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Is Greek exit from eurozone really necessary?

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The last two weeks have brought data confirming a slump in Europe and a slowdown in China, while in the US there are mounting expectations that house prices have finally bottomed.

The deceleration of activity in Europe appears finally to be having an impact on Germany. Chancellor Angela Merkel has reversed her earlier position and lent her support to more aggressive accommodation by the ECB.

China's slowdown is deepening in spite of the central bank's easing stance, and that is starting to impact on the economies and politics of neighboring countries that have benefitted from the Chinese boom.

In Taiwan, which I visited last week, the pro-China Ma administration was re-elected in January with a pledge to boost economic growth by developing stronger links with the fast-growing mainland. The subsequent slowdown there has depressed Taiwanese growth and left the government's public support rating in tatters.

Merkel lends support to ECB bond purchases

German Chancellor Angela Merkel's decision to switch course and fall in line with the ECB represents a great step forward. The eurozone currently suffers from two main problems: a balance sheet recession on one hand and capital flight—whereby Spain's private savings end up in the German government bond market—on the other. Monetary accommodation cannot be expected to have a major impact on the first but can mitigate the second. Accordingly, I see the ECB's newfound policy flexibility as a major positive development.

That said, ECB purchases of Spanish government bonds at this point will do little to address the balance sheet recession triggered by Spain's private sector increasing savings and paying down debt in spite of near-zero interest rates.

This should be clear from the fact that the Japanese, US and UK economies have yet to recover despite massive purchases of government debt by their respective central banks.

However, those bond purchases mean that the money that is no longer being spent by a debt-minimizing private sector is at least being used to purchase government debt, lowering government bond yields and enabling these countries to administer at low cost the fiscal stimulus needed during a balance sheet recession.

ECB bond purchases crucial in short term even if longer-term issues remain unaddressed

The problem in the eurozone, however, is that the surplus Spanish and Irish private savings generated by deleveraging efforts are not being used to purchase domestic government debt, as in Japan, the US or the UK, but instead are fleeing to government bond markets in places like Germany and Finland.

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When capital flows out of a country experiencing a balance sheet recession and widening fiscal deficits, bond yields rise, forcing the government to pursue fiscal consolidation. But if the government moves to repair its balance sheet at a time when the private sector is doing the same, aggregate demand will fall sharply, plunging the economy into a deflationary spiral, which in turn spurs further capital flight in a vicious cycle.

ECB purchases of periphery debt would be effective in cutting this financial negative feedback loop that begins with capital flight and ends with a dysfunctional government bond market.

Longer-term answers to this eurozone-specific problem include (1) fiscal stimulus to tackle the balance sheet recession itself and (2) a rule that addresses the issue of capital flight by restraining, if not prohibiting, the sale of government bonds to non-nationals. But given that both of those measures will probably take years to implement, the only short-term option is to have the ECB buy the government debt of peripheral countries.

ECB debt purchases similar to Fed purchases of MBS

ECB purchases of periphery debt should be viewed similarly to Fed purchases of MBS. It is only now, fully three years after those purchases began, that the US housing market is finally showing signs of turning around.

Yet if the Fed had not begun buying MBS when it did, the MBS market would likely have collapsed altogether, accelerating the drop in US house prices. The resulting negative feedback loop could have further delayed recoveries in the housing market and the US economy.

It is important that the ECB's bond-buying policy succeeds in ending this vicious cycle. Still, it will do nothing to solve the problems in the real economy created by the housing bubble collapse.

Many Germans still pushing for Greek exit

While Chancellor Merkel said in her recent remarks that she hoped Greece would stay in the euro, many in Germany would like to see Greece leave the common currency. Even within the chancellor's own party there are many who favor an eventual exit.

They cite the fact that Greece's economy is far less competitive than Germany's and note that whereas Germany undertook painful structural reforms from 1999 to 2005, Greece has done nothing. Under such conditions, they argue, a Greek exit is inevitable.

By structural reforms are meant (1) the 1999 agreement reached by German government, industry, and labor to keep wage increases below productivity improvements and (2) the pension and labor market reforms the nation adopted in the first half of 2000.

