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What can the EU and G20 do to stop the rot ?

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- Moral hazard is the obvious reason why there can never be a quick "magic wand" solution.

- The equity market typically becomes less dominated by a debt crisis as it becomes clearer that the crisis is not pushing the broader economy into recession….. and as fears about a related collapse of the financial system abate.

- The search for a resolution to the Eurozone debt crisis has gone global…. It is within the context of the above history that realistic expectations should be set.

- In the current environment of heightened fear, it seems reasonable to expect a significant increase in the potential size of funds available to deal with the risk of contagion.

- However, the imperative of moral hazard and political risk dictates that deployment of any enhanced firepower must of necessity remain highly conditional on measured fundamental retrenchment progress.

- The line taken by the French president Sarkozy, that if Greece fails then all of Europe fails, is not the basis of a sustainable solution to the crisis because its effect is to encourage rather discourage the moral hazard problem.

- The widespread view that if (for example) Greece was denied incremental Troika funding, it would either opt out of or leave the EU and the single currency with contagion effects to Irish and Portuguese membership, is highly questionable.

- The Eurozone authorities also give a "hostage to fortune" when they implicitly (or sometimes explicitly) acquiesce to the widespread view that the viability of the single currency project is ultimately dependent on full fiscal union.

- Measures to more quickly re-establish the competitiveness of the "PIIGS" economies within Eurozone must also be central to plans to contain the Eurozone debt crisis.

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What Can the EU and G20 Do to Stop the Rot ?

Looking at the history of major debt crises (Latin American sovereigns in the early 1980's, US and UK commercial and residential property in the late 1980's, Asian and Russian crises in the late 1990's etc), **the bad news is that there is no quick solution** and resolution is a creeping process over many years. **The good news is that the negative impact of the crisis on equity markets peaks long before resolution** seems in any way assured. The Latin American debt crisis erupted in August 1982 and the "Brady Bond" resolution did not emerge until 1989. The S&P500 bottomed relatively early in the process in May 1984 with the collapse of Continental Illinois bank. Likewise, the S&P500 bottomed in October 1990 long before the commercial property and "Savings & Loans" collapse had been remedied through the intervention of Resolution Trust Corp. The S&P500 also bottomed in September 1998 when the Asian and Russian debt crises were still only about a year old. So, **debt crises don't go away but markets learn to live with them.**

Moral hazard is the obvious reason why there can never be a quick "magic wand" solution to a debt crisis. The fundamental requirement for the stricken region or sector to retrench and adapt is inescapable. This typically protracted process defines the rate at which the crisis is actually being worked through.

The equity market typically becomes less dominated by a debt crisis as it becomes clearer that the crisis is not pushing the broader economy into recession (or that the recession it did trigger is ending) **and as fears about a related collapse of the financial system abate.** This is a process of time passing and gradual differentiation. The market increasingly differentiates between the outlook for the broader economy and the outlook for the financial system. It also becomes increasingly assured that policy response can protect against overall systemic failure as it increasingly differentiates between the stricken banks and those that will survive.

The search for a resolution to the Eurozone debt crisis has gone global as the crisis has escalated and equity markets have been stabilising in anticipation of some substantive measures from the EU and G20. **It is within the context of the above history that realistic expectations should be set.**

In the current environment of heightened fear, it seems reasonable to expect a significant increase in the potential size of funds available to deal with the risk of contagion. The firepower of the EFSF (and ESM) could be geared up very significantly through turning it into some kind of bank with access to ECB funding or through turning it into some kind of sovereign bond insurer (the latter seeming more likely). In extremis, the firepower of the global authorities to intervene in the stricken bond markets can also be significantly enhanced if China, Japan and other economies make funds available (whether unilaterally of through the IMF). The size of funds potentially available through these channels is clearly sufficient to deal with the crisis in Eurozone.

However, the imperative of moral hazard and political risk dictates that deployment of any enhanced firepower must of necessity remain highly conditional on measured fundamental retrenchment progress. Ultimately, the main threat to economic and currency union in Europe is political. Notwithstanding their considerable vested interest in the status quo, the electorates of Germany, Austria, Finland etc will not abide with a system that threatens to leave them as permanent financiers of persistent fiscal imbalances elsewhere in Eurozone. Nor would the Chinese or Japanese authorities be prepared to facilitate a transfer of these risks and costs beyond the borders of Eurozone.

