Friday, March 20, 2015

Global Macro Themes – EMU: Many Markets, Many Monies?

In October 1990 the European Commission under the leadership of President Delors published a cost-benefit analysis study of forming the European economic and monetary union entitled "One Market, One Money"*. The report came down overwhelming in favour of EMU. However, today's reality clearly shows that the single currency project has singly failed to live up to pre-formation expectations. Indeed, with the passage of time the EC study appears to be more a work of propaganda than a serious research investigation. As suggested by its very title, one of the key foundational principles for economic union (also laid out in the earlier Delors Report) was the creation of a single market in which "persons, goods, services and capital can move freely". In this research note we examine EMU intra-regional labour migration flows as this has been proposed by some as a potential mechanism for alleviating the crisis. Unfortunately for the EMU optimists it appears to be a classic example of "great in theory, not so in practice" leaving us – once more – to reflect on the possibility and dynamics of a Greek EMU exit.*

Curing The Crisis

In a recent BSEC research comment[1] we argued that finding a solution to the debt negotiations between Greek and its EU partners would be highly problematic due to the fact that for core member states (importantly Germany, given the size of its cheque book) Greek anti-austerity sentiment and continued EMU membership are mutually exclusive. Absent a nominal write-down in their government's debt load the Greek populace would, to borrow Finance Minister Varoufakis's words, remain *"a debt colony"* for several decades; something we considered to be politically unacceptable.

Our analysis was based a macroeconomic framework separating the various components to nominal GDP: productivity, worker effort and labour market engagement. There is, however, an alternative income source, one that has been repeatedly put forward as a potential cure to the crisis: external.

For the avoidance of doubt we are not considering a potential GDP boost from increased net exports of goods and services in the tradeables sector, rather we

[1] See: http://www.blackswaneconomics.com/in-the-news/markets-rally-ecb-begins-qe-dont-forget-greece-786.html
[2] See: http://polemics-pains.blogspot.co.uk/

are considering the ability of Greece to benefit from another export: its work force.

This argument has been neatly summarised in a recent blog post[2],

"if a country will not voluntarily adjust its fiscal policy for the greater good but take advantage of the generalised monetary policy, the last resort to adjust imbalances is for people to physically move and take jobs in booming areas, thus increasing labour supply and dampening wage pressures."

Such intra-regional labour migration flows are, of course, fully permitted within the Euro zone as per the "free-movement of peoples" condition mentioned above. So let's look at recent trends courtesy of the Eurostat database[3].

Recent Intra-EMU Migration Trends

Out of all the Euro zone member states Germany currently has the lowest unemployment rate at just 4.7% on a harmonised basis. Compared with equivalent unemployment rates in the peripheral Euro zone economies, which vary between 10% for Ireland and 26.0% in Greece, there appears to be considerable economic justification for what UK Conservative Minister Norman Tebbit was famously misquoted as saying in 1981, namely, *"Get on your bike!"*[4]. Despite such obvious economic benefits from relocating from the periphery to the core the hard data show intra-regional migration in the Euro zone is very low[5].

According to Eurostat estimates the German total population has been relatively stable over the past decade, hovering around the 82mn mark. Of this total, some

[2] See: http://polemics-pains.blogspot.co.uk/

[3] Data on intra-regional migration in the Euro zone is far from complete or timely. The data we are using comes from the Eurostat population database, which can be accessed here: http://ec.europa.eu/eurostat/web/population-demography-migration-projections/population-data/database

[4] As with many famous quotes, Norman Tebbit's words were not as concise as generally reported. What he actually said, in response to a comment that rioting was a natural reaction to unemployment, was:

"I grew up in the '30s with an unemployed father. He didn't riot. He got on his bike and looked for work, and he kept looking till he found it."

