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ANALYSIS THAT REVEALS

JULY 2014

ECONOMIC OUTLOOK *The Rebound of the Periphery*

THE CARLYLE GROUP

GLOBAL ALTERNATIVE ASSET MANAGEMENT

The Rebound of the Periphery

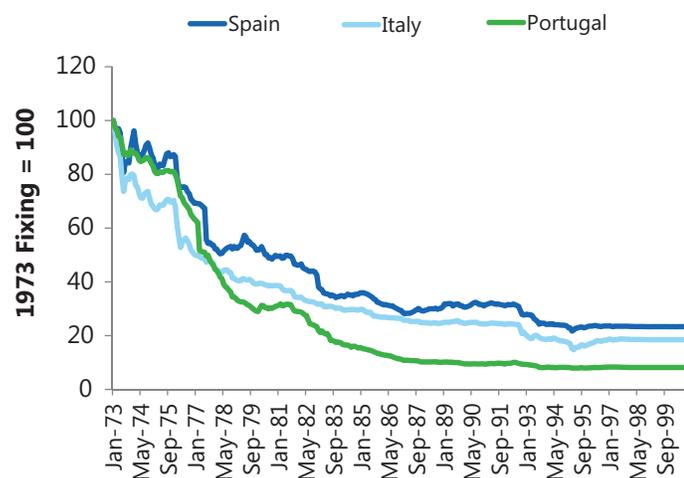
By Jason M. Thomas

The euro was introduced, in part, to pressure member governments to enact politically difficult structural reforms to enhance long-run growth and competitiveness. Instead of creating pressure for reform, the euro's introduction actually relieved it, as capital flooded into "peripheral" member states and their economies boomed. When capital flows reversed and crisis ensued, many observers forgot this original rationale for monetary union and inferred that the decline in peripheral economies' competitiveness was a failure of the euro's design. Instead, the original vision was largely proven true, as the crisis served as a catalyst for reforms that facilitated record external adjustments in peripheral economies. While painful, these adjustments resulted in dramatic increases in peripheral economies' competitiveness, a change that has increased expected returns for investors and laid the foundation for stronger future growth.

Political Economy of European Monetary Union

The move towards a currency union in Europe was partly motivated by the belief that some European economies would achieve better long-run performance if authority over monetary and exchange rate policy were transferred to supranational institutions. In the decades prior to the euro's introduction, many European economies had been plagued by "devaluation cycles"¹ where policymakers responded to economic downturns by devaluing their currency and often monetizing fiscal deficits.² Devaluation became so routine that the cumulative decline in foreign exchange values since the 1973 collapse of the Bretton-Woods system ranged in some cases between 76% and 92% (relative to the Deutsch Mark; Figure 1).

Figure 1: Foreign Exchange Values Relative to the German Mark³



1 Jakobsson, U. (2003), "Devaluation Cycles in Sweden and Finland," Economic Research and Decision Making.

2 Lubitz, R. (1978), "The Italian Economic Crises of the 1970s," Federal Reserve International Finance Discussion Paper No. 120.

3 Federal Reserve Board of Governors, H.10, Foreign Exchange Rates.

Devaluation (or depreciation in floating regimes) often appears to be optimal in the short-run, but its repeated use as a policy tool can place upward pressure on wages and average inflation, reduce incentives to focus on product quality, and slow capital formation and productivity growth. Devaluation and monetary easing were like "painkillers" that addressed the symptoms but allowed the underlying maladies of inefficient tax systems and inflexible labor markets to fester.⁴ By adopting the euro, peripheral economies committed to forgo palliatives and finally address the underlying illness.

It was widely believed that a permanent supranational currency regime would allow peripheral economies to import credible institutions, embrace time-consistent monetary policies, and reduce cross-border risk premiums. More significantly, once authority over monetary and exchange rate policy had been transferred from domestic to supranational institutions, domestic policymakers would be left with no choice but to respond to negative shocks by enacting structural and fiscal reforms.⁵ The increased ease with which businesses could exit the domestic market for other destinations in the euro area would also create pressure to improve the domestic business environment.⁶ European Monetary Union (EMU) would force elected officials to make the hard choices repeatedly postponed by devaluation and debasement.

