Eurozone at a Crossroads: The Risks Ahead

By Maria Vassalou, Ph.D. and Thomas Cooley, Ph.D.

In 2012 the yields on sovereign government debt in the Eurozone began to diverge sharply signaling a crisis of confidence in the fiscal soundness of Greece, Italy, Spain, Portugal and Ireland. As yields diverged, there was widespread talk of Greece exiting the Eurozone and much discussion surrounding redenomination risk. But, with the restructuring of Greek debt, contingent loan packages from the International Monetary Fund (IMF) and the European Union (EU) and Mario Draghi's famous promise that the European Central Bank (ECB) would do “whatever it takes” to defend the euro, the crisis seemed to pass and yields began to come more in line.

Now, there is renewed concern about a Greek exit and a run on Greek banks is well underway. What does this mean for stability in Europe and what are the paths forward? In this note we discuss some of the risks and some of the challenges that stem from the very design of the European Currency Union.

The structure of the euro still lacks the resilience to fend off or withstand crises.

The euro is a monetary union of dissimilar economies with no fiscal union and an incomplete banking union. This makes it ill-equipped to deal with internal imbalances and effectively resolve crises at a member state or regional level. The financial crisis of 2008 and the ensuing European crisis made the weaknesses of the euro construct all too apparent. The risks to financial stability stemming from these weaknesses can be significant, not only for the distressed member-states, but for the Eurozone as a whole.

**Figure 1: Real GDP, Index, 2010=1**

![Graph showing real GDP index for different countries in the Eurozone from Q1-2003 to Q2-2014.](image)

Source: OECD Main Economic Indicators, GDP Constant Prices
The dissimilarity among Eurozone countries in real growth rates is shown in Graph 1. Whereas Greece, Ireland and Spain exhibited robust real GDP gains prior to the financial crises, and indeed higher than those of the European North, we see a distinct difference between the ability of the European South and North to bounce back from the crisis. This difference in resilience across Eurozone countries lies at the heart of the European problem and underlines the structural differences of their economies. It also underscores the challenges of having these countries share a common currency.

**ECB: The pillar of stability within the Eurozone**

One of the stabilizing forces within the Eurozone throughout the crisis has been the ECB. This is the only institution of the euro currency area that has a clearly defined European policy role. The ECB has been instrumental in trying to stimulate the European economy and promoting a banking union. The ECB will also play a leading role as Europe moves forward with integrating capital markets. These are important steps to the common currency experiment. In the absence of a fiscal union, the banking sector acts as the circulatory system for the economy, and therefore, its strengthening is paramount. However, the ECB alone cannot safeguard the Eurozone in the long-run against all eventualities.

**The banking system in Europe: a problematic symbiotic relationship with the sovereigns**

Banks and sovereigns in Europe have been sharing a symbiotic relationship since the 15th century when Cosimo Medici effectively took over control of the Florentine government. He did that so that he could rely on the government’s purse to protect the Medici bank in the event of insolvency.

The fates of banks and sovereigns continue to be intertwined in today’s European currency union. To alleviate the downside risks of this relationship, Europe embarked on an attempt to unify its banking system. The European Commission established a Single Supervisory Mechanism (SSM) with the ECB as the central prudential regulator. They also proposed a Single Resolution Mechanism for the banks covered by the SSM so they can be managed through a Single Resolution Board and a Single Resolution Fund financed by the banking sector. In addition, they established a common rulebook and capital requirements that all banks must comply with.

These advances in the regulatory framework of the European banking system are steps in the right direction. However, the problem remains that they rely too much on the member-states to implement and enforce these regulations and resolutions. In addition, they effectively assume that the individual sovereigns are healthy and in a position to assist their national banking system when needed. The European crisis of the last few years has demonstrated that this may not always be the case. In fact, the case of Greece provides an example of a distress sovereign within which, an otherwise healthy banking system becomes distressed itself. The European banking system, in its current format, does not provide a framework for dealing with such cases. In order for it to transition into a robust cross-border banking system, it needs to also have euro-area level regulations, deposit insurance, and resolution mechanisms for insolvent banks. These additional mechanisms, however, are inconsistent with the strict preservation of national sovereignty that is so precious among the member-states of the Eurozone. The way the European banking system is currently set up cedes too much authority to sovereigns or sovereign bodies. In the absence of a fiscal union, this structure results into fragmentation of the banking sector and reduces its ability to respond to crises.

