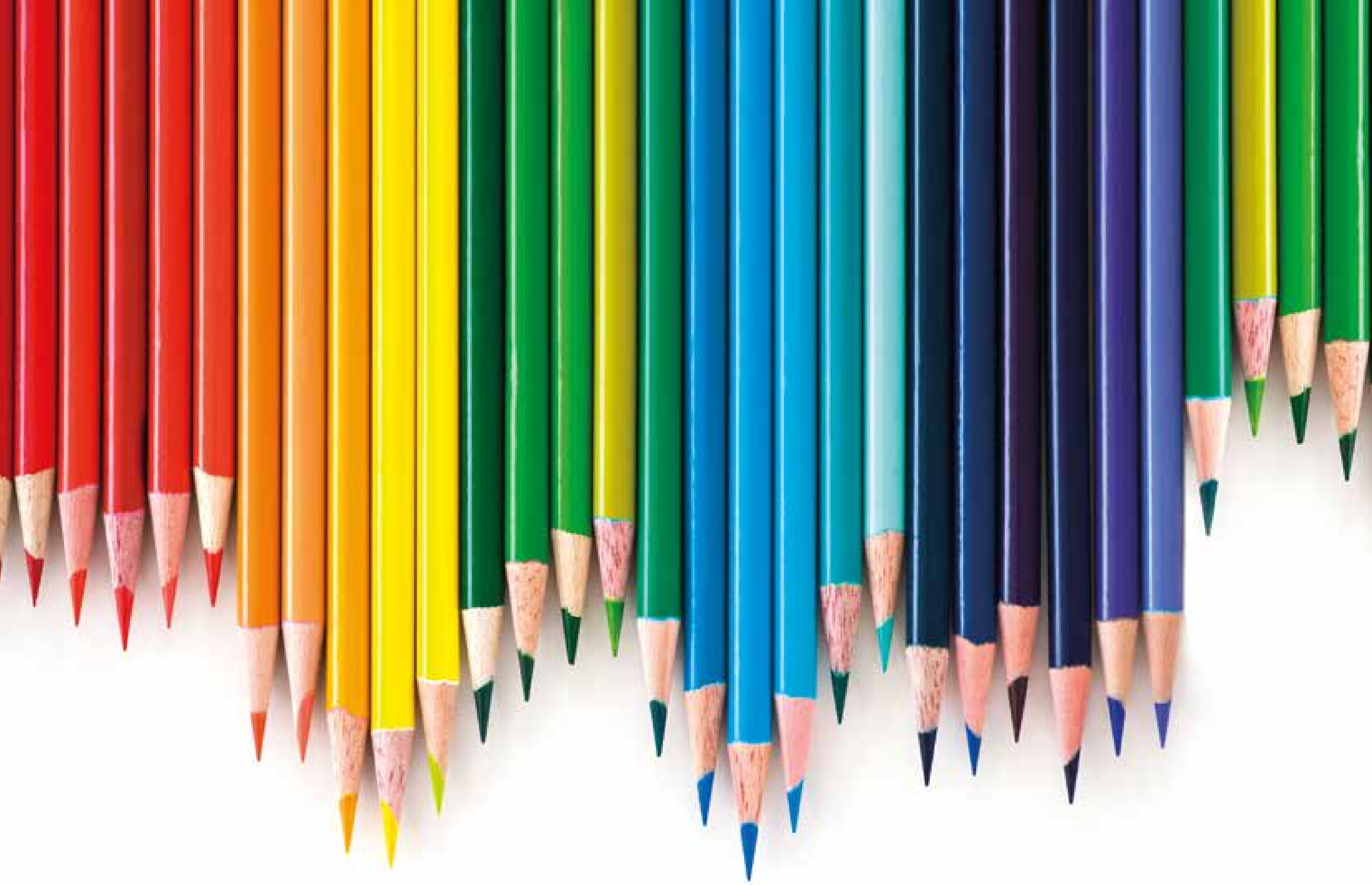

# Why the Eurocrisis is here to stay and what it means for investors

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# What the five presidents propose is nothing more than a long-term implementation of a transfer union

**No recovery without exchange rate realignment**

Postponing the inevitable is not a solution. This simple truth seems to be having a hard time in the sphere of European economics and especially politics. Constant calls for transfers of power to Brussels and a fiscal union, most recently voiced in the "Five Presidents" report by Jean-Claude Juncker, Donald Tusk, Mario Draghi, Jeroen Dijsselbloem, and Martin Schulz, are a misleading solution to the eurozone crisis. What the five presidents propose is nothing more than a long-term implementation of a transfer union. From an economic perspective it is quite obvious that fiscal transfers can do very little to solve the underlying problem of a lack of competitiveness. Nor can the proposed national and European Competitiveness Authorities solve this problem. The paper of the "Five Presidents" aims firstly at the implementation of a joint European deposit guarantee scheme, which would pool the risk of existing national schemes. Countries with already comprehensive depositor protection would see their liabilities increase, as risk is transferred from the periphery to the core of the eurozone.

