

## The Incoming Tide Lifts All Boats

### ***Why we should be optimistic about an (intact) euro zone's 2011 prospects***

The euro zone had a terrible press in 2010, particularly in the UK and the US. Deservingly so. The New Year started poorly too. But it is here argued that things can change for the better. Firstly, do the (possibly growing number of) bailouts burden tax payers?

#### ***A juicy deal***

The belief that Germans and other euro zone taxpayers have to bear the cost of bailing out spendthrift Greeks and rash Irish bankers is widely propagated, especially by German newspapers. Yet there are no examples of taxes being raised to pay for the bailouts. Rather, the money is raised in the markets at low interest rates and lent to the distressed governments at high interest rates. The profit made in this transaction ("a juicy deal") could, if the benevolent government were so disposed, be used to *reduce* taxes.

Only if the recipient of the loan fails to repay will the tax payer be on the hook. That eventuality can only materialise some years in the future. A lot will happen in the interval. Tomorrow's world will be different from today's.

How different is of course unknown, but here too pessimism reigns. It should not.

#### ***Forecasting the past***

The old quip has it that it is difficult to forecast, particularly forecasting the future. This is why many *cast forward* the past ("forecasting through the rear view window"). It seems natural that forecasts are heavily influenced by the past. Indeed the forecast will probably have little credibility if it didn't.

Inevitably, major forecasting errors are made at turning points in the business cycle. A pertinent example: in May 2009 the European Commission forecast that euro area GDP would decline by 0.1% in 2010. Made just after the preceding two quarters saw q/q declines in euro zone GDP of around 2%, the forecast was very credible. Nor was it materially different from what others were forecasting (forecasters' "herd instinct")

In its November 2010 report the Commission estimated a 1.7% gain in euro area GDP. The forecasting "error", assuming no further revisions, amounts to 1.8 percentage points. The forecasting "error" in the case of Germany was even wider, 3.4 percentage points. In May'09 it forecast 0.3% GDP growth for Germany in 2010; in Nov'10 it estimated growth to be 3.7%. What did the Commission (and others) miss? What was lacking in its forecasting model?

#### ***It's technological progress, stupid***

Mainly two things. Firstly, it underestimated the extraordinary dynamism of the developing countries which allowed Germany in particular to export itself back to prosperity in remarkably short time. Secondly, it underestimated the ongoing and equally extraordinary technological advances the world benefits from. In part thanks to the maturing of Web 2.0 as well as the replacement of the ageing modestly-computer-literate workforce by highly-computer-literate youngsters (able to fully exploit Web 2.0, invent Web 3.0).

European companies have chalked up unexpectedly bountiful earnings in 2010, the result of the severe recession which forced desperate pruning of costs and investment in productivity enhancing procedures and equipment, investments which are, to a surprising extent, self financed (no loans from stressed banks needed).

These factors still have a long way to run. The emerging countries still have a lot of emerging to do to even approach Western living standards. And they are going for it. The computer revolution is feeding on itself. In the medium to long run economic growth is determined by productivity advances. Fiscal and monetary policies, as well as debt crises, become mere “noise”. And the medium to long term is just a lot of short terms, starting now.

### ***Forecasting the future***

For 2011 the Commission recently forecast 1.7% GDP growth for the euro area, a rather neat example of casting forward the recent past. Has its forecasting model now sufficiently integrated the virility of the developing world and ongoing technological advance? The Commission is forecasting that the American economy’s “soft spot” will endure in 2011 just as the latest indicators point to the soft spot being left well behind.

German economic growth has already started its transition from export led to domestic demand led. Unemployment has plunged and the trade unions are eagerly eyeing fat corporate profits. The traditional pattern of German growth – from exports to investment to consumer spending – is being faithfully repeated. Germany is set to become Europe’s locomotive. Euro zone growth may in 2011 too surprise on the upside, confound the pessimists.

### ***Those pesky budget deficits: adapt or die***

And what about the sovereign debt crisis which is still going from bad to worse. It is certainly true that the monetary union in 2010 hit a T-junction. It could no longer advance along its earlier path. Two options presented themselves: breaking up or adapting to the new exigencies.

