





HAS THE SUPER EURO

FOUND ITS KRYPTONITE?

The Euro Crisis and the Future of Money

By Troy Anderson

Comparing the European debt crisis to our lackluster economic recovery in the United States is “almost like an ugly-girl contest.”

“We look good by comparison,” says David Mahmood, chairman and founder of the Dallas-based Allegiance Capital Corp., a middle-market investment banking firm.

“We have in this country a dysfunctional Congress, a debt crisis of a rather severe magnitude, but when you compare us to the rest of the world, we are still perceived as a fairly safe place to put money. In other words, we are not the best-looking person, but we are probably the least ugly person in the room at the moment; and as you narrow it down, Texas looks even better.”

The relative economic health of the Texas economy is a bright spot amid growing concerns about the European debt crisis and what impact it could have on the United States' economy. The U.S. and the European Union are the two largest economies in the world, accounting for nearly 50 percent of global gross domestic product. The U.S. and the EU are also each other's most important markets for products and investments.

"What happens in Europe is important to Houston, but it doesn't determine our fate," wrote the authors of a recent forecast by the Greater Houston Partnership, a 2,100-member business organization that represents the 10-county region surrounding Houston. "The Eurozone accounts for only 15.9 percent of Houston's exports. The greater danger is that the European crisis will destabilize U.S. banks holding European debt and that U.S. credit markets will tighten even more, impeding an already weak U.S. recovery."

A CONTAGIOUS RECESSION

Economic experts believe Europe is likely to plunge into a deep economic recession this year, potentially derailing the modest economic recovery in the U.S.

Daniel Hanson, an international economics researcher at the nonpartisan American Enterprise Institute in Washington, D.C., says the U.S. financial system doesn't have a high degree

THE U.S. AND THE EUROPEAN UNION ARE THE TWO LARGEST ECONOMIES IN THE WORLD, ACCOUNTING FOR NEARLY 50 PERCENT OF GLOBAL GROSS DOMESTIC PRODUCT.



of exposure to the debts of Greece, Ireland, Portugal, and Spain, but that it is "hugely at risk" when it comes to the European Union as a whole.

For instance, American money-market funds have more than a third of the assets – in excess of \$1 trillion – invested in European banks, which in turn are leveraged 35-to-one against the sovereign debt of nations like Greece and Italy, Hanson says.

"That's one way in which we could see this contagion through the financial sector that bleeds its way across the Atlantic, sort of in reverse of the financial crisis we saw in 2008," Hanson says. "We could see European banks start to fail and

American banks follow suit."

The enormity of the debt is likely to be too much for European governments to handle. As a result, Hanson believes a day of reckoning is approaching for nations like Greece and Portugal.

"I think Europe is headed for a pretty sharp recession," Hanson says. "Thanks to growth in the German economy, the continent as a whole is benefiting, but that is only sustainable for so long. And so if it continues to slow, as I think it will, and some major market relocations happen, the likelihood of a recession in Europe is pretty high. The contagion the U.S. can expect from that is pretty high, but whether that means the U.S. will slip into another recession is up for debate."

It's been nearly five years since the troubles in the U.S. subprime mortgage market erupted, igniting the worst financial downturn since the Great Depression. In the meantime, a global panic has developed in connection with the Eurozone debt crisis.

In recent months, there has been a marked intensification of the European debt crisis. The Greek economy seems to be in free fall, with a 12 percent contraction in gross domestic product over the last two years and an increase in the unemployment rate to 18.5 percent. The crisis is also affecting Ireland and Portugal, along with Italy and Spain – Europe's third- and fourth-

largest economies, respectively.

“Greek banks are now rapidly losing deposits,” Desmond Lachman, a resident fellow at the American Enterprise Institute, testified at a recent hearing before the House Committee on Oversight and Government Reform. “This makes a substantial write-down of perhaps as much as 75 cents on the dollar in Greece’s U.S. \$450 billion sovereign debt highly probable in the next few months. Such a default would constitute the largest sovereign debt default on record and would almost certainly accentuate the contagion that is already in evidence in the European periphery.”

Sovereign debt defaults in the European periphery would have a major impact on the balance sheets of the European banking system. The International Monetary Fund estimates that European banks are undercapitalized by \$300 billion. Meanwhile, private market analysts fear that European banks might reduce lending by as much as \$3 trillion over the next 18 months.