**A euro in a bank in the South of Europe is worth less than a euro in a bank in the North.**

The lack of unification of the European banking system shows up in the Target 2 balances of the various member states. Graph 2 shows the evolution of Target 2 balances as a percentage of GDP since the onset of the crisis.

Prior to the financial crisis, Target 2 balances were largely zero. Once the crisis started unfolding, we see a gradual flight of deposits from the South and an equivalent increase in deposits in the North. Target 2 balances essentially capture the depositors’ faith in the banking sector of their country and reflect their fears of redenomination risk. Indeed, these deposits’ transfers within
the Eurozone imply that a euro deposited in a Greek, Italian, Spanish or Portuguese bank is not worth the same, in the mind of the depositors, as a euro deposited in a German bank.

Graph 3 shows the Target 2 imbalances for the individual Southern countries and Germany as a percentage of their GDP. The rate at which deposits fled the European South largely reflects the level of distress these countries faced at the height of the European crisis. The graph also highlights the recent depositors’ distrust in Greek banks as the likelihood of a SYRIZA-led government increased and negotiations with the Troika came to a standstill.

The Target 2 balances reveal that, despite the additional structure put in place in recent years towards a unified European banking system, depositors continue to doubt its robustness. In their minds, it is still a tale of “two Europes”.

**Can a Greek default and exit destabilize the Eurozone?**

We believe that it can. The euro area was designed to be irreversible. The foundation of EMU, the Maastricht Treaty, makes no provision for exit. This commitment constitutes the critical difference between the euro and other fixed exchange rate regimes from which countries can (and routinely do) exit.

**Since European banks have less exposure to Greek debt, isn’t the Eurozone essentially immune to a Greek default?**

It is true that European banks have much less exposure to Greek debt now compared to 2010 or 2011, when Greece was on the brink of default. Graph 4 shows the evolution of banks’ consolidated claims on Greece. Still, in total, banks’ exposure to Greek debt is around $42bn\(^2\). Graph 5 shows the current breakdown of foreign exposures to Greece as of the third quarter of 2014. In addition, the ECB has an exposure of 110bn euros to Greece\(^3\). While these amounts are not trivial, they are relatively spread out across countries and banks. Therefore, they are expected to be manageable by the respective sovereigns in a case of a Greek default.

---

**Notes:**

default. In our view, the major risk from a Greek exit does not stem from the losses that foreign banks may realize on their Greek debt holdings. The major risk is that of a potential disintegration of the euro.

A Greek exit will convert the euro into a fixed exchange rate regime and make it vulnerable to speculative attacks. The moment a country exits the euro, for whatever reason, the concept of irreversibility of the euro ceases to exist. This effectively converts the euro back into a fixed exchange rate regime. As we know from the experience of other fixed exchange rate regimes, and also from the precursor of the euro, the ERM, fixed exchange rate regimes are vulnerable to speculative attacks. It is then simply a matter of time before market speculators attack any of the other weak members of the Eurozone. Given the absence of a fiscal union, the ECB will be limited in its ability to defend the yields of those countries through purchases of their debt instruments. The reason is the same as the one provided at the height of the European crisis. Purchases of government bonds by the ECB of any country, with the aim to keep the yields of that country from rising, is fiscal financing. It is viewed as such because it effectively allows the country whose bonds are purchased to finance its budget deficits at lower cost. Interventions of this type are prohibited by the ECB chapters. In the absence of fiscal union, there is no explicit mechanism to defend a country against such speculative attacks. The only option is to offer it a bailout assistance of the type provided to Greece, Portugal and Ireland in the past.

