Rites of Passage

The Child of Consensus

Conceived in post WWII politics, and baptized in the political waters of the 90's, a new common currency- the euro- assumed its position on January 1, 1999. Representatives of the prospective member nations masterfully achieved political consensus by both the absence of objectionable clauses and the inclusion of national constraints, as manifested in the Treaty of Maastricht. During that tumultuous process, with deep pride, the elders grasped and shielded the credit sensitive heel of the infant euro. The 'no bailout' directive for the new ECB (European Central Bank) emerged as a pillar of the political imperative to address the 'moral hazard' issue that so deeply concerned the political leadership, and, two years later, that same rhetoric of fiscal responsibility continues to ring at least as loudly when the merits of the EMU (European Monetary Union) are proclaimed. Unfortunately, however well intended as protection from a genetic proclivity toward fiscal irresponsibility, the naked heel is but a magnet for the financial market's arrows of our hero's mortal demise.

As Apollo's chariot adeptly carries its conflagration from east to west, the European Monetary Union carries its members on the path of economic growth. Unlike the path of the sun, however, the path of an economy continuously vacillates, including occasional dips into negative territory. And, like the sign most rental car agencies post by the entrance for returning cars about to drive over a one way bump strip, the new EMU, with its lurking unidirectional bias, could do a service to it members with a similar posting - WARNING- DO NOT BACK UP!

The Dynamics of the Instability

The euro-12 nations once had independent monetary systems, very much like the US, Canada, and Japan today. Under EMU, however, the national governments are now best thought of financially as states, provinces, or cities of the new currency union, much like California, Ontario, and New York City. The old national central banks are no longer the issuers of their local currency. In their place, the EMU has added a new central bank, the ECB, to manage the payments system, set the overnight lending rate, and intervene in the currency markets when appropriate. The EP (European Parliament) has a relatively small budget and limited fiscal responsibilities. Most of the governmental functions and responsibilities remain at the national level, having not been transferred to the new federal level. Two of those responsibilities that will prove most problematic at the national level are unemployment compensation and bank deposit insurance. Furthermore, all previous national financial liabilities remain at the national level and have been converted to the new euro, with debt to GDP ratios of member nations as high as 105%, not including substantial and growing unfunded liabilities. These burdens are all very much higher than what the credit markets ordinarily allow states, provinces, or cities to finance.

Since inception a little over two years ago the euro-12 national governments have experienced moderate GDP growth, declining unemployment, and moderate tax revenue growth. Fiscal deficits narrowed and all but vanished as tax revenues grew faster than expenditures, and GDP increased at a faster rate than the national debts, so that debt to GDP ratios declined somewhat. Under these circumstances investors have continued to support national funding requirements and there have been no substantive bank failures. Furthermore, it is reasonable to assume that as long as this pattern of growth continues finance will be readily available. However, should the current world economic slowdown move the euro-12 to negative growth, falling tax revenues, and concerns over the banking system's financial health, the euro-12 could be faced with a system wide liquidity crisis. At the same time, market forces can also be expected to exacerbate the downward spiral by forcing the national governments to act procyclically, either by cutting national spending or attempting to increase revenue.

For clues to the nature and magnitude of the potential difficulties, one can review the US Savings and Loan crisis of the 80's, with the difference being that deposit insurance would have been a state obligation, rather than a federal responsibility. For example, one could ask how Texas might have fared when faced with a bill for some $100 billion to cover bank losses and redeem depositors? And, once it was revealed that states could lack the borrowing power for funds to preserve depositors insured accounts, how could any bank have funded itself? More recently, if Bank of America's deposit insurer and lender of last resort were the State of California rather than the Federal Reserve, could it have funded itself under the financial cloud of the state's ongoing power crisis and credit downgrade? And, if not, would that have triggered a general liquidity crisis within the US banking system? Without deposit insurance and lender of last resort responsibilities the legal obligation of a non-credit constrained entity, such as the Federal Reserve, is systemic financial risk not ever present?

The inherent instability can be expressed as a series of questions:

*Will the euro-12 economy slow sufficiently to automatically increase national deficits via the reduction of tax revenues and increased transfer payments?

*Will such a slowdown cause the markets to dictate terms of credit to the credit sensitive national governments, and force procyclical responses?

*Will the slowdown lead to local bank failures?

*Will the markets allow national governments with heavy debt burdens, falling revenues and rising expenses the finance required to support troubled banks?

*Will depositors lose confidence in the banking system and test the new euro-12 support mechanism?

*Can the entire payments system avoid a shutdown when faced with this need to reorganize?

Conclusion

Water freezes at 0 degrees C. But very still water can be cooled well below that and stay liquid until a catalyst, such as a sudden breeze, causes it to instantly solidify. Likewise, the conditions for a national liquidity crisis that will shut down the euro-12's monetary system are firmly in place. All that is required is an economic slowdown that threatens either tax revenues or the capital of the banking system.

A prosperous financial future belongs to those who respect the dynamics and are prepared for the day of reckoning. History and logic dictate that the credit sensitive euro-12 national governments and banking system will be tested. The market's arrows will inflict an initially narrow liquidity crisis, which will immediately infect and rapidly arrest the entire euro payments system. Only the inevitable, currently prohibited, direct intervention of the ECB will be capable of performing the resurrection, and from the ashes of that fallen flaming star an immortal sovereign currency will no doubt emerge.

Warren Mosler
May 1, 2001
www.mosler.org