Confluence INVESTMENT MANAGEMENT

Weekly
Geopolitical Report
By Bill O'Grady

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The Geopolitics of the Eurobond

(N.B. Due to the Independence Day holiday, the next report will be published on July 13.)

A global hegemon provides two broad categories of public goods. The first is security. A successful hegemon enforces some degree of global security as it has the ability to project power globally. This power projection ostensibly prevents regional wars from becoming world wars. Another way of thinking about hegemony is that if a world war occurs, it is evidence of hegemonic failure. In addition to war suppression, the hegemon's global reach gives it the capability to secure sea lanes, which facilitates global trade.

The second public good is financial. The hegemon provides the reserve currency which enables global trade and investment. The reserve currency nation must have two characteristics to be a successful provider of the reserve currency. First, it must be willing to run persistent current account deficits. It is through trade that the rest of the world acquires the reserve currency. Persistent current account deficits put great strain on the labor markets of the hegemon and require a strong commitment from the reserve currency nation to absorb these imports. Second, it must have deep financial markets and an instrument that is considered safe and widely available so nations that accumulate the reserve currency can use this instrument to hold this saving until it is needed for trade or direct investment.

If the U.S. is going to be replaced as a hegemon, the successor will need to fill these two roles. Currently, there is no nation that is capable or willing to fully provide these public goods. However, it is not impossible to consider a situation where a partial replacement occurs. Such outcomes have occurred before. By the late 1800s, Britain realized that it could not defend any of its colonies in the Western Hemisphere from a determined American attack. The U.S. economy was too well developed and its navy and army too large; the costs of defending Canada, for example, would have been excessive. So, quietly, the British ceded regional hegemony, at least in terms of security, to the U.S. That allowed Westminster to focus on the other growing threat, Germany. In the current environment, the U.S. could cede a sphere of influence to China. It is arguable that the U.S. would like to see a regional hegemon arise in the Middle East to allow America to reduce its security burden there as well.

Something similar could occur on the reserve currency front as well. Some economists, notably Barry Eichengreen, have argued that there is the potential for multiple reserve currencies. Although we have had doubts about this possibility, recent developments have led us to consider the possibility that the euro could become a serious competitor for the dollar as a reserve asset. That doesn't mean the euro would replace the dollar as the reserve currency, but it would mean the euro could be a parallel reserve currency and offer competition to the dollar.

The most recent development that could create potential competition for the dollar's

reserve status is the proposed new financial instrument designed to fund Europe's recovery from the pandemic. The proposal evolved from a plan developed by Germany and France to create a €500 billion recovery fund. European Commission President Ursula von der Leyen expanded the proposal, increasing it to €750 billion. But the key element of the proposal is a specific bond backed by the full faith and credit of the European Union. The bond service would be tied to several EU-wide revenue sources, including a proposed digital tax, a carbon border tax and fees on transportation.

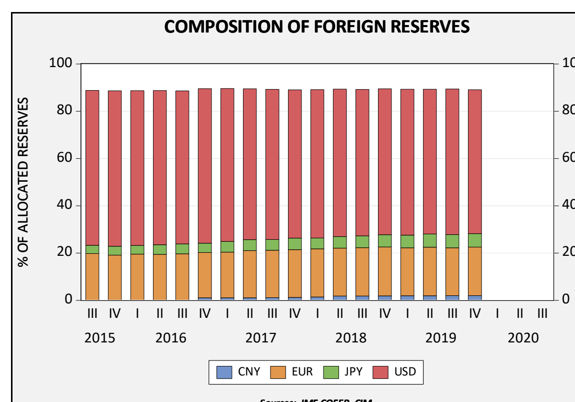
The proposed plan still requires approval by all members of the EU. The "frugal four"—Austria, Denmark, the Netherlands and Sweden—could still scuttle the proposal. But, Germany's support is a reversal of its longstanding opposition to EU debt mutualization and will probably be enough to sway the opposition toward accepting the program.

