.e. those securities with the highest liquidity and credit risk². The ECB governing council has repeatedly argued that such action, neither breaches article 123 of the European Union Treaty, which prohibits monetary financing of member states' deficits, nor that it constitutes an easing of monetary policy. Rather, the ECB's securities market programme (SMP) is designed to improve the functioning of the mechanism by which the policy rate decision gets transmitted to the rest of the economy. Because the central bank money created by the asset purchases is 'sterilised' by the ECB, it argues that there is no effect on the monetary stance set by the governing council.

Whether the SMP breaches the spirit of article 123 – it is clear that it does not breach the letter of the article – or constitutes an easing of monetary policy is not a substantive point. What matters is that the ECB, via the SMP, has taken risks that a central bank would not normally be willing to take. In public, the governing council has strongly opposed the idea that it should bear any losses on its holdings of periphery sovereign debt. The ongoing negotiation between the Greek government and private sector bond-holders looks set to be concluded with a face-value haircut on Greek bonds of 50% plus a maturity extension and coupon reduction that cuts the net present value of the bonds by 60-70% in total. At the time of writing, there was no change in the official position of the ECB, which is estimated to hold

¹ The Bank of Japan is an exception to this. It has purchased equities, real estate investment trusts (REITs) and exchange-traded funds (ETFs). However, these represent a very small share of its overall asset purchase programme.

² It has also engaged in open-market purchases of covered bonds to ease bank funding pressures. Because such instruments are collateralised against specific bank assets and relatively senior in the capital structure, risk of ECB losses on them is small.

outright €40-50bn of Greek government debt³; but market rumours suggest the governing council's line may soften on this issue. As this report has made clear, without losses on 'official' creditors' claims on the Greek government there is no possibility of convincing markets that the Greek public sector can be returned to solvency over the longer-term. Even the IMF has recently acknowledged this. Whether the ECB accepts losses on its holdings of Greek government debt at this stage, they are highly likely to occur at some point. In the event of a Greek exit from the euro, there will certainly be significant exchange-rate losses and probably credit losses as well. Even if the ECB were to participate fully in the ongoing negotiations, it is likely that this would not be the end of the matters in terms of the losses that will ultimately have to be borne. Our base case still involves Greece leaving EMU in 2012.

Any losses will be borne by the Eurosystem, i.e. the ECB and EMU member states' national central banks (NCBs). They are not borne by the NCB that actually conducts the asset purchase (or monetary policy operation). At the end of last year, the Eurosystem had capital and reserves of €81.5bn. This is the primary buffer that would be used to absorb losses on Eurosystem assets. The Eurosystem also had a much larger revaluation account totalling €394bn, which could in theory be used to absorb losses before capital is affected. But it is unclear whether this reserve, which largely reflects the difference between the book and market value of the Eurosystem's gold holdings, could in practice be used to absorb credit losses. Irrespective of how these losses are accounted for, they would be borne in proportion to the Eurosystem's capital key – these are the weights used to determine the share of ECB capital that is paid-up by each EMU member. In the Netherlands' case, the current contribution is 5.6% of Eurosystem capital⁴. This is the share of any losses on Eurosystem operations that would be borne by the Dutch central bank and at a further remove by the Dutch government.

Purchases of periphery government debt are not the only way that the ECB has taken considerable risks onto its balance sheet – in fact, these are probably the least of the governing council's worries. Over the last few years, the ECB has covertly become funder-of-first-resort (FOFR) to a large chunk of the Eurozone banking system. There is, and will continue to be, a robust debate about the desirability of the steps that the ECB has taken. Many argue that liquidity is being provided to banks that are inherently insolvent, which according to the ECB's own legal advice should be treated as a breach of the prohibition of monetary financing. Suffice it to say, the euro area would have collapsed by now but for the extraordinary liquidity support that the ECB is providing. Put simply, the ECB is all that stands between the Eurozone and a disorderly exit of one or more EMU member states.

This transition from LOLR to FOFR has occurred in stages. Over the last few years, the ECB has agreed, after much initial reluctance, to amend its own rules about

³ The ECB refuses to publish data on which bonds it has purchased via the SMP.

⁴ Non-EMU EU members also contribute to the capital base of the ECB. The actual Dutch capital key is only 4.0% of subscribed ECB capital. But non-EMU NCBs are not required to absorb losses on Eurosystem operations, so that the Netherlands effective share of any losses will be (€222.34mn / €3,978.23mn) = 5.6% of the total.

collateral eligibility. Greek, Portuguese and Irish sovereign bonds, having fallen below the minimum ratings threshold for debt securities, remain eligible collateral. It has also moved to 'full allotment' open-market operations, whereby banks' bids for funds are completely satisfied, and dramatically extended the maturity over which it agrees to lend the funds. EA banks can now bid for an unlimited amount of three-year funding.

The most remarkable changes have taken place in the last few months. A barely noticed move, announced last September and due to take effect on January 1st this year, allowed EA banks to pledge unlisted bonds as collateral, i.e. securities that are not actively traded. Previously, only securities traded on a regulated market were eligible. Over 10,000 new debt instruments were added to the list of acceptable collateral at the start of this year, most of which were debt securities issued by banks. In effect, this move has made it considerably easier for EA banks to 'manufacture' collateral eligible for ECB operations. One might be surprised that this change has been necessary, since eligible marketable collateral on EA banks' balance sheets is currently around €4trn, of which €1.8trn has already been approved for use in ECB repo operations. But this collateral may not be evenly distributed within the banking system, leaving many banks in troubled EA economies short of securities they can pledge at the ECB. And it may not just be the periphery banks that are in trouble – this move seems to have been specifically designed to ease funding pressures for French banks, which accounted for 80% of the bonds added to the eligible collateral list.