Global Credit Boom & Massive External Deficits

Unfortunately for structural reform advocates, the introduction of the euro happened to coincide with a global boom in credit and cross-border finance flows. Not only did the hoped-for pressure fail to materialize, EMU delivered such an economic windfall to peripheral economies that institutions actually weakened.⁷ By eliminating inflation and exchange rate risk, EMU allowed domestic institutions in peripheral economies – governments, households, businesses – to borrow at significantly lower interest rates. Increased access to low-cost finance relaxed the collateral and credit constraints that had previously impeded business investment, household consumption, and government purchases in these economies. New expenditures made in response to these flows improved fiscal positions and economic fundamentals, which attracted additional capital. Instead of being forced to make tough choices, elected officials in peripheral economies presided over an economic boom that allowed them to postpone necessary reforms.⁸

4 Vamvakidis, A. (2007), "External Debt and Economic Reform: Does a Pain Reliever Delay the Necessary Treatment?" IMF Working Paper.

5 Djankov, S. (2014), Inside the Euro Crisis: An Eyewitness Account, Peterson Institute for International Economics.

6 Bean, C. (1998), "Monetary Policy under EMU," Oxford Review of Economic Policy.

7 Fernandex-Villaverde, J. et al. (2013), "Political Credit Cycles: The Case of the Euro Zone," NBER Working Paper 18899.

8 Fernandex-Villaverde, et al. (2013).

Between 1985 and 1995, Spanish 10-year debt yielded 5% more, on average, than German debt (Figure 2). In the 10 years following the *de facto* introduction of the euro,⁹ the average spread was less than 0.15%. Similar declines in relative costs were evident among private sector borrowers as well. Lower interest rates substantially reduced debt service costs (Figure 3), which allowed peripheral governments to pursue expansionary fiscal policy. Governments' net interest expense fell by as much as 6% of GDP or 14% of total government outlays, which provided room to increase spending or cut taxes while still maintaining the deficit targets mandated by euro membership.

Figure 2: Yield Differential, Spanish and German 10 Year Government Bonds¹⁰

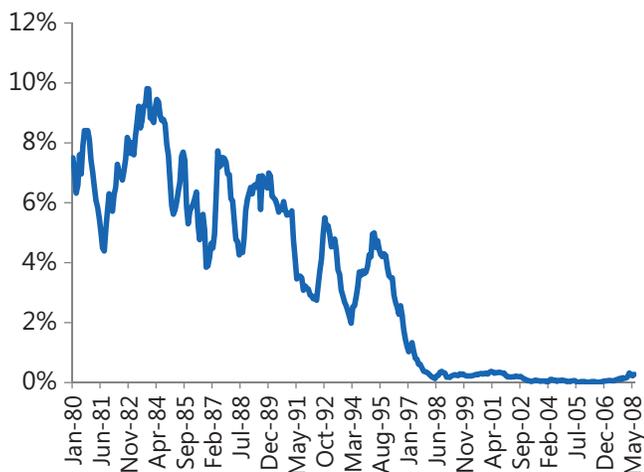
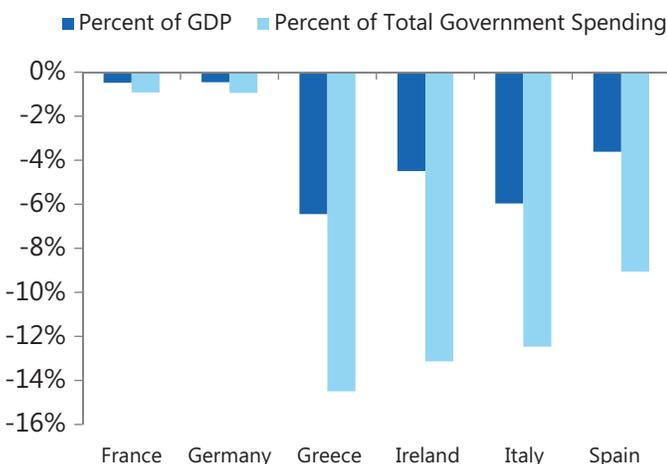


Figure 3: Change in Public Debt Service Costs, 1995-2007¹¹



While the 2010-2012 euro crisis has been traditionally understood as a sovereign debt crisis, the key issue for crisis economies was the amount of total debt owed to external

9 De facto introduction occurred in 1998, by which time interest rates had largely converged based on established exchange rates in anticipation of the 1999 introduction of the euro as a unit of account. The introduction of euro banknotes (currency in circulation) occurred in 2002.