The prospect of debt mutualization creates competition for the dollar's reserve status. The EU doesn't fulfill the other requirements for hegemony; its military strength has atrophied, and it has not shown a willingness to run persistent current account deficits. Nevertheless, a mutualized debt instrument does make the euro a much more attractive currency for reserve purposes.

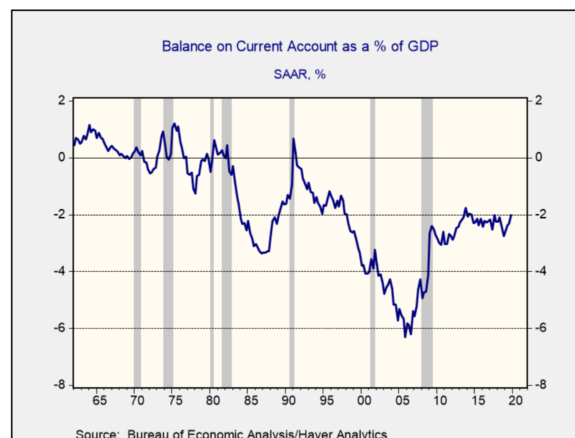
In this report, we will examine why an alternative reserve currency might be attractive for several countries. An analysis of why Germany has changed its position on debt mutualization will follow. As always, we will conclude with market ramifications.

The Reserve Currency Situation

At the end of last year, the U.S. dollar represented 60.9% of allocated foreign reserves. The next closest currency was the euro at 20.5%. Here is a chart of the data:



The Bank for International Settlements estimates that just over 88% of foreign exchange transactions have the dollar on one side of the trade; the euro is next at 32%. Although the latest data available is from 2014, over 80% of trade-related letters of credit are denominated in dollars. Although some of the dollar's dominance is due to network effects, the more important reason is that the U.S. has been willing to absorb large current account deficits. Since the early 1980s, the U.S. current account has been in persistent deficit.



The large imbalance in trade has distorted American labor markets, reducing jobs in manufacturing and other import-competing industries. At the same time, the primary driving force for these deficits is that foreign nations want to acquire dollars to conduct

trade and investment. These nations skew their economies to oversave, which generates trade surpluses.[1]

Within the U.S., support for globalization has been deteriorating. The Trans-Pacific Partnership and the Transatlantic Trade and Investment Partnership both failed to pass. The Trump administration has deployed tariffs in a bid to change trade flows. And, opposition to immigration has led to restrictions on foreigners coming to the U.S.

The dollar's reserve status underlies globalization. Although Congress has offered legislation that would make the dollar less attractive as a reserve currency, a succession of presidents has avoided taking aggressive steps to end the dollar's reserve status. Nevertheless, presidents have increasingly used the dollar's financial links to the U.S. financial system to implement sanctions.

Meanwhile, foreign governments have become increasingly resistant to Washington's use of the dollar and the American financial system to implement sanctions. However, this resistance has been tempered by the discomfort of restructuring economies away from saving and exports and toward consumption. After all, such internal restructuring will inflict harm on important sectors of foreign economies. Essentially, foreign economies have become dependent on U.S. consumption and would rather avoid the pain of change.

Germany and the EU Situation

Since Germany was formed in 1870, Europe has struggled to manage its emergence. Nestled in the middle of the continent on the Great North European Plain, Germany's geography is both a blessing and a curse. Because most of Germany is on a plain, it was easy to move goods and people around the country which fostered its industrialization. However, Germany has few natural defenses; no mountain ranges or impassible rivers could prevent invaders from either east or west from attacking the new country.

From 1870 until 1945, the German Problem dominated European geopolitics. WWI and WWII were the result of the continent being unable to accommodate the rise of Germany.

