Euro break-up could be cure

The plight of Europe and its currency went under the spotlight at HKUST's finance forum. Reports by **John Cremer**

Seminar participants included (from left) Water Cheung of StormHarbour Securities, Wendy Guo of the CFA Institute, Bruno Solnik of HKUST's Finance Department, Kenneth Howe of SCMP Publishers, and HKSFA's Jimmy Jim. Photos: Dickson Lee

After a lengthy period of delay, confusion and behind-the-scenes bargaining, the 17 members of the euro zone appear no closer to resolving their most pressing issue: what to do with their currency.

It may turn out, as many seem to hope, that given enough time, the problems will simply go away, and short-term fixes will eventually right the ship.

But as Professor Bruno Solnik, of Hong Kong University of Science and Technology's (HKUST) Finance Department, spelled out in the latest HKUST/NYU Stern – Global Finance Seminar Series, inaction or limited measures would only prolong the pain.

In his view, more drastic surgery was needed. The sooner Europe's politicians and central bankers realised this, the easier it would be to restore growth, stability and economic sense.

Solnik, who teaches the MSc in global finance programme offered jointly by HKUST Business School and the NYU Stern School of Business, spoke under the topic "Financial Markets and the Eurozone Crisis: Some Provocative Views". He said he had little time for an approach that ignored root causes and, in doing so, pumped more money into propping up a crumbling structure.

He saw the euro-zone break-up as the way forward, with the economically weaker countries leaving and the rest better able to align their interests.

"A short-lived crisis in which you address the fundamentals is better than being 'on Prozac' while the problem gets worse," Solnik said. "At the moment, people are paying hundreds of billions of euros or dollars to buy time, which is only making things more difficult. I think, though, the euro will implode – and the sooner, the better."

His reasoning stemmed from a belief that the initial concept of the euro was seriously flawed. Having economic powers such as France and Germany in a fixed exchange-rate system with smaller developing countries such as Slovenia and Malta was always going to be asymmetric.

Coupled with huge subsidies for Greece, Spain and others, plus the chance for such nations to increase borrowing capacity by issuing sovereign bonds in "risk-free" euros, and the seeds of disaster were sown long ago.

"The speculative tensions and moral hazards built into the system are too much," Solnik said. "Rather than seeing this as a chance for structural reform, the politicians just started spending wildly. This was aggravated by the credit liquidity crisis of 2007 and 2008 when you saw, for example, a dozen new airports being built in Spain because each city wanted its own."

In Solnik's view, the problems went right back to the calculation of purchasing-power parity and the "legacy rate" for each country entering the euro. It was assumed at the time that Greece, for instance, would reform, become more competitive and, within five years, resemble the idealised euro economic model. That didn't happen and, as things now stand, isn't going to.

There was too much disparity between the stronger and weaker euro-zone countries, which shows in the current account balance, Solnik said. The "southern" nations now have a significant competitive disadvantage – compared with, say, Germany – with higher unit labour costs and punitive borrowing costs.

Since the advent of the fixed euro in 1999, labour costs in most southern countries have increased by 30 per cent or more relative to Germany. Without the option of devaluation through an adjustable exchange rate, they're caught in a trap where things just get worse.

Disguising the realities or papering over the cracks simply won't work. No country can hope to hold its own if it is borrowing at 6 per cent versus 1.5 per cent for others – or if, like Spain, it has an overall debt level above 100 per cent of GDP. Countries such as Spain or Italy, where government debt is at such a significant level versus GDP, need to grow their GDP at 6 per cent annually just to offset what is burned in interest charges. Others, such as Germany, only need to grow at 1.5 per cent. For the euro zone to flourish, this growth differential needs to become smaller, but instead it is getting bigger.

Solnik advocates quick, decisive and drastic action. He believes that countries for which the euro is obviously a burden – and which continue to drag down the rest of the euro zone – should be shown the door.

A core group of "northern" countries could remain. In due course, all could find their true level of competitiveness in the global economy, implement the necessary structural reforms, and bring runaway debt back under control.

There would inevitably be knock-on effects for the rest of the world, with bond yields initially rising in most markets. But overall, Solnik thinks many assets will retain their real value.

"A divorce is usually very messy, but you have to ask whether it is better to do so or suffer through an unhappy marriage," he said. "I think a euro-zone break-up is the best solution, but politicians are politicians. They are not necessarily very smart and, if elections are coming up, they won't do anything unpopular."