German money supply growth stagnated in 2000s

While these initiatives were important, I have shown in previous reports that a key contributor to the competitiveness gap between Germany and Greece was the slump in the German economy and money supply growth (relative to other eurozone nations) after Germany's IT bubble burst in 2000, ushering in a balance sheet recession.

The eurozone money supply (ex Germany) grew a cumulative 108% from 2000 until Lehman Brothers collapsed in 2008 Q3. Greece's money supply expanded by 101.5% over this period, as Figure 1 shows.

But in Germany, where the private sector responded to the bubble's collapse by collectively moving to pay down debt, the money supply grew by just 56%. This naturally helped to restrain wage and price inflation.

Greek unit labor costs carried premium of more than 30%

German price inflation during this period was significantly lower than in the rest of the eurozone: unit labor costs moved sideways in spite of pronounced increases elsewhere in Europe.

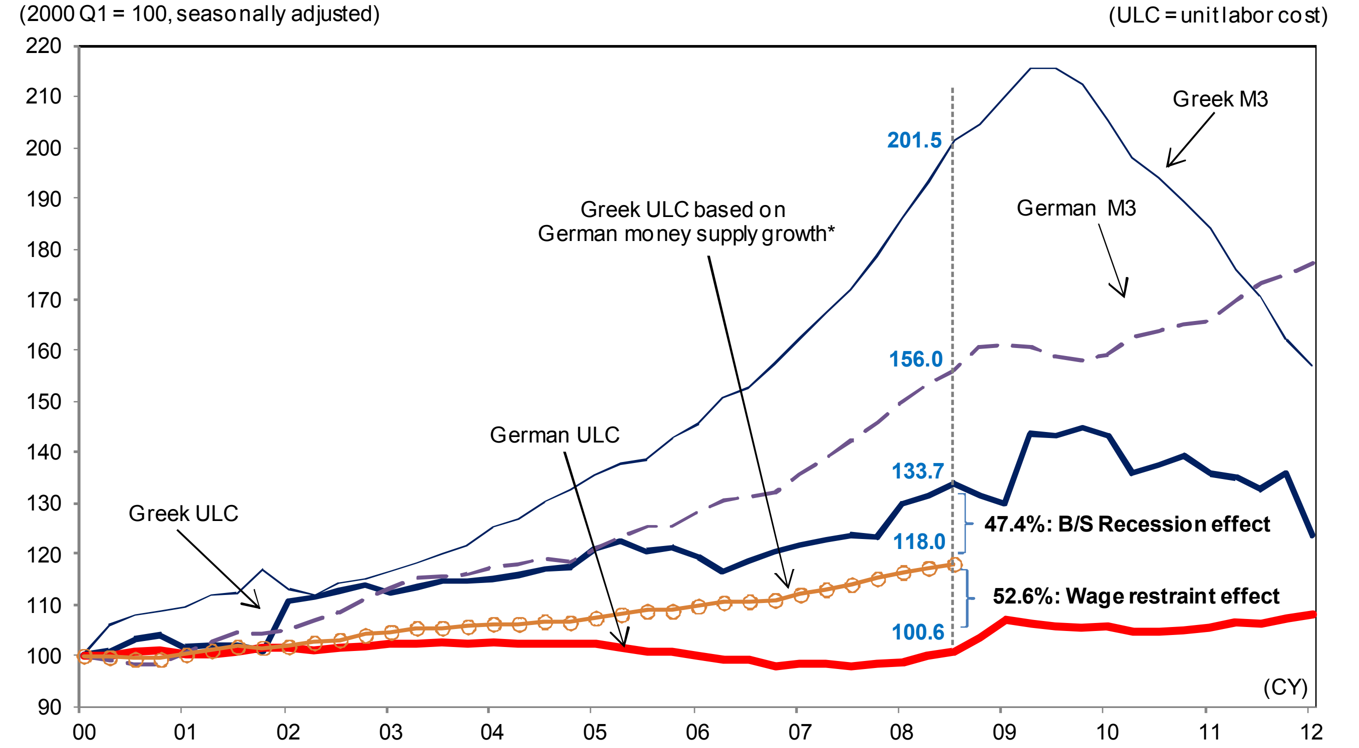
In Greece, for example, unit labor costs rose 33.7% between 2000 and 2008 Q3, while in Germany they rose just 0.6% (Figure 1).