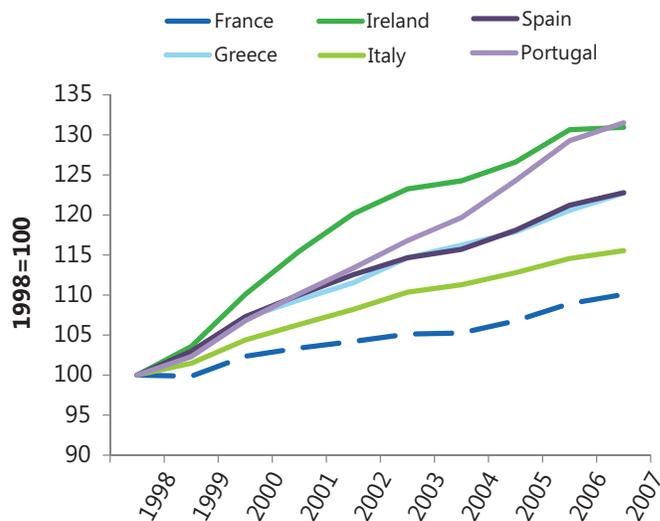
10 Federal Reserve Board of Governors, H.10, Foreign Exchange Rates.

11 IMF, 2014 WEO Database.

creditors.¹² Large external deficits were the mirror image of the net capital inflows. While some portion of these deficits reflected rational portfolio reallocation out of Germany and France into countries like Spain and Ireland with more favorable demographics and higher expected returns, much of it also reflected borrowing to cover large and growing trade deficits.¹³ When times were good, such borrowing was easy, but by 2008 the size of the external debt and concerns about the competitiveness of peripheral economies made cross-border borrowing progressively more difficult.

As of 2008, Greece, Portugal, Ireland, and Spain – the four countries that ultimately required formal financial assistance – had current account deficits that averaged more than 12% of GDP.¹⁴ Excluding valuation changes, these countries saw their net international investment position deteriorate by an average of 73% of GDP in the first ten years of EMU. During the credit boom – and partly because of it – the prices of capital, labor, and goods rose in peripheral economies at a much faster rate than in the “core” of France and Germany. As shown in Figure 4, in the first nine years of EMU, aggregate production costs in Ireland, Spain, Portugal and Greece rose by 20% to 32% relative to German production costs. Unit labor costs – wages scaled by worker productivity – diverged similarly, with labor costs in peripheral economies reaching 1.4x German levels on average.¹⁵ Higher relative wages not only pushed production to lower cost markets, but also provided a boost to imports by increasing relative purchasing power. The result was large structural deficits that raised serious questions about whether peripheral economies could repay their debts while remaining in the EMU.

Figure 4: Change in Aggregate Production Costs Relative to Germany¹⁶



12 Krugman, P. (2013), “Currency Regimes, Capital Flows, and Crises,” Jacques Polak IMF Research Conference.

13 Sinn, H.W. and Wollmershäuser, T. (2012), “Target Loans, Current Account Balances and Capital Flows: The ECB’s Rescue Facility,” International Tax and Public Finance.

14 IMF, 2014 WEO Database.

15 OECD, 2013 Economic Annex.

16 IMF, 2014 WEO Database, GDP Deflator.

The Euro “Straitjacket”

Had peripheral economies found themselves in this same situation prior to EMU, their likely response would have been a sizable devaluation to reduce domestic costs relative to those of trading partners. At the time of the crisis, elected officials in impacted economies lamented the euro “straitjacket,”¹⁷ which prevented the swift realignment of relative prices achieved in prior devaluation cycles. Yet, this “straitjacket” is precisely what the technocrats in peripheral economies wanted when they joined EMU in the 1990s. Without devaluation as an option, policymakers had no choice but to embrace policies to improve domestic competitiveness.

There is a rich academic literature, cited by some of the founders of EMU, demonstrating that economic conditions must get “sufficiently bad” for growth-enhancing structural reforms to take place.¹⁸ Yet, when those “sufficiently bad” times actually arrived in the European periphery, the tendency of many observers was to blame the rigidities of EMU instead of the underlying competitiveness issues themselves: inefficient tax systems, expensive public sectors, obstacles to entrepreneurship and market entry, employment protections, and inflexible wages. The euro was being labeled a “failure”¹⁹ at precisely the moment when it offered the greatest promise to enact the institutional and governance reforms that its introduction was intended to facilitate.