A UNITED NATIONS WARNING

Recently, the United Nations Department of Economic and Social Affairs reported that the world economy is at a critical juncture, with the momentum of global growth faltering and a heightened risk that some major developed countries could slide into a double-dip recession this year, “dragging the rest of the world into another dire economic downturn.” Economic growth has slowed in the U.S., Japan is already in another recession, and growth in developing countries like China, India, and Brazil has moderated.

“The fiscal and financial woes, combined with elevated unemployment, widening income inequality, and flagging economic growth, are posing formidable challenges for policy makers in major developed economies,” the report states.

Amid this political gridlock and fears of another global economic shock, China and other nations, and monetary experts, have stepped up calls for a new global reserve currency or a multi-currency system.

“Some countries are envious of the U.S. position,” says Robert E. Scott, director of trade and manufacturing

policy research at the Economic Policy Institute in Washington, D.C. “They would like to see their currency have more global status. There was talk for a time of the euro assuming status like that. But now the euro is basically falling apart. Europe has fundamental structural problems that the Europeans have refused to acknowledge or deal with. They keep coming up with half-baked

solutions that are attempting to punish the poor countries for what is in fact a region-wide problem in Europe.”

A CALL FOR GLOBAL AUTHORITY

Meanwhile, the Vatican just issued a report – “Towards Reforming the International Financial and Monetary Systems in the Context of a Global Public Authority” – calling

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for the creation of a “Global Public Authority” and a central world bank to oversee financial institutions that have become ineffective in dealing with global economic crises.

The Vatican report says the financial crisis has “exposed behaviors such as selfishness, collective greed, and the hoarding of goods on a mammoth scale,” along with great economic, social, and cultural inequities. In response, the Vatican has called for the creation of the Global Public Authority to ensure the “common good.”

This authority would draft policies involving “global social justice,”

financial and monetary policies that “will not damage the weakest countries and policies aimed at achieving free and stable markets and a fair distribution of world wealth.” Expressing concerns that the International Monetary Fund has lost its ability to stabilize the world economy, the report calls for the creation of some form of global monetary management too.

“It is obvious that to some extent this is the equivalent to putting the existing exchange systems up for discussion in order to find effective means of coordination and supervision,” the Vatican study states. “In fact, one can see an emerging requirement for a body that will carry out the functions of a kind of ‘central world bank’ that regulates the flow and system of monetary exchanges, as do the national central banks.”

In recent years, China, Russia, the U.N., the World Bank, the International Monetary Fund, and many economists and politicians around the globe have called for the creation of a new global reserve currency – or a multi-currency system – as a way to help avert another financial catastrophe triggered by any single country or part of the world.

GRADUAL CURRENCY CONSOLIDATION

A recent report by the World Bank – “Multipolarity: The New Global Economy” – predicts that by 2025 six major economies – Brazil, China, India, Indonesia, South Korea, and Russia – will account for more than half of all global growth, and that the international monetary system will likely no longer be dominated by a single currency. As a group, the report foresees, emerging economies will grow on average by 4.7 percent a year between now and 2025. Advanced economies, meanwhile, are forecast to grow by 2.3 percent over the same period yet will remain prominent in the global area, with the Eurozone, Japan, the United

Kingdom, and the U.S. all playing core roles in fueling global growth.

“Over the next decade or so, China’s size and the rapid globalization of its corporations and banks will likely mean a more important role for the renminbi,” says Mansoor Dailami, lead author of the report and manager of emerging trends at the World Bank. “The most likely global currency scenario in 2025 will be a multi-currency one centered around the dollar, the euro, and the renminbi.”

The IMF echoed this prediction in its own recent report – “Internationalization of Emerging Market Currencies: A Balance between Risks and Rewards.” The report notes the global financial crisis has renewed debate about the IMF and a multi-currency system.

The concentration of many functions of the international monetary system in one or two currencies, while efficient, does not reflect the increasingly multi-polar structure of the global economy, the IMF report claims. Further, such concentration may increase systemic vulnerability stemming from shocks or policy decisions in global currency issuers that may not be appropriate for the rest of the world. This also leads to an uneven sharing of currency risk among international currency issuers and others.

