AN ANALYSIS OF THE POLITICAL AND ECONOMIC DYNAMICS OF THE COMMON CURRENCY - WILL THE EURO SURVIVE AS A COMMON CURRENCY WITHIN AND/OR WITHOUT THE EUROZONE

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Summary. Over the weekend of 7 October 2011 the governments of France and Belgium agreed to nationalize Dexia, Belgium's largest bank, a top – 20 Eurozone bank by assets with debt exceeding $700 billion, an amount more than twice the size of Greece's GDP and a multiple of Greek national debt. This is an action that should have every company of any size looking very closely at its direct and indirect exposure to the Euro crisis. The question is whether this closing is an alarm to an uptick of an on-coming crisis much as the closing of Bear Stearns was in March of 2008.

Key words: *currency, Eurozone, GATT, globalization, securitization, WTO.*

A well-known aphorism is «he who pays the piper calls the tune». However, Germany, the «patron saint» of the Eurozone is finding itself subjugated to an institutional «terrorism» from smaller countries such as Finland and Slovakia. However, all nations both within and without the European Union and EMU have reason to be concerned.

In retrospect, it seems that three interacting factors are major contributors to the dysfunction in the international markets, particularly with respect to the survival of the Euro:

1) Globalization –

In the more than sixty years since the founding of the GATT, succeeded by the WTO, the international markets have become increasingly integrated, particularly more so since the 1998 Asian crisis. Total world trade turnover is estimated at $27 trillion, nearly 50% of world GDP, estimated at $60 T +/-, recessionary conditions in either the US ($14 T +/- GDP) or the EU ($14 T +/- GDP), or in China, perhaps in the coming decade, will have significant disruptive effect on the G-20 and the rest of the trading system. The problem arising out of globalization is not simply the economic problem of adjustments imposed on altered commercial contract terms and conditions based upon pre-crisis economic relationships that must be revised in the face of a new economic reality, but also the issue arising out of the fact that there is a need for recognition of a new political reality in all of the trading countries. This latter political adjustment is terribly difficult because politicians simply don't like to do anything that casts them in a bad light; and it is clear that the adjustments required in the current climate will do that. From September 2008 until the present time we have seen the American political system struggle to resolve critical issues in the financial system and fail to arrive at reasonable regulations which might prevent future crises from arising. Simply stated the requirement is for substantially reduced leverage for all types of financial instruments involved in domestic and international commerce. Reducing leverage is not favored among the various institutions in the financial markets, and far less favored when foreign competition is not equally retrained.

We note also that this is not a failure simply identified to the American political system but is identified with all political systems. It is important to realize that solutions are complex and the interaction of global markets with respect to multinational competition means that resolution within one country or political block and be achieved without regard to is international competitive consequences.

Perhaps the greatest difficulty in achieving the required adjustments will be within the European Union and the European Monetary Union (Eurozone). Simply stated, in the founding documents forming the European Union and the EMU, no provision was made for resolving a crisis of the breadth and depth of that currently confronting Europe. Although such crisis was foreseeable, none of the nations entering into the European Union or the EMU were willing to give up the financial autonomy required to prevent such conditions arising.

2) Securitization –

The idea of securitization is to «lay-off» or transfer risk from short-term capital resources to long or longer – term investors. In so doing, the short term originators are refunded and enabled to support on-going originations, while the institutions with extended investment horizons inventory assets matched to their goals. In the current crisis, globalized supply & demand coupled with political motivation (and far too liberal central bank support, especially from the U.S Federal Reserve Bank) drove assets values far beyond reasonable bounds. The key to understanding why securitization became destructive to the international financial system arises not inherently from its legal form and the process of securitizing assets, but from the failure to restrict over - leveraging of the assets securitized. Moreover, as noted above, even three years following the eruption of the crisis, no country has adopted serious restrictions on leverage. We can recall that Basel I collapsed in the 1998 crisis and led to Basel II which collapsed in the current crisis leading to Basel III which, in its earliest fully implementation, will only come into effect in 2019. However, it is much more likely that an intervening crisis will interrupt Basel III leading inevitably to Basel IV.

3) The Founding of the Euro –

Economically speaking, the founding of the Euro was reasonable and healthy. The problem is that neither the European Union nor the EMU had institutional structures that were adequate to deal with the current crisis. That is now clear. Certainly the Eurozone crisis can be resolved, but only with a major reformation or disregard of the legal parameters of the institutional framework. Whether that happens will depend on the multinational political decisions as to whether the economic fundamentals of the monetary union are worth saving.

