Tomorrow is not a game changer

Charles Gave | GaveKal | 04 June 2014

Tomorrow we expect to see the latest Band-Aid solution being applied to the eurozone. Having teased the market for months, it seems likely that the European Central Bank will trim its main refinancing rate, possibly announce a negative deposit rate and even promise a few asset purchases. Forgive me if I don't roll out the barrel. This is fiddling which does little to correct the fundamental dysfunction at the heart of the system. Let's be clear, the euro was and remains a political project. However, the adoption of a fixed exchange rate system creates economic problems which cannot be quickly fixed. As I see it, there are four key problems.

1. LIQUIDITY

When investors fret that a multi-country fixed exchange rate system may break up, capital inevitably flees from the weak to the strong countries. Bond yields in the weak economies will rocket higher and collapse in the strong. However, when the divergence reaches a sufficient width, it often pays to buy the weaklings and sell the strong (so long as you can stomach the volatility).

Back in the summer of 2012, Mario Draghi promised to stabilise the euro system, which was as things should be since the job of a central bank is, above all, to manage liquidity problems. As a result, interest rates fell and, of course, the biggest beneficiaries were those badly managed economies with the largest debt burdens. After all, most money is managed with reference to an index and so by design money flowed to those "undervalued" southern economies. This became a self-reinforcing phenomenon since Draghi could simply let the index-chasers do his bidding.

That was then. As I recently argued, the yield premium offered by the peripheral markets no longer covers the implied risks and high quality bonds at the center of the system are now more attractive. Should markets recognise this reality, a new liquidity issue may quickly arise, which will quickly raise the second problem.

2. SOLVENCY AND THE DEBT TRAP

Here the rule is very simple. If long rates are above the growth rate of the private sector GDP, then a country enters a debt trap such that its obligations grow much faster than its ability to repay. For Italy, Spain, France, Greece or Portugal there has been no material progress - their debt/GDP ratios are on a unsustainable trend since their stock of debt has risen sharply over the last three years. Hence, any rise in rates created by the re-emergence of a liquidity

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problem will cause a rapid deterioration in their budget deficits and so intensify the clench of the debt trap's jaws. In turn, this would reinforce the unequal distribution of growth within the single currency area.

3. UNEQUAL DISTRIBUTION OF GROWTH

Germany sits at the center of the euro system and has a lower cost of capital, cheaper labour, often a lower tax rate and a budget equilibrium or surplus. Unsurprisingly, Germany is the country which captures most investment. Indeed, since 2000 (using a base of 100), German industrial production has risen to 125, while France's has declined to 88 and both Spain and Italy stand at 78. Moreover, in the last two years, there has been no pick-up in factory output despite stellar purchasing manager surveys. The story behind this divergence is that Germany built up a huge trade surplus with its main European competitors. And, just to rub salt in the wound, at the point that these erstwhile rivals had seen their industrial systems pretty much destroyed, the Germans were able to move in and displace them in external markets such as Asia.

But, of course, there is no free lunch for Germany given the codependency of a single currency system. As the balance of payments always adds to zero, Germany's giant current account surplus has had to be matched by offsetting capital account outflows. During the good times, German banks were forced to extend credit to the deficit economies in the eurozone which left these institutions vulnerable to a huge balance sheet hit in the event that the system broke. But once the fragility of the periphery became clear, the result was to create an uneven distribution of credit, thrusting the weakling economies into an unavoidable deflation.

4. UNEVEN DISTRIBUTION OF CREDIT

Imagine an Italian bank with a portfolio of loans to Italian firms. Most of these businesses are going bankrupt, which will force the Italian bank to write off a lot of loans. The capital of the Italian bank will go down accordingly and, since a bank lends 12 times its capital, credit creation in Italy will collapse. Since MV=PQ with M and V going down, PQ (output) can only go one way - and that's down. Prices and economic activity will fall with these declines, more businesses will go bankrupt and the country will enter into a good old fashioned debt-deflation spiral.

Next, move the mental map to Germany. German banks will not be keen to lend to Italian banks or Italian companies. Moreover, if new regulatory requirements are also forcing all European banks to hold more capital per loan unit, then the German banks will stop lending to everyone (including German companies) and will buy only bunds which are not subject to reserve requirements or risk. M and V will go down in Germany and prices (not economic activity) will decline.

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This is what we have seen, with Germany's producer price index lower than a year ago. The effect has been to force producer prices even lower in France, Italy and Spain in order for these economies to regain some competitiveness. Sadly, falling prices across Europe are now a reality baked into the cake, while falling economic activity outside Germany is unavoidable.

CONCLUSION

From its conception, the euro system has been a financial Frankenstein – but the reality is that the member economies cannot see their economic performance diverge indefinitely. Providing more liquidity will solve nothing. If the ECB wants to do something which might work, it should buy existing loans made by Italian, French, Spanish banks to local companies, and so directly arrest the decline in credit creation.

It would be a good idea also to cancel the stupid Basel III rules and ongoing Asset Quality Review. These banking systems are bust and the only solution is to pretend they are not, allowing time to rebuild the capital base (as with those international banks exposed to Latin America after 1982).

Alternatively, all the European banking systems should be nationalised and the euro fixed exchange rate system dismantled.

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