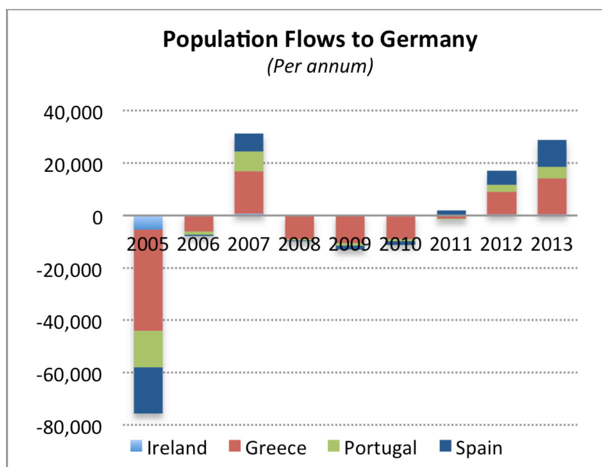
Regardless of the fact that that the exact quote is not correct, the policy message is clear: in the face of substantial regional unemployment (his comment was aimed at the masses of unemployed workers in the north of England following the first wave of Thatcherite economic reforms) unemployed workers should move to where there is work.

[5] In the interest of efficiency, and due to data limitations, we have restricted our data analysis to Germany versus the periphery rather than the wider Euro zone core. However, given the relatively smaller size of the other core Euro zone member states with respect to Germany, our conclusions stand. (We do not consider Italy, or even France, to be "core" from an economic perspective.)

7.7mn people are classified as non-German citizens, which equates to approximately 9.4% of the total population. This ratio has increased by 0.5 percentage points since 2004, with the majority of the rise having occurred since 2011; the beginning of the EMU crisis.

Notably, over the past decade the German domestic population (classified by Eurostat as reporting country citizens) fell by just over 220,000. This has been offset by an inflow of foreign migrants totalling almost 500,000, of which only 69,000 came from citizens of other Euro zone member states.

Admittedly, as shown in the chart, the classically defined Euro zone peripheral member states contributed to fully 2/3rds of these inflows - due for the most part by Greek and Spanish people relocating to Germany. As can also be observed, this represents a notable shift from the post-EMU/pre-crisis years when the economic boom in the periphery encouraged the diaspora to return to their country of citizenship.



It appears, therefore, that the Euro zone economic crisis is prompting intra-regional migration flows away from the periphery into the core member states. So, is this *prima facie* evidence of the Euro zone behaving as one market, and hence a validation of the EC's 1990 report, "*One Market, One Money*"?

Good News For The Core

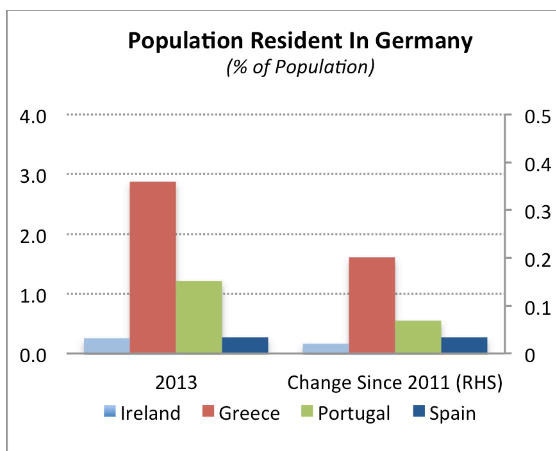
The economic benefits to Germany and other core EMU states from such intra-regional population shift are all too obvious; an influx of skilled foreign workers (or at least those with skills in demand) from the periphery effectively constitutes a positive aggregate supply shock to their economies. By providing an additional labour input these foreign workers not only add additional production capacity, but as they represent an effective supply of labour, they also should mitigate inflation pressures during an economic upswing. Moreover, importantly for Germany, it also helps alleviate one of their major structural negatives (leaving aside for the moment, the sustained current account surplus) namely its aging population.