This is not to say that EMU was without serious architectural flaws. As we have noted previously, the severity of the crisis was due in large part to an ambiguous relationship between monetary and fiscal institutions,²⁰ uncertainty regarding the convertibility of sovereign debt into euro banknotes,²¹ and a balkanized and lightly supervised banking system.²² The simple point is that the macro rigidity and adjustment difficulties of 2009-2012 were not an oversight or unintended consequence, but rather a well understood element of currency union that was intended to achieve reforms not possible under prior currency regimes. And there is little doubt that the crisis *did* serve as a catalyst for structural reforms, especially in economies that received formal assistance from the European Commission, ECB, and IMF (the “troika”).

The Adjustment in the European Periphery

Since 2009, several euro area countries have passed laws to relax product market regulations and reduce employment protections with the aim of increasing competition, accelerating the adjustment process, and reducing disincentives

to hiring.²³ At the same time, reforms of public finances and wage-setting mechanisms²⁴ have increased public saving and placed downward pressure on wage rates in the periphery. The result has been a substantial improvement in competitiveness and record improvements on external account balances.

Figure 5: Change in Aggregate Production Costs Relative to Germany²⁵

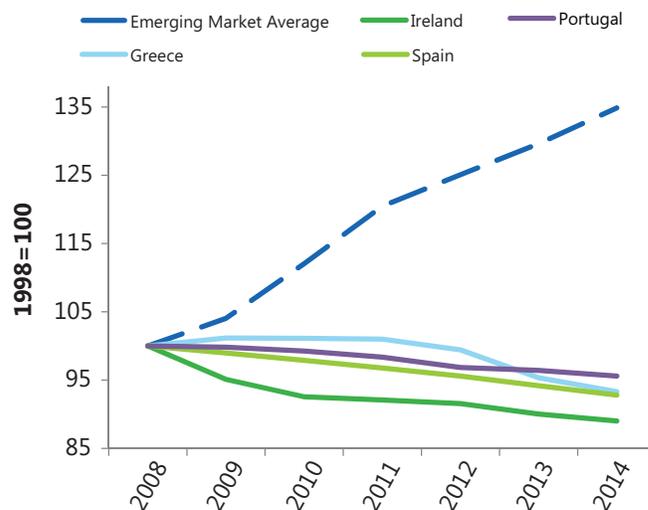
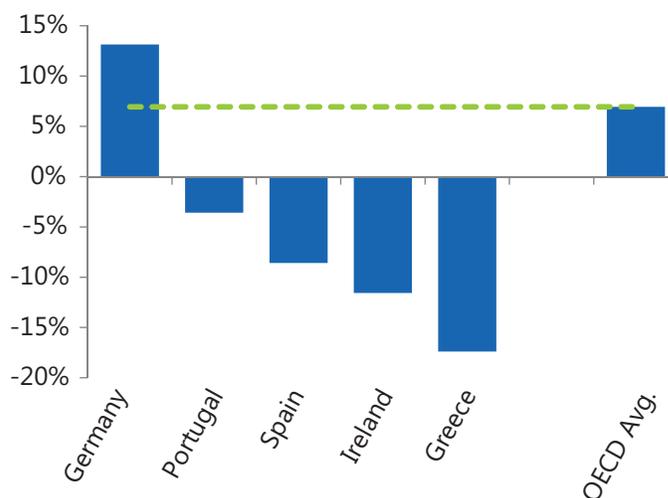


Figure 6: Cumulative Change in Unit Labor Costs, 2009-2014²⁶



As shown in Figure 5, aggregate production costs in Greece, Ireland, Portugal, and Spain have declined by an average of 8% relative to Germany and by 31% relative to the largest emerging market economies since 2008.²⁷ The improvement in competitiveness is also evident in unit labor costs (Figure 6). By raising the profitability of domestic operations, the decline in relative costs has increased returns on new fixed capital investment by 22%,

17 Jose Luis Rodriguez Zapatero, Interview with CNBC, Nov 26, 2013.

18 Sun, J. (1999), “Wage Reform, Soft Budget Constraints and Competition,” World Institute for Development Economics Research Working Paper No. 156.

19 Felstein, M. (2012), “The Failure of the Euro,” Foreign Affairs.

20 “Back from the Abyss? Improved Economic Data Meet Heightened Solvency Concerns in Europe,” The Carlyle Group, Economic Outlook, October 2011.

21 “A Brief History of the European Debt Crisis, 2010 – 2013,” The Carlyle Group, Economic Outlook, February 2013.

22 “Recovery in Europe: Financial Sponsors and the End of the Beginning,” The Carlyle Group, Economic Outlook, March 2014.