Are there any other channels through which a Greek default could lead to contagion?
The argument often made is that a Greek default and exit will act as the poster child for bad behavior and the dire consequences it can bring, inducing the other weak member states to push forward structural reforms and get their house in order. The problem with this argument is that structural reforms of the type needed in those countries are politically costly to make and take time to be implemented and pay off. In the meantime, rational citizens are likely to react in the same way they have been reacting since the onset of the financial crisis: by moving their deposits to safer lands. Target 2 imbalances in countries like
Italy, Spain and Portugal are likely to grow further. This will put stress on the banks of those countries and subsequently on the yields of the sovereigns, further encouraging the appetite of speculators to test the resolve of not only those member-states but the Eurozone as a whole.

Which country is the most vulnerable to contagion from a Greek default?

It is our view that all periphery countries may be vulnerable. However, Italy may be the first to draw attention. While its budget deficit is -19.6bn euros as of March 2015, corresponding to around 3% of its GDP, Italy’s debt-to-GDP ratio stands at 127.9% and its unemployment rate is 12.7% as of February 2015. Furthermore, Italy has been in a recession for the past three years. These facts paint a bleak macroeconomic picture for the country. The only reason that Italy is not currently in distress is because it can borrow at extremely low yields. With its 10-yr yield presently at 1.26%, it is easy for it to roll over its debt and finance its budget deficits. This would not be the case, however, if Italian yields rise sharply from current levels. On the positive side, Italy has made progress at structural reforms of the labor market and has reduced its long term pension obligations. But its banks are still big holders of Italian debt which puts them in danger in case of a speculative attack.
What are the implications for the Eurozone and the euro going forward?

The Eurozone is at a critical stage of its existence. The way it handles the Greek crisis will largely determine its long-term viability as a currency union and the ability of the euro to act as a reliable reserve currency going forward. Unfortunately, policymakers in the Eurozone seem to underestimate how difficult it will be to hold the Eurozone together if Greece exits.

The path ahead is likely to be volatile. A monetary union without a fiscal union, or a full-blown banking union is not viable on the long-run. Interim agreements with Greece may buy some more time for the Eurozone. However, it will take more than releasing the next bailout tranche to Greece to convince the world that the euro is not yet another fixed exchange rate regime, vulnerable to speculative attacks.
Maria Vassalou, Ph.D.
Partner & Portfolio Manager, PWP Global Macro

Maria Vassalou is Partner and Portfolio Manager for the PWP Global Macro strategy. Dr. Vassalou joined Perella Weinberg Partners from MIO Partners, a subsidiary of McKinsey & Company, where as a Portfolio Manager she managed a similar global macro investment strategy in a dedicated legal entity, and as Head of Asset Allocation she provided counsel on allocation for liquid assets within MIO’s portfolio. Prior to joining MIO, Dr. Vassalou was a Global Macro Portfolio Manager at SAC Capital Advisors, LP. She joined SAC from Soros Fund Management where she was responsible for global quantitative research, as well as the development and management of global quantitative trading strategies. Prior to her career in asset management, Dr. Vassalou was an Associate Professor of Finance at Columbia Business School which she joined in 1995 and where she established many of the investment principles she employs today. Dr. Vassalou is a Past President of the European Finance Association and was the Chair of the 2008 European Finance Association Meetings. A Research Affiliate of the Centre for Economic Policy Research (CEPR) in London for many years, Dr. Vassalou is a past member of the Academic Advisory Board of the Vienna-based Guttmann Center of Competence in Portfolio Management. Her research focus has been on the interrelation of the macro-economy and financial markets with applications in hedge fund strategies. A frequent speaker to both academic and practitioner-oriented seminars and conferences, Vassalou has published in leading academic journals, such as the Journal of Finance, Journal of Financial Economics, Journal of Financial and Quantitative Analysis, Journal of Business, Journal of International Money and Finance, and the Journal of Economic Dynamics and Control. While she was on the faculty of Columbia University, she also served as a consultant to many premier hedge funds and asset management institutions in the U.S. and Europe. Dr. Vassalou received a Bachelor of Arts in Economics from the University of Athens and she holds a Ph.D. in Financial Economics from London Business School.