Finally, while perhaps not the most important benefit given their fiscal metrics but nevertheless significant, inflows of foreign workers stand to further increase the tax base for the German government, benefiting the public finances.

What About The Periphery?

For the periphery, however, the benefits from its domestic work force relocating to the core member states are much less obvious if for no other reason that it will – in mirror image to the German experience - undermine its domestic tax base.

In addition, it is important to put these intra-regional population flows into perspective. The chart below shows both the percentage of the peripheral populations[6] residing in Germany in 2013 and the cumulative percentage point change since the start of the crisis.



Take, for example, the 318,000 Greeks that presently reside in Germany. This equates to only 3% of the population that resides in Greece. Moreover, since the start of the EMU crisis, the number of Greeks resident in Germany has increased by 22,000, which represents an increase of barely 0.2 percentage points of the Greek population. For the other members of the Euro zone periphery the numbers are even lower.

Compare this with the magnitude of Greece's debt problem, where gross liabilities are in excess of EUR 300bn, or 180% of nominal GDP! Even assuming that the Greek diaspora repatriate a significant proportion of their earnings back to Greece (according to World Bank figures in 2013 Greek inward remittances totalled just 0.3 percentage points of nominal GDP[7]) the degree of population shift required to bring Greece's nominal debt/GDP ratios back to some semblance of sustainability is orders of magnitude higher than is presently the case.

Language Barriers

Many reasons are cited as to why there has not been greater intra-regional labour movement within the Euro zone, but it is clear that in addition to

[6] By percentage we mean when expressed as a ratio of the home country populations.
[7] See: http://econ.worldbank.org/WBSITE/EXTERNAL/EXTDEC/EXTDECPROSPECTS/0,,contentMDK:22759429~pagePK:64165401~piPK:64165026~theSitePK:476883,00.html#Remittances. One of the best examples of an economy, which successfully exports labour, is the Philippines with annual remittances around 10 percentage points of nominal GDP.

cultural/social barriers there is the not insignificant problem of language[8]. According to a survey conducted in 2012 by Eurobarometer[9], 43% of Greeks do not consider themselves able to hold a conversation in another language.

This is by no means the worst reading in the EU (interestingly, Spain, Portugal and Ireland all have higher ratios[10]). Nevertheless, it represents a clear impediment to being able to relocate between the various member states. Moreover, it is something that can only be corrected over many years/decades, and hence therefore, certainly not at on timescale that is relevant for the Greek/EU debt negotiations.

Even though the EMU crisis has been a catalyst for increased intra-regional labour mobility - a step in the right direction - the magnitude of the step (the increase in migration flows) is incredibly small. So, even if the legislation is supportive of the EU political elite's vision of *"One Market, One Money"*, the reality is very different; more a case of "*Many Markets*", particularly for labour. Corrective action to address this problem can only occur very gradual and certainly not at a pace that will resolve the Greek debt crisis to the satisfaction of both sides. Inevitably, this leads us to the question that forms the title of this BSEC research note and the possibility of a Greek exit.

Practicalities Of Exit

Many financial commentators have argued that exiting the European single currency is impossible. Even Greek Finance Minister Varoufakis in his, by now, infamous presentation recently uploaded on Youtube[11] agreed. Rather than focus on the alleged "finger pointing", we prefer to focus on the rest of his presentation, especially the arguments Varoufakis made as to why Greece needs to remain part of the single currency. As we will outline, in our opinion, some of his arguments are flawed.

Varoufakis's argument is that the best course of action would be for Greece to default on its government debt – thereby releasing themselves from being "debt

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[8] By way of a personal anecdote, one of the author's brother's recently relocated 2,500 miles within the US. Even though this involved a change in employment, it went smoothly and without a hitch.

[9] See: http://ec.europa.eu/public_opinion/archives/ebs/ebs_386_en.pdf

[10] Interestingly, and consistent with general perceptions, the UK is once of the worst offenders with 61% of the population unable to speak a second language – yet another reason for a British EU exit perhaps?)

