Evolution of the Eurozone
Implications for Investors

By Clement K. Miller, CFA

In late 2009, the incoming Greek government revealed that its predecessor had underreported its budget deficits and public debt. This revelation triggered a series of events that have shaken market confidence in the creditworthiness of eurozone “peripherals,” namely Greece, Portugal, Ireland, Spain, and Italy. Investors have witnessed the ongoing spectacle of eurozone member states establishing and frequently revising plans for managing the sovereign debt crisis. At times, it has appeared that the crisis might well lead to the collapse of the euro.

Given these developments, it is fair for investors, especially U.S.-centric investors, to question whether it is sensible to invest at all in the eurozone, which is made up of the countries that use the euro as currency. However, there are compelling reasons to invest in the eurozone but actually derive much of their earnings from outside the eurozone. Despite these reasons for maintaining exposure to the eurozone, it is reasonable for investors to consider adopting underweighted positions while the sovereign debt situation remains unresolved.

This article describes two possible paths for the evolution of the eurozone and implications for investors. The first path involves the orderly departure of Greece and possibly other peripheral countries, such as Portugal, from the eurozone. The second, and more likely, path involves the orderly consolidation of fiscal authority in Brussels, the capital of the European Union.

Exit of Peripherals from the Eurozone

We start from the fundamental premise that member states of the European Union (EU) are deeply committed to the preservation of the union. It is not lost on European leaders that the EU’s predecessor institution—the European Economic Community (EEC)—was established in the 1950s to pool German and French industrial resources and thereby reduce the likelihood of a new conflict between those European powers. In the 1970s, the EEC agreed to admit fledgling democracies such as Spain, Portugal, and Greece. In the 1990s, the EEC became known as simply the European Community and extended invitations to former communist countries in Eastern Europe. At each juncture there was an abiding fear of backsliding toward new intra-European warfare, military dictatorship, or communist rule. In recent years, the objective of European integration has been to create a Europe that is a unified major world power that rivals the United States in political and economic (if not military) influence and is stronger than Japan, China, and other potential rivals.

Throughout the EU, there always have been “euro-federalists” and “euro-skeptics.” Euro-skeptics have played a prominent role in the politics of the United Kingdom and Denmark, and these countries have not participated in the euro. In most EU countries, however, euro-skepticism is the province of smaller or fringe nationalist political parties, and the major parties are led by strong euro-federalists who are prepared to preserve the EU and advance further integration. Consequently, I believe that EU states will continue to encourage EU institutions to pursue economic and financial actions that might be necessary to preserve the union.

EU preservation does not necessarily require continued participation by Greece and other peripherals in the eurozone. In fact, one might argue that the euro could become a stronger currency without Greece and other peripherals. Any peripheral’s exit from the eurozone must and will be via an orderly process that will enable the exiting country to remain in the EU itself. One should keep in mind that a number of EU countries, including the United Kingdom and Denmark, do not participate in the eurozone.

Currently there is no legal process for a participating state’s exit from the eurozone, so most commentators believe that any exit would be disorderly and irreversible. The popular conception is that the central bank of a peripheral would substitute highly devalued “revived” national currencies (drachmas, escudos, pesetas, punti, or lira) for the euro. These currencies then would become legal tender for payment of all obligations, in effect invalidating previously contracted euro-denominated financial instruments.

Needless to say, such a process would have devastating impacts. Investors would avoid fixed-income and equity markets of exiting countries for many years. There likely would be a high degree of capital flight from exiting countries to countries still within the eurozone. Investors likely would lose confidence in the
An orderly exit process is feasible, and I believe that it would require the following five conditions:

- The European Central Bank (ECB) would closely manage the process, even to the extent of issuing replacement local currencies.
- The ECB would control the extent of the devaluations to ensure that they do not unfairly impact the competitiveness of other EU members.
- The process would preclude invalidation or conversion of euro-denominated debts.
- The process would be temporary, with a multi-year phased approach involving specific budgetary and debt-reduction targets, allowing for restoration of the euro at a devalued conversion rate.
- To preclude strong nationalist attachment to temporary national currencies, the ECB would assign neutral names and place neutral illustrations on bills and coins. For example, the local temporary Greek currency would not be called the drachma and would not depict the Acropolis or some other Greek landmark or personage. Lack of nationalist sentiment would facilitate later political reversion to the euro.

Such an unprecedented process no doubt would raise considerable concerns among investors about its practicality and potential for success. This would place some temporary strains on the value of the euro and on the value of equity and fixed-income instruments denominated in the euro. However, investors would come to comprehend and accept the logic of orderly and temporary exits of peripherals from euro participation. With a stronger “core” eurozone and a well-designed process for re-admission of peripherals, investors are more likely to develop renewed confidence in the euro and in euro-denominated financial instruments.

Consolidation of Fiscal Authority

The more likely path, in our view, is not the exit of peripherals from the eurozone but rather the consolidation of fiscal authority in Brussels with the establishment of a fiscal union—an institution such as a unified finance ministry, or in U.S. parlance, a treasury department. The primary function of a finance ministry is to fund government operations through a combination of taxation and net borrowing.