But to be clear, from the beginning, most of the conditionality of European Union membership has been ignored by most, if not all, of the member states.

A driving force for the current crisis had been the largely political motivation to accept an unproven financial instrument, the euro, as a reserve currency. The motivation, widely supported, was to reduce the influence of the dollar, ergo, the United States, on the world economy. In the 1990s, no central bank held euros as reserve currency (the euro did not exist). A decade later more than two trillion euros are held as reserve currency, with related derivative instruments held by commercial banks throughout the world. This almost hysteric flight from the dollar led to the overvaluation of the euro, ergo easing access to capital by the so-called «southern tier» and other governments. It is not at all surprising that market forces seek to equilibrate the international capital markets. The founding of the euro was a well - intended economic undertaking. Although the euro started at a level of near - parity relatively close to that of the dollar in the initial quarters following its founding, the markets chose to reduce its value relative to the dollar by about 20%, initially falling to €85 cents in the quarters after its founding, then rising steadily to a rate of more than €1.50 prior to the 2008 crisis. In the succeeding quarters, from late 2002 to mid-2008, the euro strengthened impressively largely due to the actions of the US Federal Reserve keeping returns on dollar instruments at very low levels, especially following the events of 9/11. In this period of steadily increasing value of the euro and the continuing weakening of the dollar, there arose a sense of euphoria that the euro would achieve a firm status as a second international reserve currency. For the most part, the monetary and fiscal gurus of the world really looked ahead at the calamity that could arise were there to be an asset bubble arising out of what we now know to be irresponsible governmental borrowing.

The period of euphoria has now passed. The European Union and de facto the rest of the international community is faced with the fact that the political framework of the European Union and the EMU are inadequate to deal with the crisis. However, one could assert that the European Union was so grossly negligent in the due - diligence of its monitoring of the economic conditionality of membership, especially with respect to Greece, that it de facto ignored its own constitutional requirements. Therefore, it seems that there may be a basis of legal action to the bar Greece from membership based upon its economic manipulations with respect to fulfilling the terms and conditions of membership conditionality. Another approach would be to accept the fact that adherence to the terms and conditions of conditionality were essentially ignored, de facto ignoring the Constitution. Since the politicians have been so willing to look the other way and ignore the Constitution with respect to membership, one might argue that they might just do the same thing now and provide liquidity necessary to resolve the crisis, notwithstanding the political consequences of such action. Of course, the political consequences of providing so much liquidity to the system might be enough to drive the Germans from continuing its membership.

This article will further discuss:

The Failures of Risk Management at the Micro (Corporate, Capital Markets) & Macro (Governmental) Levels - Including Assessments of the Basel II & III Accords, The European Systemic Risk Board (ESRB) and Solvency II and the international trading system (WTO).

With all of the focus in academe over the past three decades in the subject of risk management, it should be shocking that the international merchant community has found itself faced with an economic crisis of a magnitude comparable to the great depression of the 1930s. It is inevitable that the intellectual community must scrutinize the inability of domestic and international institutions to fend off the current crisis.

A number of the so-called «lobal» issues will be discussed briefly below but, in the end, the great failure arises out of a combination of populism, political arrogance and managerial ineptitude. The increased globalization over the past two decades and, in particular, more so in the past decade, while not a directly causative factor, nevertheless has been a major indirect factor of the current crisis. The reason is that techniques have been developed - particularly securitization - that shift risk away from its origins. This is certainly most evident in the case of the securitization of manifold financial instruments e.g. mortgages, automobile and credit card loans that were packaged by investment banks and sold all over the world to central banks, commercial banks, pension funds and other institutional investors. The risk is heightened by the fact that there are no effective coordinating institutions to measure the worldwide exposure faced by the industrial, financial and governmental sectors. For three years the United States has been wrestling with legal measures to rectify the economic damage done over the past decade and manifested at the outset of the crisis in September 2008. Even now we are seeing the European Union increasingly faced by the same issues that have faced the U.S. since September 2008. One major question facing the financial community at this time is whether China and India and to a lesser extent Brazil will be faced with the same issues with respect to effective risk management.