[11] The Youtube clip is part of conference presentation given by Varoufakis in 2013 prior to becoming the Greek Finance Minister. This clip has caused a bit of a media storm, particularly in Germany, for reasons that are all too obvious (Ed note. Around the 1.50 min mark in the clip) and has contributed to a further deterioration in relations between Greek politicians and their Euro zone counterparts. Subsequent to the release of the video clip Varoufakis has denied that the video is an accurate representation of his presentation and that it has been visually doctored. See: https://www.youtube.com/watch?v=1KSmcUyAZwU

slaves" - but remain within the Euro zone, i.e. they should continue to use the EUR[12].

The crucial element underpinning his argument is that unlike Argentina (his chosen comparison not ours), which abandoned its currency peg versus the USD in 2002, Greece has no currency and hence devaluation is impossible.

The only alternative Varoufakis suggests is, in effect, to pre-emptively announce a devaluation in eight months time (his guesstimate as to how long it would take to print and distribute an alternative currency to the EUR); a scenario that he correctly considers flawed as it is a *"recipe for wealth liquidation"*, requiring the imposition of capital controls. He concluded by saying that this means, *"we [Greece] would have to get out of the European Union"*.

We wholeheartedly agree with Varoufakis's conclusion that a *de facto* pre-announcement of a currency devaluation would be unmanageable. It would lead to the hollowing out of the Greek banking sector and an exodus of wealth out of the country. But is this really the only alternative?

One possibility is that the Greek government "prints" new drachmas (NGD) and stockpiles them in the vaults of the Greek central bank in anticipation of an exit, thereby reducing the time window between announcing EMU exit and switching currencies. For this to work it would have to be done in secret as any hint that it was occurring would likely trigger capital flight from Greece in much the same manner as a pre-emptively announced devaluation would. In our view, this would be extremely difficult to achieve. Moreover, the NGD bank notes would have to be exactly the same dimensions as existing EUR notes and coins in order for ATMs and other cash vending machines to work.

There is, however, international precedent for an alternative. During the break-up of Czechoslovakia following the fall of the Berlin Wall and the break-up of the USSR, the two constituent countries shared the same currency initially but due to concern that a 1-for-1 exchange rate was not sustainable (Slovak banks experienced bank runs immediately after the separation was announced) the authorities were forced to act. First, closing the borders for six days to stop physical cash transfers and second replacing the existing Koruna with two separate currencies.

What is important though is the method used to separate the currencies. Rather than print new bank notes, which would – as just mentioned - obviously be impractical given time pressure, the new notes were "created" by stamping existing bank notes: one stamp for the Czech Republic and one for the Slovak

[12] There is, of course, the not unsubstantial point as to whether such an outcome would be politically viable as it would, in effect, represent the Greek government unilaterally imposing a nominal write-down of its government debt, something the Germans are steadfastly opposed to.

Republic[13]. Given that Greece would face very similar macroeconomic and financial conditions, stamping existing EUR bank notes circulating within Greece immediately following a Greek exit would, therefore, avoid one of Varoufakis's key objections to exiting the single currency.

Regards his argument about capital controls, as we have written previously, in our view they are unavoidable in Greece. This does not, however, mean as Varoufaksis suggests that Greece would *"have to get out of the EU"*.

Chapter 4, beginning with Article 63 of *The Treaty Of The Functioning of The European Union,* allows for the introduction of capital controls as exceptions to the general principle of free-capital mobility. Indeed, Cyprus introduced capital controls in 2013 to avert a bank-run following its crisis, prompting the European Commission to issue a press release containing the following excerpts (Ed note: our emphasis)[14]:

*"**Member States** may introduce restrictions on capital movement, **including capital controls,** in certain circumstances and under strict conditions on grounds of public policy or public security. In accordance with the case law of the European Court of Justice, measures may also be introduced for overriding reasons of general public interest.*

Such exception to the principle of the free movement of capital must be interpreted very strictly and be non-discriminatory, suitable, proportionate and applied for the shortest possible period.