Thomas F. Cooley, Ph.D.
Paganelli-Bull Professor of Economics at the Leonard N. Stern School of Business, New York University

Thomas F. Cooley is the Paganelli-Bull Professor of Economics at the Leonard N. Stern School of Business at New York University, as well as a Professor of Economics in the NYU Faculty of Arts and Science. He served as Dean of the Stern School from 2002 to January 2010. Cooley is known for his scholarly work in the areas of macroeconomic theory, monetary theory and policy, and the financial behavior of firms as well as for his commentary in many economic and business publications. Responding to the financial crisis of fall 2008, he spearheaded a research and policy initiative that yielded 18 white papers by 33 NYU Stern professors, published as Restoring Financial Stability: How to Repair a Failed System, (Wiley, 2009). Together with Stern colleagues he edited and wrote a second book, Regulating Wall Street, The New Architecture of Global Finance, which was published by Wiley in 2010. His book, Understanding Business Cycles, Princeton University Press 1995, is a widely cited reference on macroeconomic fluctuations. Cooley is a Research Associate of the National Bureau of Economic Research and a member of the Council on Foreign Relations. He is also the former President of the Society for Economic Dynamics, a Fellow of the Econometric Society, holds an honorary doctorate from the Stockholm School of Economics. In the corporate sector, Cooley has been a senior advisor and member of the board of Managers of Standard & Poor’s, served on the Board of Directors of Thornburg Mortgage and has been an advisor to Ameriprise, eTrade Securities, and Cedar Consulting. Cooley received his Ph.D., and M.A. in Economics from University of Pennsylvania. He received his B.S. in Engineering Science from Rensselaer Polytechnic Institute. Before joining Stern, he was a Professor of Economics at the University of Rochester, University of Pennsylvania, and UC Santa Barbara.
Legal Disclosures:

The Information has been provided to you by Perella Weinberg Partners and its affiliates (collectively “Perella Weinberg Partners” or the “Firm” or “PWP”) solely for informational purposes and is not an offer to buy or sell or a solicitation of an offer to buy or sell any security or to participate in any trading strategy. If any offer of securities is made, it will be pursuant to the Confidential Offering Memorandum (the “Memorandum”) prepared on behalf of Perella Weinberg Partners which contains material information not contained herein and which supersedes this Information in its entirety. Any decision to invest in the investments described herein should be made after reviewing the Memorandum, conducting such investigations as the investor deems necessary and consulting the investor’s own investment, legal, accounting and tax advisors in order to make an independent determination of the suitability and consequences of an investment.

The Information including, but not limited to, Perella Weinberg Partner’s organizational structure, investment experience/views, returns or performance, risk analysis, sample trade plans, idea filtration process, benchmarks, investment process, investment strategies, risk management, market opportunity, representative strategies, portfolio construction, capitalizations, expectations, targets, parameters, guidelines, and positions may involve our views, estimates, assumptions, facts and information from other sources that are believed to be accurate and reliable and are as of the date this information is presented—any of which may change without notice. We have no obligation (express or implied) to update any or all of the Information or to advise you of any changes; nor do we make any express or implied warranties or representations as to the completeness or accuracy or accept responsibility for errors.

Perella Weinberg Partners and its affiliates do not provide tax advice. Accordingly, any discussion of U.S. tax matters contained herein (including any attachments) is not intended or written to be used, and cannot be used, in connection with the promotion, marketing or recommendation by anyone unaffiliated with Perella Weinberg Partners of any of the matters addressed herein or for the purpose of avoiding U.S. tax-related penalties.

Please refer to the Memorandum for more information on fees including early withdrawal charges and other important information. The investments discussed herein, including any pooled investment vehicle, may be speculative and involve a high degree of risk; could involve possible loss of your entire principal; may be leveraged which can potentially increase investment risk; may have volatile performance; can be highly illiquid and investors may be required to retain their exposure to investments for an indefinite period of time; do not have a secondary market for the investor’s interest and none is expected to develop; may have restrictions in transferring interests of the assets; may not be required to provide periodic pricing or valuation information to investors; may include international investments that are subject to political influences, currency fluctuations and economic cycles that are unrelated to those affecting the domestic financial markets and may experience wider price fluctuations; are not subject to the same regulatory requirements as mutual funds; may involve complex tax structures and delays in distributing important tax information; and, may have high fees and expenses offsetting profits.