Another factor in the issue of an effective risk management is that both the academic communities and the business communities became far too enamored with the ability of mathematical models to provide precise measurement of the full panoply of market risk. The current risk failure was foreshadowed by the Long Term Capital Management (LTCM) collapse in 1998. And, although mathematical models provide excellent paradigms for analyzing key variables in the marketplace, ultimately consumer behavior has a randomness that does not lend itself to stochastic analysis.

Governments of all genres are far too involved in economic micromanagement. Markets need the broad parameters that provide for a stable business climate and moderate frames of reference for business conduct. The unfortunate reality is that governments today all over the world are in the business of government and, first and foremost, they are in the business of institutional self-preservation. Indeed, the future of the European Union and, in particular, the Eurozone sufficiently depends upon the ability of the transnational elites to juggle the interests of their own self-preservation against the instinctual reaction of the citizenry of the member states.

Much of the world has endured an economic malaise which began with the financial crisis and United States in September/October 2008. The magnitude of the US economy relative to that of other countries has created a ripple effect which has slowed the growth throughout the world. Of the so-called BRIC countries, Brazil, China and India, have managed to maintain growth remarkably well in view of the catastrophic economic impact of the crisis in the US and European economies. Of the BRIC countries, only Russia with its proximity to and dependence on the European economies have experienced a continuing economic malaise, although Russia so far has managed to stave off a 1998 – type collapse.

Throughout the world most of the talk and writing of political pundits addresses the issue of the financial component of the crisis, specifically, the sovereign debt crisis and its impact on the financial institutions in the United States and the European Union.

A neglected aspect of the analyses is the impact of the crisis on the world trading system and, in particular, the WTO. It is arguable that the crisis revealed the fact that, indeed, there is no true international rule of law, that is, all law is national subject only to a particular nation's acceptance of the convenience of rules of law parameter is by treaties and conventions.

In the nine months following the outbreak of the crisis in September/October 2008, at the time of the cram-down bankruptcies of General Motors and Chrysler Corporation, many in the legal community questioned the comportment of federal governmental legal procedures in terms of constitutionality and consistency with historical legal tradition.

Although the WTO continues to function and issues interesting findings such as those with respect to the Boeing/Airbus crises and the most recent ruling with respect to the Chinese restriction of the export of certain rare earth elements, it seems clear that it is important to question whether rules of law matter at all or whether WTO member countries will simply ignore the mandates of WTO rulings.

Much of the debate of the Boeing/Airbus dispute arises with respect to the legality under trading rules of various types of assistance to the respective companies. But the amount of that assistance pales in comparison to the approximately $80 billion of federal "loans" that had been provided to GM and Chrysler in the pre-and post-bankruptcy period. Moreover, certain tax provisions included in the federal bankruptcy authorization will carry forward subsidization for years. Throughout the European and Russian auto, truck and machine tool industries similar substantial infusions of capital have been provided. With respect to China, much of the auto industry is derivative of the military-industrial complex and its related large-scale industrial enterprises, so it's clear that China would not come to the table in a WTO dispute resolution on the matter of state subsidization with entirely «clean hands».

The recent decision by the WTO the China is in violation of trade rules by restricting its export of a variety of rare earth elements raises extraordinarily interesting issues. For example, although oil & gas are not covered by WTO regulations, it certainly not hard to imagine that energy importing countries would much like to make a demand of oil and gas exporting countries that said exporters are in violation of international fair trade regulated norms by restricting their exports. Indeed, importing countries could make the same argument against export restrictions on all types of goods and services.

In a sense, this is the flip - side of the argument that the United States is making with respect to its recently passed health care legislation, the so- called Obama Care Health program, which its opponents argue will necessitate all American citizens to purchase healthcare. Clearly citizens of all countries around the globe are «equired» to purchase governmental services whether or not they agree with the quality and quantity of those services. Indeed, as we have seen with the dissolution of the Soviet Empire and the recent events in the Middle East, at times the citizenry will reject a socio – political order. The Obama Care opponents are arguing that the federal government in the United States is moving in a direction which will ultimately require American citizens to purchase not only governmental services but all kinds of goods and services which are now provided by the private sector, but under the mandate of public purchase requirements, the private sector suppliers of goods and services would ultimately be driven out of business. It is with the same line of reasoning that Chinese suppliers, for the most part admittedly controlled by the central government, are mandated to supply the market with rare earth elements.