*In current circumstances, the stability of financial markets and the banking system in Cyprus constitutes **a matter of overriding public interest and public policy justifying the imposition of temporary restrictions on capital movements**.*

*Such restrictions may include **bank holidays, limits on withdrawals, freezing of assets, prohibition of terminating fixed term deposits, prohibition on certain payment orders, restrictions in using credit/ debit/prepaid cards, restrictions on other banking operations** as well as execution of certain transactions subject to the approval of the Central Bank and other measures."*

Retroactive Referenda

A more substantive issue with a Greek exit is that while the Syriza-led government has a mandate from the electorate for "anti-austerity" it does not have a mandate for a Greek exit from the single currency area. Hence therefore, it

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[13] The addition of stamps to existing bank notes has a long history as outlined in the following article. See: http://www.thecurrencycollector.com/pdfs/The_Significance_of_Stamps_Used_on_Bank_Notes.pdf

[14] The full press release can be found here: http://europa.eu/rapid/press-release_IP-13-298_en.htm

would almost certainly require the consent of the electorate via a referendum or fresh general elections. Rather like the pre-announced devaluation scenario, either of these options would likely fuel a Greek bank run as it is a rational response to the possibility of a Greek exit.

That said, it is not always the case that governments seek electoral approval for a major policy change in advance, there is precedent for governments doing so retroactively. This could prove to be important given the serious possibility that a Greek exit is either externally imposed – the most likely mechanism being the ECB failing to extend the ELA to the Greek banking sector - or occurs by accident.

On 22 January 1972 the UK Conservative government under Europhile PM Ted Heath signed an ECC accession treaty paving the way for entrance on 1 January 1973. This decision was taken without a public referendum contrary to the generally accepted view that further integration with Europe would not occur without the consent of the electorate. Given the contentious nature of the decision on 5 June 1975 the newly elected UK minority Labour government, living up to its manifesto pledge, held a post-legislative referendum, which simply asked: *"Do you think that the United Kingdom should remain part of the European Community (the Common Market)?"*[15][16].

Admittedly, relative to the British referendum the situation in Greece would be somewhat different (read – extremely messy) as it would be a case of joined, exited and potentially rejoining. That said, these are unusual times and, as we have indicated in previous commentary, the Greeks are stuck between a rock and a hard place.

Yet another major obstacle to a Greek exit from the EUR relates to the handling of the existing contractual debt obligations. As Goldman noted in a recent research note[17], one consequence of the international response to the Greek crisis is the loans given to Greece,

"For all intents and purposes, [they] are foreign treaties with other governments and failure to pay them does not lead to an automatic write-off, particularly as maturities of those loans are primarily 15-30 years in the future (except for IMF loans that mature in the years ahead). They also cannot be redenominated."

Moreover, a substantial proportion of Greek liabilities no longer fall under Greek law but foreign, typically English, law.

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[15] Evidence of the attractiveness of the status quo is the fact that the traditionally Eurosceptic UK electorate backed remaining within the ECC by more than two-thirds.

[16] There are so many unusual occurrences within that paragraph we were simply amazed rereading it: a Conservative government seeking closer European integration; a Labour government living up to manifesto pledges; not to mention the government allowing a popular referendum at all given it violates the principle of parliamentary sovereignty.

[17] To clarify we have not seen the full note just the selected highlights that have been publically reported.

Both of these factors greatly complicate the task of government default and/or redenomination into the NGD in the event of an exit and could lead to Greece being effectively excluded from international capital markets[18].

We readily admit that international monetary law is by no means our area of expertise[19]. However, as we wrote in *"GMT – Greece: EMU's Slippery Slope"*, 9 January 2015, a Greek exit would almost certainly be extremely damaging not only to Greece but to the remaining EMU member states[20] because it would explode the "irrevocability myth".