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> BRUNO SOLNIK, PROFESSOR, HKUST FINANCE DEPARTMENT

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Water Cheung, senior partner and CEO of Asia-Pacific, StormHarbour Securities, predicts an asset attack.

Crisis creates opportunities

Everyone has an opinion on how the euro-zone crisis should be resolved, but according to Water Cheung, an expert panellist at the latest HKUST/NYU Stern – Global Finance Seminar Series, only a few individuals hold the key to the solution.

"It all depends on the politicians and the Germans," said Cheung, a senior partner at StormHarbour Securities (Hong Kong). "They have to draw a clear line on what the euro-zone countries are collectively willing to do, and then convince the rest of the world that they are doing enough to re-establish order."

Cheung said he was keeping an open mind on whether that should mean a smaller euro-zone or keeping the status quo. Either way, viewed by an investor from Asia, the situation would create a number of opportunities.

Indebted countries and potential sellers know all about Asia's strong balance sheets and foreign-exchange reserves, and can sense what is around the corner. Politicians in Europe are naturally averse to stirring up public resentment by disposing of state-owned assets at a steep discount, but they can always find reasons to do a deal.

"The more successful transactions are those underpinned by extremely good-quality assets which were not previously available in the market," Cheung said. "A case in point is China's Three Gorges, one of the largest hydroelectric power companies in the world, acquiring a 21 per cent stake in Portuguese energy company EDP."

Cheung also noted that significant amounts of capital had been accumulating in the US with a view to snapping up distressed assets in Europe. So far, though, potential investors had largely kept back, pending developments.

"The main reason is waiting for the currency issue to be resolved. Until then, the exchange-rate risk is deemed too high and too volatile for a proper risk or return evaluation," Cheung said.

In the event of the euro zone breaking up in a "messy divorce", there would be different types of uncertainty. However, as every trader or investor knows, that would also bring opportunities.

"We are seeing now that different countries in Europe have different utility functions," Cheung said. "But remember, too, that we live in an imperfect world, and imperfection often lasts longer than people expect."

Leaders failing to unite in one voice

Like many people wondering how Europe could extricate itself from its current crisis, Jimmy Jim, president of the Hong Kong Society of Financial Analysts (HKSFA), said he was struck by the inherent contradiction between what was being said and what was being done.

One day, all the talk could be about austerity and the need for self-discipline. The next, following the latest summit or national election, attention would focus on a new round of measures to support debt and stimulate spending.

"If you go back to the fundamentals, there are two possibilities," said Jim. "You take the medicine, endure the pain, and then see the gains of a recovery. Or you keep the stimulus going in a big way and hope you can grow your way out of the crisis."

His major concern was that, between them, Europe's disparate centres of power were pulling in different directions and didn't speak with one voice. As a result, it would take longer to achieve any kind of sustained turnaround. In the meantime, other markets and regions would have to keep dealing with the consequences.

"When Europe floods the market with liquidity, it isn't going into the real economy there [creating jobs and consumption]," Jim said. "It goes 'out' to chase assets which can give a better return. People are looking to Asia, trying to buy assets there to hedge their situation until things improve."

All this stimulus money flowing into Asia wouldn't help anyone much in the long run. It could spur inflation and threaten growth. In Hong Kong, people were already feeling the pinch from higher property and food prices. Elsewhere, the impact on GDP and the cost of living could slow progress on numerous fronts.

"The ECB [European Central Bank] keeps flooding markets with liquidity while saying you have to impose austerity," Jim said. "Buying time in this way doesn't fix the structural problem. You have to find the right direction and the right dosage. We need to see real action, but it seems it is all a politicians' game now."

As part of this "vicious cycle", he believes Asia faces a second risk. When the first signs of a marked pick-up appear in Europe or the US, investment in emerging markets could leave as fast as it arrived. This was because today's financial market mechanisms, more geared to short-term opportunities, won't necessarily work in a way that would encourage prudent, "slower" strategies.

"If all that hot money moves out of Asia again, you will see a bubble burst, so either way it is not good," he said.

On a lighter note, Jim said he had noticed his overseas contacts have distinct perspectives on how Europe would fare. "If you talk to Americans, they say there is no hope, it is a doomsday scenario. If you talk to Europeans, they say give us time, we'll sort it out in a few years," he said.

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>
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Jimmy Jim, president of the HK Society of Financial Analysts, says real action is needed in the euro zone.