The approach advocated by the Troika and the Eurogroup, namely internal devaluation, is also a self-defeating option if the need for devaluation is significantly high. According to a study by the Ifo-institute, a well-known German economic think tank, by spring 2015 Greece had managed to internally devalue about 8 of a necessary 21 percent it would need to restore competitiveness.[1]

The first and foremost problem of the eurozone is the reluctance to recognize what is at its heart: the misalignment of exchange rates within the eurozone. Until this central problem is resolved, the eurozone will struggle to emulate the recoveries seen in the United States and the United Kingdom. The consequences will be slower growth and higher unemployment, lost business opportunities, and below potential returns for investors.

*1 See CES IFO Forum "The Greek Tragedy", June 2015.*

### Making business in times of crisis

Would Southern Europe be the place you look for exciting investment opportunities? To be fair, there could be some bargains because of a strong privatization agenda, but the most important ingredient of a good investment, namely a healthy growth perspective for the economy, is missing. The European Commission estimates growth in Italy and Greece to be between 0 and 1 percent for this year. However, the Commission has gained notoriety for its overly optimistic forecasts in recent years.

From the perspective of the management of a hypothetical Southern European company, the situation and outlook are depressing. Low growth rates in the region, stagnation or even severe recession in recent years suggest internal demand has been crushed by deflationary policy. At the same time, external demand has also been undermined due to a still overvalued currency. Spain, often highlighted as the model pupil, has a 7.5 percent share of the EU28 economy, but only 5 percent of the group's external trade.[2] Its consumer base has been harshly diminished. The chief beneficiary of the eurozone seems to be Germany, for which the undervalued currency is working like a subsidy. It represents 21 percent of the EU28 GDP and 28 percent of external trade.

It is challenging for firms in the periphery of the eurozone to get credit because their local banks are suffering from non-performing loans due to high unemployment levels and capital flight. According to information by the European Central Bank (ECB), the capitalization of Southern European banks remains dire. More than 20 percent of core bank capital consists of deferred tax credits in Italy and Portugal; in Spain the amount is 18 percent, while in Greece it reaches 46 percent.[3]

The last financial statement could drive firms to cut labor costs significantly, but this will be met with strong resistance from employees. Additionally, policymakers appear to have conflicting aims: the need to come to a balanced budget in times of crisis; governments are forced by the so-called institutions—the former Troika—to increase tax levies on businesses, while at the same time talking about improving the business environment.

The recent problems of companies are the concerns of future investors. The dysfunctional European Monetary Union creates a very fragile and crisis-prone environment with high political uncertainty, demonstrated by the frequent government crises in Greece and Italy. Many companies in which you consider investing would have difficulty realizing projected revenue streams in such a weak growth environment. In every economy there are winners and losers, but the abnormally high level of losers in Southern Europe stems from the aforementioned reasons. The rapid acceleration of deindustrialization in Greece, Italy, Spain and France is a consequence of the loss of international competitiveness. According to Confindustria, since 2007 Italy has lost about 15 percent of its industrial capacity.[4]

The success of Northern Europe´s export industries is underpinned by a strongly undervalued currency and not by an increase in productivity

*2 Data from Eurostat, own calculations.*

*3 This data was obtained by the authors in a Parliamentary Question to Daniele Nouy, President of the Supervisory Council at the European Central Bank.*

*4 See http://www.spiegel.de/international/europe/economic-crisis-in-italy-continues-to-worsen-a-912716.html*

## Quantitative easing cannot cure the eurozone crisis

The European Central Bank was called to the rescue. After having exploited the scenario of cutting interest rates, the ECB turned to quantitative easing. This has not helped the real economy as banks have been reluctant to lend to businesses, but has greatly inflated asset prices and depressed interest rates to historical lows. Conservative investors are now having a difficult time because traditional low-risk bonds deliver hardly any attractive return.

Investors with a bigger appetite for risk could be happy about inflated asset prices because the ECB will improve their returns this year and maybe next year. But short-term happiness can come with a bitter long-term price. Identifying the right moment to realize profits is difficult, as by definition not everyone can beat the market. Maybe last time you did, but can you be sure that you will beat it again? A look at The Economist's house price index reveals strong value growth of property in Germany and the United Kingdom, among others. A more dynamic market is thus not necessarily a bad thing. However, one should be aware that the recent indicator spike is caused by a few big cities. Excessive house price developments in some regions are a prime example of asset bubbles in the making, especially if the underlying economic fundamentals have not changed. Cheap money policy after the dotcom crisis delighted investors in the run-up to the Great Recession, but was undoubtedly itself one of the main causes of the meltdown, as it led to excessive risk-taking by investors.