Many commentators repeatedly have accused EU members of having erred by agreeing to a currency union without first adopting a fiscal union. There is nothing profound about this analysis. The United States provides an historical example of fiscal union preceding currency union. There is, however, a minority view that adopting the euro first was a strategic move by euro-federalists who recognized that a currency union inevitably would require a common finance ministry. At the time, a common currency enjoyed broad popular support but a common finance ministry enjoyed very little, if any, support, so eurozone proponents chose to pursue common currency to clear a political path for eventual fiscal union.

But the EU has possessed several structures that provide some functions of a finance ministry. Two groups exist that enjoy some degree of authority in economic and financial monitoring. The Economic and Financial Affairs Council (Ecofin) comprises all EU members and a euro group for its subset of eurozone members; the European Investment Bank (EIB) issues bonds denominated in the euro and many other currencies and finances projects, generally in poorer or remote EU regions and neighboring countries.

Now additional structures are emerging that could evolve into the EU equivalent of a finance ministry. In October 2011, member states approved the use of the European Financial Stability Facility (EFSF) to provide partial guarantees on the sovereign borrowings of peripheral member states. Moreover, the EFSF is issuing bonds to fund its operations. Beyond EFSF, member states are laying the groundwork of a European Stability Mechanism (ESM), to be implemented in 2012 or 2013. An important part of ESM is the strengthening of centralized authority for EU review of the budgets of eurozone member states, with possible sanctions for violators.

One possible ESM outcome is peer review of budgets. I believe that financial markets would not view such a process as credible. Positive marks on a peer review would be met skeptically and negative marks would spook markets. Greece provides an example of why peer review would not work: Eurozone members have been certifying Greek budgetary compliance because withholding such certification would create market panic. Clearly a system more credible than peer review is required. I believe that eurozone member states inevitably will agree to pool a large degree of fiscal sovereignty, with the authority to tax and borrow, in an EU institution.

A eurozone finance ministry—I use the term “eurofin” as convenient shorthand—would directly receive a substantial portion of each member state’s tax revenues. At present, the eurozone requires harmonization of value-added taxes (VAT) and external tariffs to ensure a “single market”, so it is one additional step—albeit a giant one—to pool a portion of tax receipts. In return, a eurofin would use these pooled tax receipts to fund approved budgets of member states.

A eurofin would, in effect, manage the distribution of tax resources across the EU. Presumably this would involve some degree of budgetary transfer from the EU’s wealthier members to its poorer members, similar to the current function performed by EIB, except that EIB finances projects in poorer or more
remote regions. Furthermore, a eurofin would issue bonds in capital markets, much as the EFSF or EIB are doing now. These bonds would finance any deficits in a eurofin’s own budget; however, it seems likely that the European parliament and other European institutions, as well as member states, would closely monitor a eurofin’s budget and borrowings.

Wealthier eurozone governments oppose the idea of “eurobonds,” jointly-issued bonds to finance budget deficits of member states. This resistance is based largely on a moral hazard argument that states might run larger deficits if they are virtually guaranteed eurobond financing. Establishing a eurofin that reviews and approves member-state budgets, funds them, and issues its own bonds is a superior model. In our view, the establishment of a strengthened eurofin would bolster investor confidence in the euro and euro-denominated financial instruments, both equity and fixed income.

Given the sizable share of state pension plans, social security retirement systems, and national health plans in member-state budgets, budgetary approval would necessarily imply eurofin involvement in establishing eligibility and coverage parameters. One might expect efforts to harmonize eligibility and coverage parameters across the EU. Current fiscal austerity efforts in France, Italy, Greece, and elsewhere are aiming to raise eligibility ages.

In all likelihood, member states would continue to possess some residual authority such as collecting, retaining, and spending some residual tax receipts on a discretionary basis. They might be permitted to cover temporary cash-flow shortfalls with bills or notes of less than one-year maturity. Otherwise the national finance ministries would act as national agents of a eurofin, paralleling the current structure of the eurosystem, in which eurozone countries’ national central banks act as agents of the European Central Bank.

Are member states prepared to pool their fiscal sovereignty in this manner? Aside from common currency, member states have pooled sovereignty in many other areas: a single market for goods and services; common agricultural, fisheries, and external trade (vis-à-vis nonmember states) policies; a common passport for travel outside the EU; and passport-free travel within the EU. Moreover, the EU has established political structures that mirror those of a European parliamentary state: the presidency (head-of-state); the European Commission (a collective prime minister); the European parliament (the lower chamber); the council of the EU (the upper chamber); and the European court of justice (a high court).

EU integration is less advanced in many areas. The Lisbon Treaty provided for the equivalent of a diplomatic service, but individual member states are not planning to transfer diplomats to the collective pool. Most importantly, the EU has taken very few practical steps toward military integration. The neutrality of some EU members, such as Sweden, Ireland, and Austria, provides an obstacle to military integration. Furthermore, most EU members are members of NATO, which provides a high degree of military integration alongside the United States and Canada. Nevertheless, given the strides the EU has made toward pooling sovereignty in other areas, it is not unreasonable to expect that member states would agree to pool a considerable degree of fiscal sovereignty in a eurozone finance ministry.

Conclusion

The current euro crisis likely will lead to the establishment of a fiscal union. A potential but less-likely scenario is an orderly process by which one or more peripheral countries would temporarily exit the eurozone, with a process established for subsequent re-admission. A disorderly exit process is highly unlikely because it would be so disruptive. EU member states likely will take all actions necessary to preserve the Union.

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