In addition, the report states, the global financial crisis and debt sustainability concerns have raised questions over the long-term store of value properties of the main global currencies, and along with it, have created interest in encouraging wider use of the IMF’s Special Drawing Rights (SDRs) and various emerging market currencies, particularly the renminbi.

CAN THE EURO SURVIVE?

But Lloyd J. Dumas, a professor of political economy, economics and public policy at the University of Texas, Dallas, says proposals for a global currency are a “very bad idea,” especially in light of the problems now associated with the euro – the official currency of the Eurozone first introduced in 1999. Today, 17 of the 27 members of the European Union use the euro. More than 330 million Europeans use the euro, and more than 175 million worldwide – including 150 million in Africa – use currencies that are pegged to the euro.

“One of the reasons the euro got itself into trouble is the fact that all these different countries with different fiscal policies are trying to operate with a single monetary authority and a single currency, which put everybody into the same bucket, so to speak,” Dumas says. “What the EU has tried to do with the euro with a common monetary authority has led to serious problems with the value of the euro. So, I think doing that on a global scale is a bad idea.”

As far as the Vatican’s call for a Global Public Authority to guide economic policies and decisions, Dumas says he understands why the Vatican is concerned with growing economic inequities in the world, but a global authority is not the answer.

The genesis of the problem is not in monetary policies, says Dumas. And tax laws and spending programs, rather than monetary policies, are the best tools for reducing inequities. “Tax policies and spending programs are also the best way to stimulate the economy when it needs it and the way to cool an overheated economy.”

OVERSPENDING AND OVER-OWING

Steven Craig, a professor of economics at the University of Houston, says a Global Public Authority or global currency is not going to address the underlying problems plaguing the EU and the U.S. – massive debts and lack of political will to address an addiction to borrowing and spending.

Craig doubts that calls for a new global reserve currency will gain traction, but he says a multi-currency system in the future is a good possibility.

“As globalization occurs and other countries like China, India, and some in South America became wealthier, it would not be unreasonable to be holding a basket of currencies instead of one currency,” Craig says. “So, the role of the dollar will be reduced over time.”

Mike Larson, an analyst at Weiss

Research, an investment advisory firm in Jupiter, Florida., says the financial crises in the EU and U.S. were years in the making and will take substantial time to resolve.

“I think this boils down to a problem of too many sovereign nations and too many banks owing too much money and having too much debt,”



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Larson says. “There isn’t a pot of money out there that we are somehow missing that is big enough to solve this problem.”

As a result, neither a global currency, nor a multi-currency system, nor other proposed reforms are going to solve the core issue of too much debt and spending by the developed nations. “We’ve been trying all these stopgap measures for five years, and

despite all the time and money spent, our housing market is still stuck in the mud,” Larson says. “When you have a massive bubble, you’ll have a long-term phase to work off the excesses. No politician will admit this.”

The U.S. can have sub-par economic growth and companies can still succeed, says Larson. “But this is an environment where we won’t have the

1990s-style economic growth. That was almost a Goldilocks economy – low interest rates and strong growth. But this is a different world where companies need to adapt. Companies need to have reasonable expectations in terms of returns.”

THE DOLLAR STILL STRONG

Mahmood says the Eurozone crisis “scares the bejesus” out of him. He describes it as a bomb with a slow-burning fuse. “Nobody knows whether it’s a few sticks of dynamite or whether it could be devastating enough to drive the world into another recession or even a depression.”

On a positive note, Mahmood expects Texas to outperform the rest of the nation this year, regardless of what happens to the Eurozone. Meanwhile, Mahmood expects the dollar to remain the “gold standard” as the world’s reserve currency.

“But if we don’t address our problems, then certainly the Chinese will eventually overtake us and there will be a change, but it’s not something that is imminent,” he says. “If I had to guess, I’d say it’s seven to 10 years out, and maybe even longer; but a larger part of our future relative to the dollar is in our hands. We are either going to strengthen our economy, deal with the debt crisis, or we are going to continue to muddle along – little by little, like Nero fiddling while Rome burns. If our leaders and politicians don’t get their act together, we’re in for some tough sledding.” **N**

Troy Anderson is an award-winning journalist with 20 years of experience, including 12 years as a reporter and editorial writer at the Los Angeles Daily News and The Press-Enterprise (Riverside, Calif.). He writes for Reuters, Bankrate.com, World, Christianity Today, and many other magazines and online publications. He lives in Southern California.