After WWII, the U.S., due to planning and circumstance, solved the German Problem. The allies from WWII had divided the country, and the obstinance of Joseph Stalin prevented reunification after the war. Thus, it was divided into two separate nations, East and West Germany. The U.S., through the evolution of the Marshall Plan and NATO, effectively guaranteed West Germany's security. The Bretton Woods agreement rendered the dollar as the Free World's reserve currency, which created an avenue for Germany's economic recovery. West Germany became an exporting power. Germany's neighbors no longer had to fear the country's army (it had essentially been demilitarized), so Germany was able to participate in the overall European recovery fostered by the U.S.

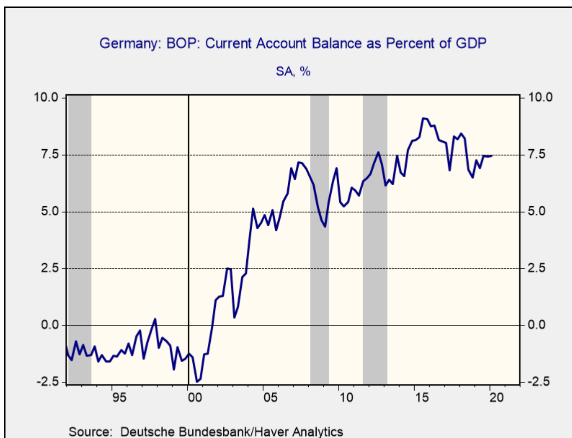
European leaders were determined to prevent the specter of nationalism from embroiling the continent in another world war. Their plan was to unify Western Europe's economies into a free trade zone that would foster prosperity and overcome nationalist feelings. From the 1950s into the end of the Cold War, the leadership of European nations steadily moved to include more members in the European Common

[1] We covered the macroeconomics of trade in an earlier WGR series. See "Reflections on Trade: Part I, II, III, and IV," (5/1/17-5/22/17).

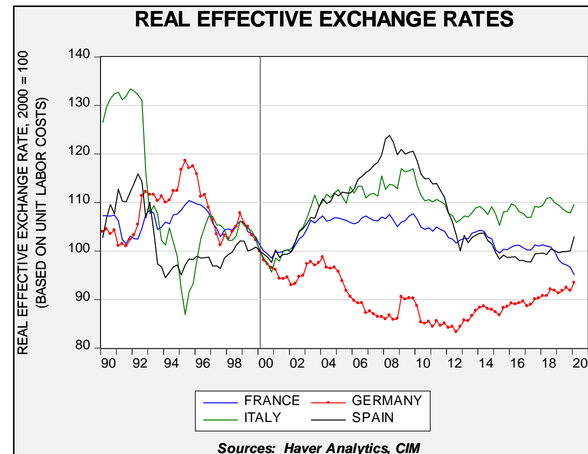
Market and allowed Brussels to influence more of the lives of Europeans.

The end of the Cold War and the reunification of Germany raised fears that the German Problem would return. To counteract this threat, European leaders prevailed upon Germany to give up its beloved currency, the D-mark, and join a currency union with a single currency, the euro. The idea was that the single currency would tether a unified Germany to Europe to create a "European Germany" and avoid a "German Europe."

Unfortunately, the latter has been the outcome. A series of labor market reforms in Germany, called the Hartz reforms, improved German competitiveness and increased saving. That led to a large German current account surplus.



This chart shows the German current account relative to GDP. The vertical line marks the onset of the Eurozone. The Hartz reforms, which began in 2003, led to a reversal in the account to positive and it steadily widened. These labor market reforms led to conditions that supported a positive and large current account. If the D-mark had still existed, the exchange rate would have appreciated sharply and probably prevented the current account surplus from rising as much as it did.



This chart shows the real effective exchange rates derived from unit labor costs, rebased to the onset of the euro. Note that Spain, France and Italy all saw their effective exchange rates appreciate into the 2008 Financial Crisis. Germany's real effective exchange rate depreciated into 2013, lifting its competitiveness.