Given what was announced at the December ECB meeting, it is clear that even this step is not considered sufficient to safeguard the EA banking system. The governing council went even further than they had done in September, by relaxing rules on eligible asset-backed securities (ABS) and most importantly making it much easier for banks to pledge 'credit claims', i.e. bank loans, for repo operations. We do not yet have any details about the exact changes that the ECB has made, but the ECB will allow national central banks (NCBs) to accept as collateral "additional performing credit claims that satisfy specific eligibility criteria". The ECB has previously accepted loans to non-financial companies and governments as collateral, but is clearly pushing banks to make greater use of this kind of (much more risky) collateral for ECB operations. Notably though, "the responsibility entailed in the acceptance of such credit claims" as collateral is going to lie with the NCBs, not the ECB. Mr. Draghi's intention would seem to be clear – allow troubled banks to fund their loan portfolios via the central bank because the markets will not do so, but leave the (much greater) risk on the balance sheet of the NCBs, hence the national governments, and not the ECB.

Each NCB can already lend funds to domestic banks at a penalty rate via so-called Emergency Lending Assistance (ELA) schemes. These differ from normal Eurosystem operations because any losses are solely borne by the NCB undertaking them. Both the Irish and Greek central banks have been forced to lend considerable sums of money to their banks via ELA loans and in the process accept (one assumes) collateral that the ECB is not willing to. We estimate that outstanding ELA lending to Greek and Irish banks was €56bn and €40bn in

November and December respectively⁵. This is in addition to the €864bn of outstanding Eurosystem lending operations to EA banks.

Over the first couple of months of 2012, which include the second three-year long-term repo operation (LTRO), we would expect a significant increase in the riskiness of collateral accepted in Eurosystem operations, and probably a big increase in the volume of funds lent as well. The 29th February LTRO should also mean more “responsibility” for official lending to EA banks, i.e. risk-bearing, shifting to NCBs and hence national governments. One could quite reasonably argue that the ECB is allowing a massive increase in the scope of ELAs across the euro-area – previously they were charged at a penalty rate, with a very short maturity (seven days in the Irish case), whereas banks will now be able to use ELA-style collateral to access three-year funds at the ECB’s policy rate. This means the ECB is now well and truly in the business of funding banks over the medium-term, a role that has never before been accepted by a central bank because of the inherently fiscal nature of the move.

These changes may appear incidental and trivial in the wider scheme of things. But they are hugely relevant for two reasons. First, they highlight the dire state of the European financial system – a large number of the Eurozone banks are on their death bed, kept alive by the ECB’s life support machine. By its actions, the ECB is acknowledging that conditions in recent months have deteriorated very rapidly and that private investors will be unwilling to fund the banking systems of the periphery economies for some time. Second, they increase, potentially by some margin, the possible losses that the Eurosystem, hence EMU member governments, might have to bear. In theory at least, losses on any ELA loans and Eurosystem repos based on credit claim collateral will be borne solely by the NCBs lending the funds. In practice, however, the capital buffers of the NCBs undertaking most of the high-risk lending are far too small to absorb likely losses. For a central bank in a leaving country, these will not be currency losses since the assets and liabilities vis-à-vis domestic banks will both be redenominated, but credit losses as banks default on their liabilities. Greek banks, for instance, fund 30% of their balance sheet via the Bank of Greece, i.e. around €130bn. Currently, the Bank of Greece has complete risk exposure to €56bn of liquidity support to Greek banks (the size of the ELA); but this figure could rise significantly if Greek banks take advantage of the new rules implemented by the ECB. The Bank of Greece’s capital and reserves were €815mn in November last year. Even if its revaluation accounts are included, its total loss absorbing capacity was still only €4.8bn. A similarly concerning picture emerges for the Central Bank of Ireland where capital, reserves and revaluation accounts only amount to €2bn. In both of these countries, governments therefore have large contingent exposures to their banking systems, which will go up rather than down as a result of recent ECB decisions. This might potentially reduce the possible losses faced by ‘core’ EMU members. In reality, however, it is unlikely to do so while member states remain part of EMU. In the event of either government or banking sector default, in which the central bank was at risk of taking losses on its lending operations, the Eurosystem would most likely have to step in and absorb the losses anyhow. Even if the support came from a European rescue facility, it would ultimately be the other member states taking the hit. The scenario in which

⁵ NCBs refuse to publish up-to-date estimates of outstanding ELA loans.

this does limit the losses to be taken by the remaining EMU members is an exit scenario.

As a pragmatic response to the acute nature of the crisis, the ECB has transformed its support to the banking system. It has dramatically increased the riskiness of assets it will accept in its lending operations, extended their maturity and made them unlimited in size. Without these moves, the Eurozone would already have imploded – they have been a necessary evil. To the extent that the ECB is simply preventing a self-fulfilling downward spiral, these actions are right and proper – they are stopping irrational market illiquidity from creating a solvency crisis. But to the extent that the ECB is funding insolvent banks and governments, its behaviour would be considered deeply inappropriate by some.

This *is* a crisis of solvency, not liquidity. It cannot be solved by the ECB's actions, but they can buy the time for a sustainable solution to be found. This chapter highlights the considerable risks the ECB, NCBs and EMU member governments now have to take to keep the show on the road. The hope is that by bearing these risks today, the ECB can limit the losses that the Eurozone will ultimately have to bear to save EMU. Were there a reasonable plan to make troubled economies solvent once again, it might work. Unfortunately, that plan is nowhere to be seen.

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