That implies that if Greek and German labor competitiveness had started out at the same level in 2000, Greek labor would have been more than 30% more expensive (33.1ppt) by the time Lehman went under.

What drove the competitiveness gap?

The question then becomes how much of this 33.1ppt differential can be explained by Germany's painful structural reforms and how much by the nation's balance sheet recession. I estimate that each factor was equally responsible.

Fig. 1: Macro- and microeconomic factors driving competitiveness gap



Note: * Parameters obtained from the regression result on Greek ULC on Greek M3, log (Greek ULC) = 2.92075 + log(Greek M3) x 0.372586, applied to German M3 data indexed to 2000 Q1= 100.

Sources: Nomura, based on ECB, Deutsche Bundesbank and Bank of Greece data

Starting with the fact that unit labor costs in Greece climbed by 33.7% during this period while the money supply grew by 101.5%, I conducted a regression analysis to determine to what extent changes in Greek unit labor costs can be explained by changes in the money supply. When the findings were applied to German money supply growth, they suggested unit labor costs would have grown by 18.0% over the same period if the Greek money supply had grown at the same rate as Germany's. This is considerably lower than the actual figure of 33.7%.

Accordingly, I conclude that 15.7ppt of the gap in unit labor costs (33.7% – 18.0%), or 47.4% of the 33.1ppt gap, can be explained by differences in money supply growth between the two nations.

Structural reforms responsible for only half of competitiveness gap

As German unit labor costs rose by only 0.6% over this period, the 17.4ppt (18.0% – 0.6%) that cannot be explained by differing rates of money supply growth—52.6% of the 33.1ppt gap—can be attributed to structural reforms.

This means while a microeconomic factor—the structural reforms often touted by Germans—played an important role, accounting for more than half (52.6%) of the competitiveness gap with Greece, the remaining 47.4% is attributable to a macroeconomic factor—a balance sheet recession in Germany at a time when Greece had a robust economy.

These are very rough estimates, of course, and there are a number of issues with the analysis, but I think they provide an indication of the extent to which Germany's balance sheet recession has affected competitiveness.

Competitiveness disparity is narrowing

The above macroeconomic factor is now working on both the Greek and German sides to narrow the competitiveness gap.

Since 2010, for example, money supply growth has accelerated in Germany while falling sharply in Greece, which continues to experience capital outflows. Money supply lines for the two countries in Figure 1 intersected in 2011 and have since continued to move in opposite directions.

This trend implies that Greek inflation and unit labor costs will continue to fall, and in fact unit labor costs have already dropped more than 10% since the 2010 peak. Given the time lag between changes in the money supply and their impact on prices and unit labor costs, I anticipate further declines in the latter.

The gap between German and Greek unit labor costs has already dropped to less than half the 2009 peak, and I suspect it is only a matter of time before it disappears altogether.

Benefits of Greek exit diminish by the day

There is clearly less justification for a Greek exit from the euro now that the unit labor cost gap is closing, in part because of macroeconomic developments (ie money supply growth) in both countries.

The biggest reason for an exit, after all, was to allow Greece to restore competitiveness with a devalued currency. But the country is already a long way toward achieving that end with the decline in unit labor costs, and the remaining gap will eventually be closed by money supply trends in the two nations.

Had it not been for Germany's structural reforms, the competitiveness gap between the two countries would already have been eliminated.

This argument, of course, is based on the premise that unit labor costs in the two countries were roughly similar in 2000, but given that there was no discussion of a "competitiveness gap" in 2000 I think the assumption is largely valid.

Turmoil in Argentina took many years to subside

That the unit labor cost gap will disappear in the near future is significant because it would also take a long time for Greece to overcome the turmoil resulting from a decision to leave the eurozone.