23 ECB, “The Phillips Curve Relationship in the Euro Area,” Monthly Bulletin, July 2014.

24 EuroFound, “Changes to Wage-Setting Mechanisms in the Context of the Crisis and the EU’s New Economic Governance Regime, June 14, 2014.

25 IMF, 2014 WEO Database, GDP deflator time series.

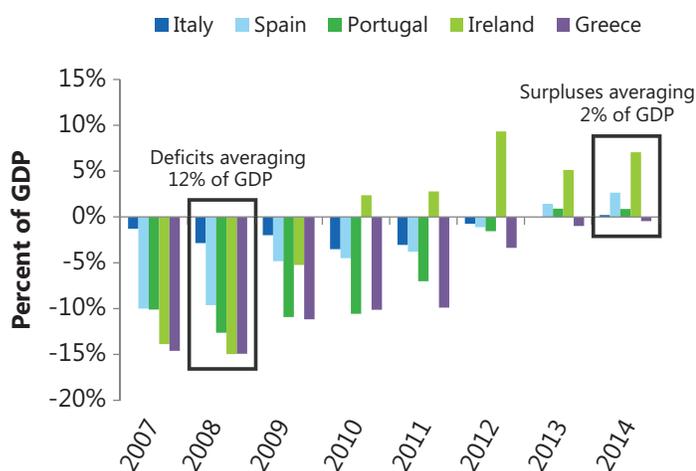
26 OECD, 2013 Economic Annex.

27 IMF WEO 2014 Database. The emerging market average is the arithmetic average of the GDP deflators of Brazil, Russia, India, Indonesia, China, and South Africa.

on average since 2009, which has created incentives to place productive capacity in newly competitive peripheral economies.²⁸

These dramatic cost reductions have also allowed for an unprecedented improvement in external balances. Between 2008 and 2013, record current account deficits had been turned into surpluses (Figure 7), with export growth in 2013 twice the global average.²⁹ This 14% of GDP average improvement on the current account is the largest external adjustment in world history that occurred in the absence of currency devaluation. Among advanced, non-commodity exporting economies, this external adjustment was rivaled only by that of Korea between 1996 and 1998, which was aided by a 40% depreciation against the U.S. dollar.³⁰ These types of adjustments are inevitably painful, but generally allow for a swift resumption of growth once completed. In the five years following Korea's adjustment, the economy achieved trend growth equal to 90% of its pre-crisis average.³¹

Figure 7: Current Account Balance of Peripheral Euro Area Economies³²



As the ECB explained in its July 2014 Monthly Bulletin, more can be done to improve competitiveness. With the exception of Germany, countries that have not experienced a crisis have generally not been willing to embrace structural reforms. The result is a euro zone economy that is 11% smaller than would be the case if labor and product markets were more flexible and competitive, according to ECB estimates.³³ The inability to achieve such reforms in the absence of crisis has led ECB President Draghi to propose new institutional arrangements to “federalize” such decisions, as the lost output is of consequence to all members of the EMU.³⁴ Others, citing the scale of the adjust-

28 IMF WEO 2014 Database, Return on incremental capital calculation using perpetual inventory method.

29 IMF, 2014 WEO Database.

30 IMF, 2014 WEO Database.

31 IMF, 2014 WEO Database.

32 IMF, 2014 WEO Database.

33 ECB, “The Phillips Curve Relationship in the Euro Area,” Monthly Bulletin, July 2014.

34 “Draghi Calls for Closer Economic Integration in Europe,” New York Times, July 9, 2014.

ment in crisis countries, have offered the rather extreme suggestion that the ECB should actually tighten monetary policy to create new pressure on governments to reform.³⁵ Perhaps the pressure will come when other economies lose businesses to Spain and other newly competitive peripheral economies.

Conclusion

The euro area periphery emerged from an extremely difficult period of adjustment with better institutions, a more competitive cost base, and significantly reduced structural deficits. Since 2008, production costs have declined by over 30%, on average, relative to emerging market economies and expected returns on fixed investment in peripheral economies have risen by over 20%. Ironically, neither the scale of the initial contraction or subsequent adjustment would have been possible without EMU. While the euro area economy still faces significant challenges, peripheral economies are far better positioned for growth over the next several years than is commonly supposed.

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35 See the rebuttal of this suggestion in Bini-Smaghi, L., “The folly of central banks tightening to keep governments on the leash,” Financial Times, July 10, 2014.