After a series of debt crises from 2010 through 2012, austerity measures were forced upon nations suffering from excessive debt. That has led to improved competitiveness of these nations; on the above chart, the real effective exchange rate has weakened, while Germany's has appreciated. Even with these actions, Germany essentially remains very competitive due to its membership in the Eurozone.

Although there have been calls for easing austerity and debt relief, the general stance of Germany has been that the rest of Europe should become more like Germany, restructuring economies and focusing on saving instead of getting relief. That stance has led to rising friction in the Eurozone. In addition, the increase in the Eurozone's current account surplus has raised tensions with the U.S.

An Inflection Point?

Although the pandemic will appear to be the proximate cause of the consideration of debt mutualization, as is true of inflection points,[2] in general, there were other factors that preceded this particular event that likely contributed to this potential shift.

Uncertainty over the U.S. security guarantee: Since 1945, the U.S., through NATO, has underwritten European security. This costly decision was made by American policymakers after WWII due to fears that another world war was possible if the German Problem wasn't resolved. As the memories of the horrors of WWII fade, current U.S. policymakers are clearly moving away from the broad level of security support that existed during the Cold War. In some respects, this change isn't all that sudden; successive American presidents have complained about European "free riding" on U.S. defense spending. The Trump administration has moved to reduce troop strength which has raised questions about America's commitment to defending Europe.

As long as Germany didn't need to provide its own security, it didn't need to cooperate with debtor nations in the Eurozone. In other words, it could maintain its calls for austerity and not worry about Spain, Greece or Italy refusing to participate in Europe's defense. But, if the U.S. is no longer going to be reliably providing security, it means Berlin will need the cooperation of these nations. Thus, the shift to accepting debt mutualization may be tied to security concerns.

The growing global power vacuum: One of our postulates which we have held for the past decade is that the U.S. is slowly relinquishing its global hegemonic role. Our position is that the U.S. was not a natural hegemon; our government structure didn't lend itself to the superpower position (e.g., division of powers makes global management awkward), and given American geography (surrounded by non-threatening powers and oceans), hegemony was always a choice, not a necessity. With the communist threat abated, America has been steadily withdrawing from the world.

Since there is no other nation capable of the level of U.S. power projection, as America withdraws, we expect a set of regional hegemons to emerge. In Europe, Germany is the most logical candidate but has been reluctant to accept the responsibility; due to its history, it likely preferred to shift the burden of hegemony to the U.S.

The pandemic has revealed the power vacuum in Europe. Germany appears to have concluded that if it doesn't take on a regional hegemonic role in Europe, the EU project could fail and the continent could find itself facing the same geopolitical problems that led to two world wars. It is unclear how Germany will manage this role, but if the acceptance of debt mutualization is any clue, it is a favorable first step.

Concerns about the dollar's reserve currency role: This issue is not new. The French questioned the dollar's role during the 1960s and the de Gaulle government's aggressive use of the gold window in the late 1960s was one of the triggering events to President Nixon's decision to remove the U.S. from the gold standard. However, even with the occasional tensions, Europeans have found that participating in the dollar system is ultimately to their benefit. This is especially true of Germany.

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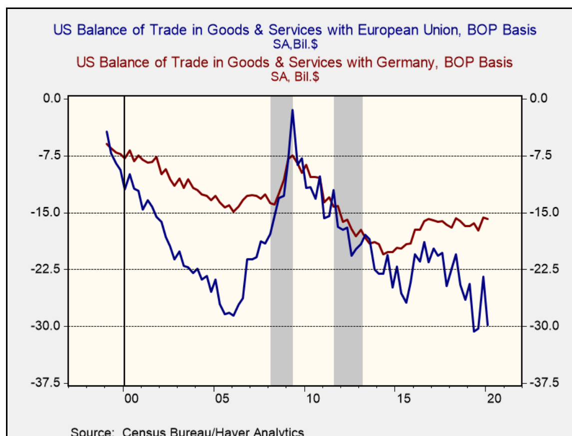
[2] For background on inflection points, see WGRs, "Reflections on Inflections: Part I" (1/7/19) and "Part II" (1/14/19).