Argentina's 2001 default and discontinuation of the dollar peg is often cited as having many parallels with the Greek situation. It took Argentina more than five years to overcome the resulting disruption to its economy even though the country had its own currency in the peso.

When I visited Argentina last summer at the invitation of the nation's central bank, I had the opportunity to speak with locals about those events. People who had worked in the financial sector when deposits were frozen said they did not even want to think about those events and never wanted to go through a similar experience again.

Those employed at private-sector banks in particular said that, amid the turmoil and breakdown of social order, they went to work every day with the expectation they might be killed by angry rioters or depositors.

As a rule, transitions from a weak currency to a strong one tend to go smoothly and be well-received, while moving in the other direction is extremely difficult and often requires heavy-handed measures like the freezing of deposits.

Long adjustment period means there are no benefits to Greek exit

If the gap in unit labor costs between Germany and Greece were to disappear in two to three years, there is no reason why Greece should choose to exit the euro when the resulting turmoil would take five to ten years to subside.

It may not even take two or three years to extinguish the disparity in unit labor costs, if Greek labor unions agree to wage cuts on the condition that current employment levels are maintained.

And such an agreement is not at all unlikely with the unemployment rate at 23%.

A senior German official I spoke with on my June visit to Berlin said Greek prices and wages were starting to become more competitive. If that recognition leads to greater private investment in Greece, it could signal a new dawn for the economy there.

Unit labor costs also falling elsewhere in eurozone

Unit labor costs have also declined markedly in Ireland, Spain, and Portugal, as Figure 2 shows.

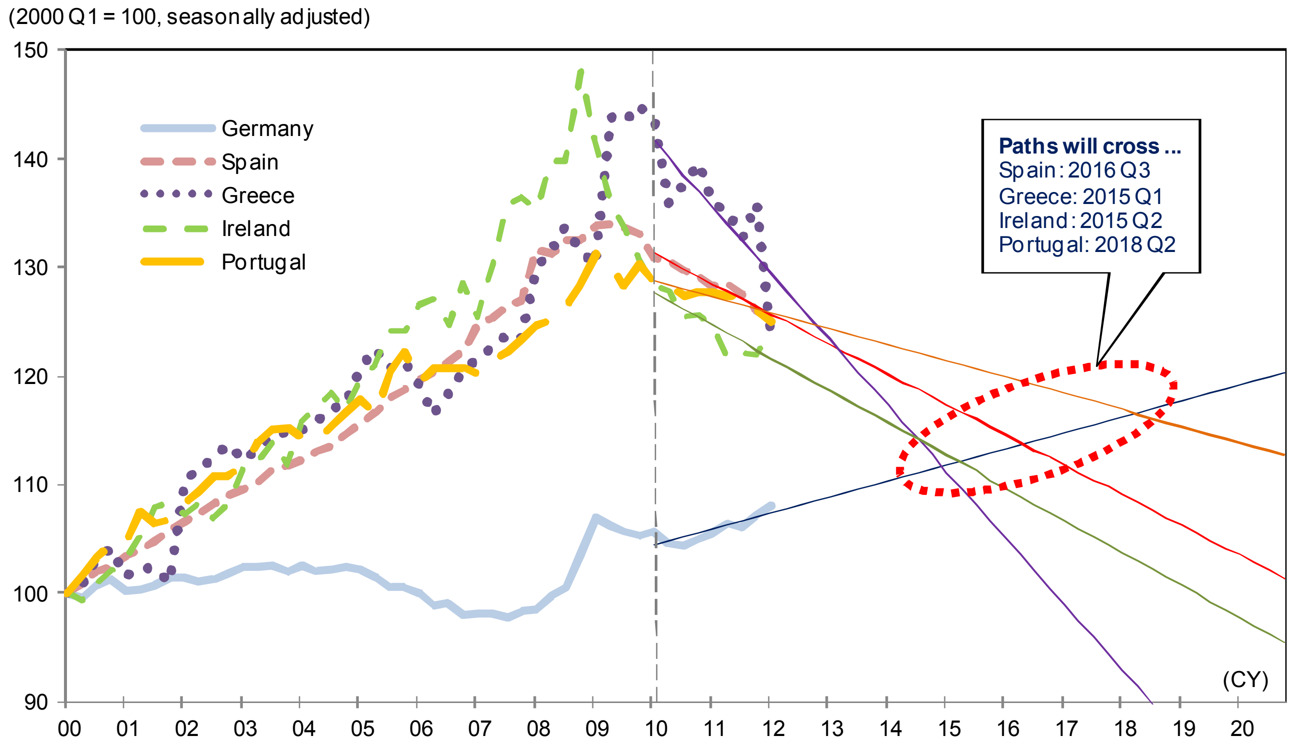
This is a natural outcome given that these economies are in severe balance sheet recessions and Spain's unemployment rate in particular is approaching 25%.