Many, especially in the Anglo-Saxon world, opted for the first. They still doubt the single currency’s survival even now and after the euro zone has already done much adapting, if in acrimonious-midnight-sausage-making fashion. One sacred cow after the other has been slaughtered (feeding the sausage). Germany has become a major financier of the Greek and Irish budget deficits, the ECB is buying up distressed government bonds of the euro zone’s over indebted countries (quantitative easing in fact, if not in name). New crisis resolution mechanisms are being constructed.

Precedents have been set, taboos broken, surely more adjustments will come as the markets demand them.

### ***One man one vote***

The ECB has considerable fire power. Belief in its readiness to act has been undermined by its two vociferous German members, Axel Weber and Jürgen Stark. It is perhaps forgotten that decisions are made in a Governing Council of 23 members, each with one vote (in law that is, in practice the Council strives for consensus). Of the 23, nine hail from countries which have recently seen their government bonds come under attack in the markets. At least another three members hail from countries potentially at risk.

Of course all members are obliged to vote in the interest of the euro zone, definitely not in the interest of their country. Still...

### ***It’s hard to break up***

The certainty with which many forecast a fracturing of the euro zone is in part based on the belief in the supremacy of markets. Sensing the weakness of Greece markets bid up the yields on Greek bonds until Greece can no longer afford to borrow. Ireland followed. Others may follow until bailouts become unaffordable.

Yet the prohibitive costs of a break up of the euro zone, or of a country leaving, was documented as long ago as 2007 by Barry Eichengreen and elaborated more recently by

Jacob Kirkegaard of the Peterson Institute, Willem Buiter at Citibank, and others. However hard adjusting to life within the euro zone, life outside is a good deal harder still.

### ***No third world economy, please***

The major advantage for a country leaving the euro zone is its ability to devalue and print its own money. Apart from the capital flight, inflation and generalised chaos created, one decisive disadvantage of leaving the euro zone is commonly overlooked. That is passing up the opportunity to rectify the structural deficiencies which plunged the country into crisis in the first place.

Take Greece. Its shortcomings are well known: monopolistic product and services markets, tax & benefits system penalising work, inefficient public administration, tax avoidance, wage developments divorced from productivity, etc. Left to its own devices vested interests may undermine structural improvements, relegating Greece to a third world economy. Staying in the euro zone will force change, laying the foundations for a prosperous economy. Which would you chose?

### ***Bond vigilantes to the rescue***

European integration has its roots in two wars in the previous century, the horrors of which are difficult to comprehend today. It started with the Coal & Steel Community in 1951 and has marched on steadily since. Germany is a major beneficiary, politically and economically. EMU is an integral part of integration. It is not going to stop now because the bond vigilantes have (finally!) flagged EMU's shortcomings. On the contrary, the bond vigilantes are strengthening EMU by forcing on it the additions which will make it work better.

### ***Wishful thinking***

In trying to understand the so firmly held belief, of so many in Britain and America, in a fractioning, of one sort or another, of the monetary union, in spite of the weighty factors making this unlikely, one can't help wondering whether some wishful thinking is involved here. The single currency project was never much liked by Britain for reasons that go all the way back to the enduring legacy of Foxe's 1653 Book of Martyrs (which celebrates England's sovereignty and burnishes its self-reliance).

The US administration has always been supportive of European integration. Still, the euro is a potential rival to the dollar as the world's leading currency, could even undermine its "exorbitant privilege". It was interesting to note during last summer when the euro was under attack, briefly falling below USD1.20, how many American forecasters predicted that parity was just around the corner.

### ***A potential 600 million rival***

The euro clearly *is* a potential rival to the dollar, unreal as that may seem today. This, of course, assumes the above analysis is correct and EMU emerges from its current toils strengthened. In terms of population the euro bloc and the US are about equal, exceeding 300 million souls. But the euro area is unfinished business.

In the course of the current decade up to 10 more countries may join (excluding the UK), raising the people count to 430 million. That too may not be the end. More countries are queuing up to join the EU and will presumably join the euro zone in due course. By 2030 the euro zone may conceivably consist of 30 plus countries with a combined population of 600 million.

Don't write the euro off.

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