Hence, while there are political considerations which argue in favour of the remaining EMU members making the situation as politically and economically difficult for Greece in the event of exit – in order to discourage other peripheral member states from contemplating similar action – rationality will likely prevail. In our judgment, this implies that some debt forgiveness will be granted to Greece, albeit at the cost of leaving the single currency. This would, to some extent, assuage German concerns about the moral hazard implications from allowing debt forgiveness in the context of continued EMU membership.

"No Ready-Made Export Market"

As mentioned above, unlike Varoufakis we see no serious practical impediments to Greece reintroducing the NGD[21], so what about his final argument for staying within the EUR, namely the lack of a ready export market.

It is well documented that the Greek tradeables sector is very small by international comparison around the 20% of GDP mark[22]. Hence, the economic growth kick from any currency devaluation associated with the introduction of the NGD would – the argument goes - be limited.

It is indisputable that the Greek economy is not open enough to international trade to witness a growth miracle from an immediate currency devaluation following the introduction of a NGD, although a significant boost to

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[18] No doubt international law firms are licking their lips in anticipation of such an event given the prospect for generating substantial revenues as the potential for litigation is huge.

[19] As part of our background reading for this research note we came across the following comment by Christoph Herrmann, a Professor of Public and European Law at the University of Passau. After highlighting the obvious fact that EU law makes no provision for the reintroduction of national currencies, he provides a very clear and concise discussion of the pertinent legal complexities associated with the Greek exit. It is well worth a read (see: http://www.verfassungsblog.de/en/auf-der-suche-nach-dem-ariadnefaden-von-den-rechtlichen-schwierigkeiten-von-grexit-und-graccident/)

[20] US academic Barry Eichengreen earlier this year described a Greek exit as *"Lehman Brothers squared"* – we wholeheartedly concur.

[21] Legal objections are, as we intimated above, beyond our area of competence.

[22] See: www.ceps.eu/system/files/.../Can%20Greece%20grow%20solvent.pdf

competitiveness would benefit the not inconsiderable tourism sector[23]. Equally, it is indisputable that significant structural reform is badly needed in Greece, as Syriza already acknowledges, irrespective of what happens.

However, as we have outlined before, the return of an independent monetary policy in Greece – and hence the ability to print their own currency – would, in conjuncture with a radical structural reform and a reduced government debt burden, at least provide the foundation for eventual economic recovery from what will be a serious economic downturn; the immediate consequence of a Greek exit[24].

As those who have been through a separation know full well, no matter how good intentions are at the start, there is no such thing as an "amicable divorce". But, in the event of a Greek exit from the single currency at least there would be some light at the end of the tunnel; quite a contrast to the decades of fiscal servitude that otherwise faces the Greek populace[25].

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[23] According to the World Travel & Tourism Council the direct contribution to the Greek economy from travel and tourism in 2014 was EUR11.2bn (6.5% of GDP) with a total contribution of EUR 28.3bn (16.3% GDP). See: http://www.wttc.org/-/media/files/reports/economic%20impact%20research/country%20reports/greece2014.pdf

[24] Varoufakis has argued previously – and with considerable merit - that in the event of a Greek exit the international ramifications will be such that it would *"create the circumstances for a new Great Depression"*. This does not sound like a global macroeconomic backdrop conducive to Greek export-led economic recovery. However, as we argued in *"GMT – Fiscal Dominance: Fifty Shades Of Debt"* 3 March 2015, when the next global economic downturn occurs, whether induced by a Greek exit or some other development, global policymakers will be forced by circumstance to adopt much more radical economic policies to mitigate the immediate downdraft to the global economy.

[25] We ran through some Greek fiscal calculations in a recent post. See: http://www.blackswaneconomics.com/in-the-news/markets-rally-ecb-begins-qe-dont-forget-greece-786.html