Both the EU and Germany enjoy a large trade surplus with the U.S., but that reliance comes at a cost.

In the wake of 9/11, the U.S. moved to "weaponize" the dollar and the U.S. financial system. Given the centrality of the dollar and the U.S. financial system associated with dollar flows, the U.S Treasury was able to constrain funding to Islamist terrorist groups. Once this lesson was learned, it was used to sanction Iran and was a factor in getting Tehran to negotiate over its nuclear program.

When the Trump administration withdrew from the Iran nuclear deal, Washington applied financial sanctions on Iran. The Europeans, who wanted to maintain the arrangement, threatened to trade with Iran in violation of the new sanctions. But, in the end, the risk of losing access to the U.S. financial system was too great a risk.

Some nations are chafing under the weaponization of the dollar, but the lack of an attractive alternative reserve asset prevents countries from violating American sanctions. A mutualized Eurobond could offer such an alternative and reduce the power of American financial sanctions.

Brexit: The EU requires unanimity on major decisions. That can make managing change in the EU and the Eurozone difficult. This problem is exacerbated by the degree of expansion seen in both the EU and the Eurozone. When the various groupings within Europe (European Steel and Coal Union, ECC) were smaller, France and West Germany could dominate the bodies and generally force compliance. But, as the group evolved into the EU, especially by adding the U.K. in 1973, attaining consensus became more difficult.

Although Britain's exit from the EU has been problematic, it has created one benefit—creating consensus is easier. It is highly likely the U.K. would have opposed this move to debt mutualization. The "frugal four" nations used to be able to count on the U.K. as an ally; post-Brexit, this coalition has lost heft. Thus, Brexit may have been necessary for a Eurobond to emerge.

Populism: Populism is a widespread phenomenon across the West. As inequality has risen, there is growing anger at the ruling class, a concern that led to the rise of left- and right-wing populist parties across Europe. Northern European nations have managed to fend off the threat, but Italy did have a populist coalition and populism in Spain has made it nearly impossible to form a government. German Chancellor Merkel appears to have concluded that without EU-wide support for pandemic recovery, populist parties could flourish. In other words, fears of populism appear to have softened German opposition to debt mutualization.

Opposition

Opposition to debt mutualization remains significant. For example, the German courts have attempted to overrule the European Court of Justice of ECB policy. This legal assault on policy stimulus has widened. It is

possible that one of the 27 nations in the EU may [vote against the current pandemic response proposal](). However, if this program fails to pass, it is quite possible the EU will fail as an organization. And that fear, coupled with the determination of France and Germany to get it passed, means it is more likely than not it will be confirmed.

Ramifications

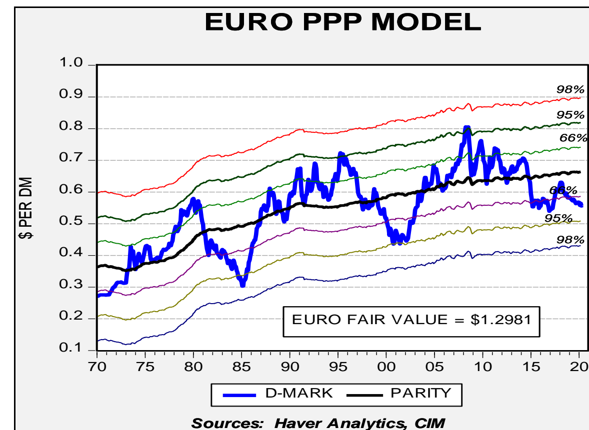
A common concern in the financial media is the end of the dollar's reserve status. Ending it abruptly would create significant dislocations; the demand for Treasuries from abroad would decline and force deficits to be funded internally. That doesn't mean it would be impossible to fund increased fiscal spending, but it would complicate matters.