If we look at the trend of unit labor costs in these countries and Germany, starting from 2010 Q1, Germany's trend line intersects Greece's in 2015 Q1, Ireland's in 2015 Q2, Spain's in 2016 Q3, and Portugal's in 2018 Q2.

Germany's competitiveness gap with other countries also expected to vanish in several years

While such estimates depend heavily on the period chosen, more recent trends indicate that—with the exception of Ireland—the competitiveness gap with Germany may disappear even sooner than the estimates above suggest.

Fig. 2: Eurozone unit labor costs seen converging



Notes: The figures of Greece, Ireland and Portugal are seasonally adjusted by Nomura Research Institute. Path of ULC growth was estimated based on trend from 1Q 2010 to 1Q 2012.

Source: Nomura Research Institute, based on ECB's data

The correction is likely to end long before 2015 in Greece, where money supply growth has fallen so sharply.

In Ireland, unit labor costs have already slid nearly 20% from their late 2008 peak, and given the nation's reputation for low wages in 2000 I suspect it has already regained much of its former competitiveness.

Growing German acceptance of rising wages has also helped narrow gap

In Germany, meanwhile, there are growing calls for the nation to rectify the excesses of the three-party agreement of 1999. Even the Bundesbank, renowned as an inflation fighter, said several months ago that German wages should be allowed to rise as long as they were accompanied by corresponding gains in productivity.

With Germany's unemployment rate at a 20-year low and industrial output almost back to the pre-Lehman peak, it is only natural that German wages should rise, which means the competitiveness gap is likely to disappear even sooner.

Of course there is no guarantee that an internal deflation-driven revival of competitiveness in peripheral nations will lead to economic recovery. This is particularly true in countries like Ireland and Spain, which are in the midst of severe balance sheet recessions and will experience further drops in domestic demand if nothing else is done.

Could diminishing competitiveness gap spur acceptance of fiscal stimulus?

Until now the argument commonly heard in Germany was that peripheral countries were in such deep recessions because their economies were uncompetitive. In effect, they were looking at phenomena caused by a balance sheet recession and trying to attribute them to a lack of competitiveness, when in fact that is only partly responsible.

Hence the German argument that there can be no economic recovery in the periphery without structural reforms. But as noted above, much of the improved competitiveness that structural reforms are supposed to produce has already been achieved by internal deflation.

That these nations' economies have still not recovered is due to the fact that—with the exception of Greece—they are in balance sheet recessions, and the only way to address those recessions is to administer the fiscal stimulus that Germany so strongly rejects.

Germany may be unable to accept the theory of balance sheet recessions until unit labor costs in the periphery drop to German levels. In other words, the pain in the eurozone is likely to continue until the competitiveness gap disappears and Germans realize the theory of balance sheet recessions is the only way to explain the continued economic slump.

US economy likely to contract in 2013 unless fiscal cliff is averted

Last week the Congressional Budget Office (CBO) published estimates of the impact of the so-called fiscal cliff that Fed Chairman Ben Bernanke warned about. US GDP will shrink by 0.5% in 2013 and the unemployment rate will rise to 9.1% unless the fiscal cliff is avoided, according to the CBO.

