What Lies Ahead for the Eurozone?

By By Peter Dollé, Germany Correspondent

The Eurozone may be ringed with the dark clouds of pessimism, but there are some rays of hope shining through.

Latvia is standing tall this summer after receiving the go-ahead to join the Eurozone in January 2014. It has met all economic criteria and will become its 18th member. The big question now is: with domestic GDP at 5.6 percent, why join a recession?

Viewed from abroad, it would seem the Eurozone doesn’t have such a bright future.

Not so, say many economists in Northern Europe. The euro is actually the device holding the continent together. And despite reports predicting the Eurozone’s demise, there are signs of improvement, according to ECB officials.

“Recently, we have seen some signs of progress in the Euro area and more specifically in the so-called programme countries,” ECB executive board member, Jörg Asmussen told INSEAD Knowledge in an interview from his offices in Frankfurt recently. "There has been a marked reduction in spreads. Bank debt funding conditions have improved and banks' dependence on central banks' liquidity intermediation is decreasing. We have observed significant improvement in the process of correcting serious imbalances."

Driving Down Bond Yields

Nearly one year after the ECB's radical announcement that it would buy government bonds of heavily-indebted Eurozone countries in an effort to drive down yields, financial markets have calmed down. This Outright Monetary Transactions (OMT) programme was the latest ECB weapon – on top of other rescue programmes – the European Financial Stability Facility (EFSF) and the European Stability Mechanism (ESM) – which are meant to restore confidence in the euro. It has been extremely effective in bringing down Eurozone bond yields, although it has never been used before.

"We set up the programme with the specific purpose of eliminating 'redenomination' risks, or risks stemming from concerns about a break-up of the Eurozone and the reintroduction of national currencies in some parts," Asmussen explains.

Critics charge that the OMT programme violates the bail-out clause of the EU's Maastricht Treaty by financing deficits in other European states. In Germany, critics complain that the OMT challenges the constitutional authority of the German Parliament by spending German taxpayers' money. Prominent critics include German Economics Minister, Philipp Rösler, and Jens Weidmann, president of the Deutsche Bundesbank, Germany's central bank and largest shareholder in the ECB.

Weidmann filed suit in 2012 with the German Constitutional Court to force a decision on the bond-buying plan. Although the German high court has no jurisdiction in EU affairs (a responsibility of the EU Court of Justice in Luxembourg) the suit could call into question Berlin's future role in the Eurozone and further roil financial markets. The high court is not expected to rule before German national elections in September.

Eurozone Fund

So far most bailout support for troubled Eurozone countries has come from the financial markets, with collateral guarantees provided by individual EU countries, the European Commission and the IMF. The permanent Eurozone fund – the European Stability Mechanism – has an authorised capital of €700 billion of which €80 billion is paid-in capital. Because of its economic might, Germany is required to post 27 percent of the tally, or €21.6 billion paid-in capital.

Heavily-indebted countries in the South are in deep recession and lenders in Frankfurt, Brussels and Washington D.C. are at odds over how to stimulate economic growth in these states. Asmussen rejects deficit spending to boost growth and insists on restructuring and belt-tightening.

“The best way out is to reform our economies, make them more competitive. There are no free lunches in economics, though the temptation to believe in them is always great,” Asmussen argues. “We know that this can be painful. But we have to face it… the higher the debt levels, and the more risky they are perceived by markets, the more resources will have to be diverted to service the debt, at the expense of productive investments and future generations.”

What Price Stability?

There is some light at the end of the tunnel. The combination of austerity and the OMT are beginning to stabilise the finances of Eurozone countries once thought to be beyond repair. “In Greece, a major step has been the recapitalisation of the four major banks in the country, which is expected to be completed by mid-June,” Asmussen points out. “This, coupled with measures aimed at orderly resolution of non-viable banks while preserving depositors’ confidence, have contributed to the consolidation and further stabilisation of the Greek banking system.”

Cyprus remains a weak spot: “Risks however remain high in the short-term, and firm further steps have to be taken to complete the financial sector reform and rebuild confidence in the banking system of the country.”

Financial professionals have long pushed the idea of issuing Eurobonds to harmonise debt throughout the Eurozone, but German leaders see such a move as an option of last resort. Asmussen also believes Eurobonds are premature: “I personally think much more needs to be achieved in the process of integration before we could seriously consider it. In a full-fledged fiscal union a joint-debt issuance is a natural instrument, but it comes with joint-control over expenditure and revenues. At this stage we need to focus all our energies on establishing a fully functional banking union."

If the German Constitutional Court strikes down the government's support of the OMT programme, volatility could return to bond markets. If that were to happen, Eurobonds might be a viable replacement. The question then is whether countries like Latvia and Lithuania, with GDP rates of 5.6 and 3.7 percent respectively, would still want to join the Eurozone. The short answer is yes, because healthy economies profit from it.

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