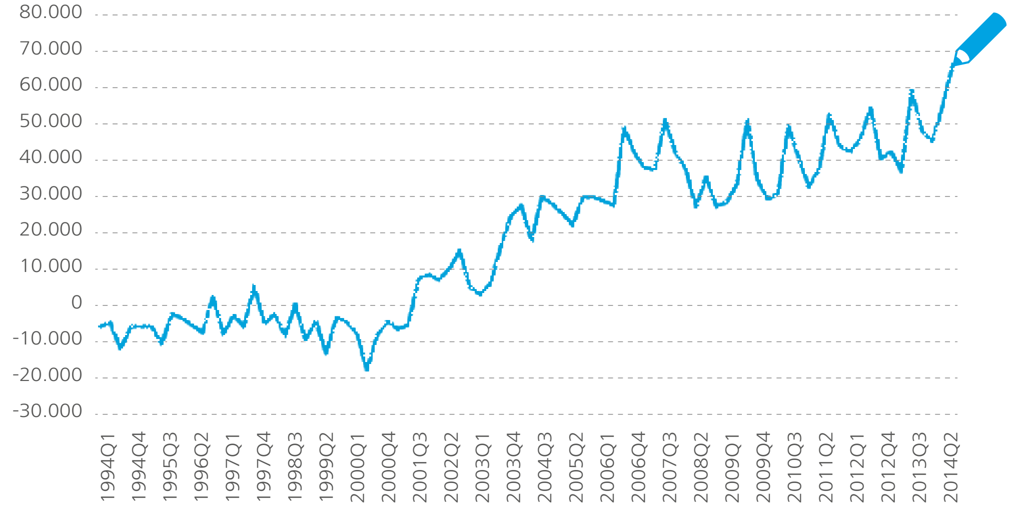
Additionally, it remains highly disputed among economists whether quantitative easing has any effect on the real economy. Whereas data from the United States and the United Kingdom suggest there is, unconventional monetary policy has not helped Japan to overcome its long-term crisis. As John Maynard Keynes correctly observed, you can lead a horse to water, but you can't make it drink. From the perspective of creating a healthy economic recovery in the eurozone, quantitative easing is disappointing, as it cannot resolve the issue at the heart of the eurozone crisis, namely the misalignment of the exchange rates within the monetary union.

The first and foremost problem of the eurozone is the reluctance to recognize what is at its heart: the misalignment of exchange rates within the eurozone

## Conclusion

Economic recovery prospects in the eurozone remain bleak. The success of Northern Europe´s export industries is underpinned by a strongly undervalued currency and not by an increase in productivity.

**Figure 1: The Swelling of the German current account**




At the same time, Southern Europe's industrial sectors are suffering from an overvalued currency. The approach to restore international competitiveness by internal devaluation means undermining demand, which makes the life of companies in non-export-oriented industries extremely challenging. In Italy alone the number of bankruptcies has more than doubled from 6,000 in 2007 to more than 14,000 in 2014. The wave of bankruptcies and disappointing revenue streams across Europe is understandably deterring investors from engaging in the region.

The costs of not addressing the real cause of the eurozone crisis are rising every day for businesses and investors. Any manager knows if a company is struggling and its business model is not working, you need to make tough decisions to come to reverse your fortunes and save the company. Without a realignment of exchange rates within Europe, as an essential component for a real recovery, there is virtually no chance that European businesses will be able to realize their full potential. Faith in the ECB's QE is misplaced. Additionally, the by-product of ECB's unconventional monetary policy was weakening the euro vis-à-vis the U.S. dollar. As a result, the dollar appreciated and this hit the earnings of U.S. companies. The beggar-thy-neighbor-policy is no solution to the eurozone's woes, but rather increases the number of those negatively affected by the eurozone crisis. Because of the crisis, not only have investment opportunities in Europe been significantly reduced for U.S.-based investors, but they also suffer from the damage done to the U.S. firms by the euro-rescue policy.

A reform-oriented agenda following the realignment of exchange rates must be part of the U-turn in order to secure a return to a sustainable economic health of European economies. And the investment community will once again be pleased with the scale of business opportunities flourishing across the continent.

**To the point:**

- A misalignment of exchange rates is at the heart of eurozone stagnation
- Businesses will struggle to thrive under the economic conditions in Southern Europe
- The ECB’s loose monetary policy will not help firms, but will risk asset bubbles
- The longer this misalignment prevails, the higher the potential costs for businesses and investors will be
- U.S. companies are also suffering because of the euro’s devaluation and lost business opportunities