The interesting thing about the WTO is that over the 60 years of its evolution from its precursor, the GATT, there are a number of important sectors of the economy which are not covered by the WTO rules. These include agriculture, maritime businesses, phyto-sanitary issues, oil & gas and, of course, important defense-related industries.

It is too early to assess the damage to the world trading system that might result from USA and EU policies adopted following the 2008 international financial crisis. However, the danger is real and it could parallel the perils faced by the European Monetary Union with respect to the current euro crisis.

It is quite possible that the monetary union could dissolve or that one or more of its members may elect to leave the monetary union. If this does happen, it does not necessarily imply that the trade agreement, which is the nucleus of the European Union, would necessarily dissolve or even be diminished.

The experiment by certain members of the European Union to create a common currency was a Herculean undertaking and an admirable effort. Not surprisingly, the current economic crisis is posing a serious challenge to the Eurozone. The issues of oversubscribed debt by Portugal, Italy, Ireland, Greece and Spain (the so-called PIIGS») is testing the patience of the other members of the common currency.

Recent history shows that the dissolution of a common currency can happen very quickly and can have very serious economic consequences for the former members of that currency group. The most recent example of a common currency which was dissolved is that of the former Soviet ruble zone. Historically, the ruble was a functional means of exchange but was so heavily subsidized in various respects but it's nominal value was very often an understatement of its real value by an order of magnitude or more. But in the end, when it's time had come, in the period from 1991 through early 1993 the ruble cease to exist as a common currency and was replaced by the national currencies of each of the members of the former Soviet Union.

The question should be discussed seriously with respect to the viability of the euro as a common currency. There is a very strong constituency which certainly wishes to see a counterpart currency to the dollar. This constituency is essentially all of the countries in the world except the United States. But practically speaking, only the countries with substantial export earnings such as Saudi Arabia, China, Japan, Germany, Russia and South Korea have the muscle to support the euro and ensure its future. Since the revelation of the euro crisis in the spring of 2010, the central banks around the world, exclusive of the US Federal Reserve, have kept the euro at a relatively stable exchange rate vis-à-vis the dollar.

In the Fall of 2010, adding to the complexity of the euros continuing existence is the feared outbreak of a currency war among the major trading nations of the G - 20. It is quite clear that the recent announcements by the Federal Reserve Bank of the United States with respect to continued quantitative easing will put pressure on the international trading system that will further exacerbate the problems confronting Eurozone nations, especially the southern tier.

Although it is clear that the G.-20 membership, excluding the United States, would like to see a viable alternative to the dollar as an international reserve currency, what is not clear is what penalty will be acceptable to key political constituencies within the Eurozone. Specifically, the key political constituency is the German electorate. Should the reevaluation of the euro have a significantly negative impact on the German economy, the German electorate could vote in an ultraconservative government which would reestablish the deutsche mark as a national currency. Notwithstanding the multinational Eurozone compacts barring dissolution, the practical matter is that the Eurozone cannot survive without the strength of the German economy and the German electorate has the ability to forge a dissolution of the common currency should determine it is in its best interest to do so.

From the point of view of the German electorate and, for that matter, the other members of the Eurozone, the case for continuing with the euro is based upon three primary factors: 1) a certain euro-centric pride in having a common currency; 2) the economic benefit arising from intra-zone trade transactions (which may range from a fraction of a percent up to his much as 2 to 3% on small transactions) in a common currency; and 3) a sense of independence which arises from having an alternative reserve currency other than the dollar. It is still early to determine whether the economic impact of the current crisis on the international monetary system will be such that the impact within the Eurozone will be sufficient to motivate the German electorate towards the radical action of reinstating the deutsche mark as a national currency.

It is my opinion that there is enough global interest in seeing the Euro survive as an alternate international reserve currency, which, coupled with the pan- European trade relationships and the political and economic interests of the monetary union itself, ensures its survival.

For the medium and long term, the question really becomes how much of their reserves are the countries noted above with substantial currency reserves willing to sacrifice to ensure that the euro survive?

Resources:

1. «Basel I» of the Basel Committee on Banking Supervision at the Bank for International Settlements of 1988.
2. «Basel II» of the Basel Committee on Banking Supervision at the Bank for International Settlements of 2004.
3. «Basel III» of the Basel Committee on Banking Supervision at the Bank for International Settlements of 2010.