The CBO estimates that US taxpayers face a potential tax increase of $500bn. With government expenditures likely to remain largely unchanged, the CBO expects the US budget deficit to decline by a corresponding amount.

These estimates are based on the assumptions that the Fed implements QE3 and overseas economies continue a modest recovery.

Fiscal contraction most dangerous during balance sheet recessions

Increasing taxes by 3% of GDP at a time when the US private sector is already saving 7% of GDP each year in spite of zero interest rates could deliver a tremendous blow to the economy.

And if the government reduces its borrowings by $500bn at a time when the private sector has not only stopped borrowing but is actually paying down debt, the money multiplier will turn heavily negative at the margin, and the money supply could shrink substantially.

Under normal economic conditions fiscal consolidation can boost economic growth by lowering interest rates and therefore making it easier for the private sector to borrow and spend. But it is likely to have little impact with short-term rates already at zero and the 10-year Treasury note trading at a record low yield of 1.8%.

This is because if companies were waiting for lower interest rates to undertake capital expenditures, they would already have done so while the rates were coming down to these low levels.

The CBO's other assumption—that overseas economies will continue to recover—is also questionable at best. The economies of China, India, and Brazil are all slowing, and the downturn in the eurozone is growing increasingly severe.

CBO estimates overly optimistic

In light of the above, I think the CBO estimates of a 0.5% contraction in output and a 9.1% unemployment rate are overly optimistic. Under current conditions it is extremely unrealistic to assume that a tax hike equal to 3% of GDP will only depress GDP by 0.5%.

In Japan, the Hashimoto administration undertook a fiscal consolidation program equal to 3% of GDP in 1997. The result was an economic meltdown, with data at the time indicating five straight quarters of contraction. GDP shrank by 3.0% in real terms and 4.0% in nominal terms. The resulting double dip sparked major bad loan problems in the banking sector, and the fiscal deficit, originally projected to decline by ¥15trn, *increased* by ¥16trn instead.

Japanese real estate prices at the time had finally dropped back to the pre-bubble levels of 1985, attracting many so-called asset strippers from New York along with a large number of overseas Chinese investors and lending support to the apparent bottom in prices. Moreover, the private sector was a net saver to the tune of 6% of GDP in spite of nearly zero interest rates, mirroring the situation in the US today.

But the CBO's report makes no mention of the possibility that fiscal consolidation during a balance sheet recession could cause the economy to collapse and produce a *larger* fiscal deficit, as happened in Japan.

Japan suffered greatly despite reversing course only six months later

One difference between Japan in 1997 and the US today is that Prime Minister Ryutaro Hashimoto had the ability to reverse course if he realized a mistake had been made. And he did just that only six months after implementing the austerity policy.

Even then, it took nearly two years for the Japanese economy to recover from the shock and almost ten years for the fiscal deficit to fall back to 1996 levels.

With Democrats and Republicans evenly matched, it would not be nearly so easy for the US to undertake a similarly bold policy change away from the fiscal cliff, and in any case it would probably take a great deal of time, while the economic wound continued to fester.

CBO issues half-hearted warning about fiscal cliff

In any event, implementing austerity measures valued at 3% of GDP at a time when the US is in a severe balance sheet recession and the economy is being propped up by tax cuts and other fiscal stimulus is a major mistake. Assuming those measures will depress GDP by only 0.5% is extremely unrealistic, in my view.

The CBO's role is to provide politically unbiased economic analysis and opinions. The report in question tries to be all things to all people, saying that the fiscal cliff will result in serious pain but that, once endured, it will provide a foundation for a fiscal policy that is healthy and sustainable in the long term.

It should not be surprising if some interpret this as saying that a 0.5% hit to GDP next year should be accepted as the cost of regaining fiscal health for the future generations.

What the CBO is not taking into account is the possibility that GDP will contract not by 0.5% but by 3% or even more once the US jumps off the fiscal cliff, with the budget deficit increasing instead of decreasing as was the case in Japan in 1997.

In short, I think the CBO's warning on the fiscal cliff is as half-hearted as its forecasts are optimistic.

Appendix A-1

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