However, history suggests that dominant reserve currencies aren't replaced in a discontinuous manner. Instead, users tend to replace the dominant one over decades. It was apparent by the mid-1920s that the British pound was losing favor as a reserve currency. But, none of the European currencies was deemed any better for that role and the U.S. seemed to have no interest in accepting the position. So, for two decades, the world drifted between the pound and the dollar until Bretton Woods.

At this point, there is no currency that is a candidate to fully replace the dollar for reserve purposes. No other nation has the combination of military and financial strength to displace the dollar. China isn't ready to open its financial markets to foreign flows to the point where it relinquishes control. Europe isn't ready to accept persistent current account deficits.

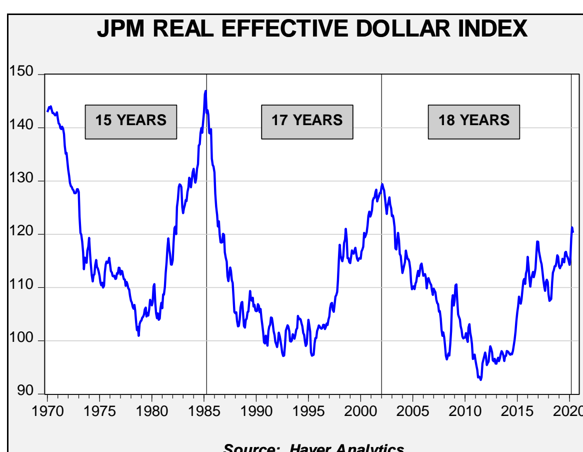
However, full displacement isn't required to have an impact. All that is necessary is an alternative currency for some of the reserve flows. A mutualized Eurobond, even of limited scope, gives nations that are unhappy with U.S. reserve management an alternative asset for holding reserves. It is true that these reserve managers could use the euro now (and it is used to some extent), but appropriate financial instruments are lacking. In other words, the safest Eurozone assets tend to have unattractive (negative) yields and the highest yielding bonds have risky credit qualities. A mutualized Eurobond overcomes this problem.

On a purchasing power parity basis, the euro is undervalued.



Purchasing power parity measures exchange rates based on relative inflation, based on the notion that a country with higher inflation will have a weaker exchange rate to offset the higher price, thus equalizing the price of tradeable goods across two countries. In reality, it's a crude measure, but at extremes it has been useful for showing points where valuations are excessive. We are at such a point now; fair value for the euro, based off German inflation, would be at 1.2981 €/$.

Another way of looking at this issue is in terms of currency cycles.



Since floating exchange rates began in 1971, there have been three peak-to-peak cycles in the dollar. Each peak coincided with levels of overvaluation, but each had a political event that precipitated the end of the bull market. In 1971, it was the closing of the gold window. In 1985, it was the Plaza Accord. In 2002, the Enron scandal, the persistent bear market, aggressive Fed rate cuts and concerns about the "strong dollar" policy led to the 2002 peak.

As the chart shows, roughly every 15-18 years, the dollar tends to peak and begins a bear market. The current peak is mostly due to the Trump administration's tariff policy; as tariffs have been implemented or threatened, nations have allowed their currencies to depreciate to offset the measures.

Our position is that the dollar is already richly valued but needs a catalyst to change the trend. An alternative reserve currency asset might be the precipitating event for this cycle. The euro doesn't have to fully replace the dollar as a reserve currency; it simply has to offer an alternative to the dollar for nations like Russia, Iran, China and others trying to reduce the power of U.S. sanctions.

If the dollar does begin a bear market, the beneficiaries are foreign equities, commodities and precious metals. Large cap U.S. stocks also benefit because of the improvement in competitiveness in foreign operations.

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June 29, 2020

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