A new year fir the Euro: What could happen and why Americans should be concerned

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Despite a slowly improving U.S. economy, Americans have watched the stock market continue on its roller coaster ride, in large part because of uncertainty about the economic future of European countries, such as Greece, Portugal, Ireland, Spain and Italy, experiencing well-publicized problems. An international finance expert from the W. P. Carey School of Business at Arizona State University explains what we can expect as we enter the New Year in the future of the Eurozone.

"Plan to see ongoing high volatility and deteriorating credit ratings for countries in the Eurozone for 2012, which will keep influencing the American economy," says professor Werner Bonadurer, a Swiss native who served as a former board member and global head of trading and sales at financial giant UBS, and who was nominated a Global Leader of Tomorrow at the World Economic Forum in Geneva in the mid-1990s. "Our financial markets are interconnected and now generally moving in the same directions at the same times, following the same risk-on/risk-off patterns."

Bonadurer says the European Union (EU) is the largest market in the world and a huge recipient of American exports, as well as a location of many U.S. multinational companies. Therefore, if the Eurozone gets in enough trouble, it will really damage the still-recovering U.S. economy. Less demand from European buyers will also cause problems for China and emerging markets. Globally, we could suffer even more in the form of persistent unemployment, weak domestic and international growth, and elevated risk. Ongoing global balance-sheet problems are already

stalling the economic pace.

For now, Bonadurer does not expect the Eurozone to break up, despite speculation about whether the European countries with stronger economies, such as Germany, will continue to support the countries with weaker ones. The reason is that an even more dire financial situation would face both the countries breaking off and those staying in the Euro group.

“If individual weaker countries were to leave the Eurozone, that would only be a temporary fix for those countries, a shot in the arm for a structurally ill patient,” explains Bonadurer, faculty director of the W. P. Carey School’s highly ranked executive MBA program. “They would presumably go back to their earlier currencies basically overnight, and those currencies would experience severe devaluations. Therefore, people holding local assets in Euros would see their redenominated values cut in half; citizens would face major inflation in prices, and the fundamental problems with the economy still wouldn’t have been addressed. A devalued currency might help in the short run, but it wouldn’t secure sustainable global competitiveness.”

Bonadurer likens the situation to an unhappy couple that can’t afford to get a divorce. He expects to see more EU summits this year, each billed as a “last chance” to solve the problems. He also predicts lots of tension with an expectation that the European Central Bank become a lender of last resort, like America’s Federal Reserve. Currently, the European Central Bank is charged with preventing inflation and carrying out monetary policies, not bailing out European countries.

Bonadurer expects hardest-hit Greece to default on its debts and go into a depression, regardless of what is done at this point. He also refers to several fundamental problems that need to be addressed in the Eurozone overall.

He says the issues are:

Design problems – The monetary union isn't fully backed by a fiscal and complete political union, which makes it unsustainable in the long run.
Identity problems – The Euro project is not supported by an overwhelming segment of the European population and suffers, in part, because of the vast national differences across the region.
Institutional problems – Without constitutionally defined and legally enforceable sanctions, countries and politicians will lack fiscal discipline and remain addicted to spend-and-postpone market reforms.
Leadership problems – The EU governance structure is inefficient; political leaders in each country are playing first to their own constituents in dealing or not dealing with the Eurozone issue.
Economic problems – The root problems in the ailing countries are sub-par productivity and weak global competitiveness; financial bailouts won't fix this.
Bonadurer says that in a worst-case scenario, American taxpayers might even have to help indirectly with a bailout, since the International Monetary Fund (IMF) might be expected to get more deeply involved in the situation. He says about 18 percent of IMF money comes from the United States.

Bonadurer recommends that Europe continue with its massive short-term liquidity supply (injecting huge amounts of cheap money and credit into the system) and its efforts to meaningfully resupply its banks with capital and make sure they're solid. He also recommends the Eurozone start a strategic-growth initiative with far-reaching structural reforms and a reduction in welfare entitlements across countries.

"Long-term credible fiscal consolidation is a must," says Bonadurer. "However, without economic growth, there won't be success."

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