The line taken by the French president Sarkozy, that if Greece fails then all of Europe fails, is not the basis of a sustainable solution to the crisis because its effect is to encourage rather discourage the moral hazard problem that could all too easily spell the political demise of European unity. The only viable objective in this regard is to bolster the system (i.e. the economy, the financial system and the single currency project) and demonstrate that it could in fact withstand and survive in the event of any Eurozone member being cut off from funding support (and related sovereign default) in the event of a persistent failure to correct a fiscal imbalance. Some contingent recapitalisation of the Eurozone banking system would be consistent with this objective, along with assurances from global authorities that the global financial system would be protected at all costs from post-Lehman type failure risks. To reassure about the Eurozone economy, the ECB could communicate a more "Fed-like" propensity to respond to such deflationary conditions or events with timely and aggressive monetary easing.

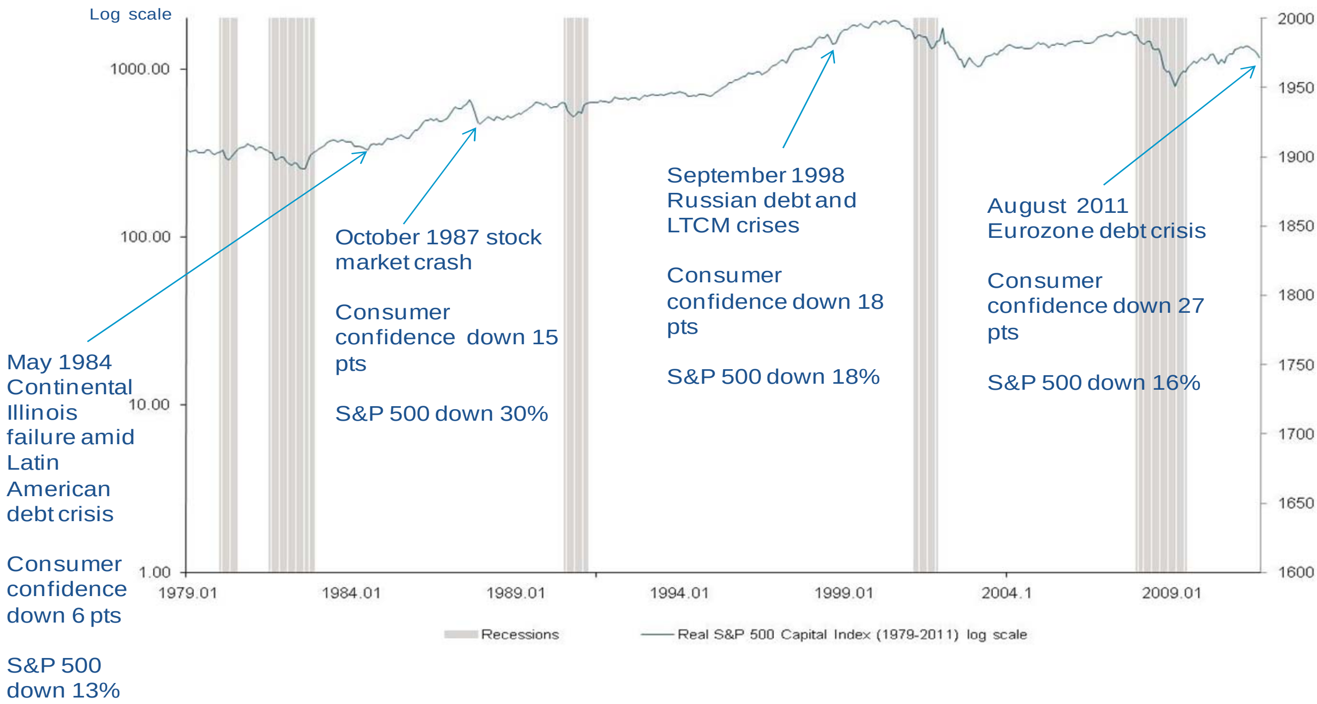
The widespread view that if (for example) Greece was denied incremental Troika funding, it would either opt out of or leave the EU and the single currency with contagion effects to Irish and Portuguese membership, is highly questionable. It is much more likely that any country in this position would of necessity remain within Europe and the Euro with the door left open to renewed funding if and when targets are met. The Eurozone authorities could do more to minimize these perceptions of Euro membership contagion risk by breaking the taboo and openly discussing the framework for continued inclusion and support that would apply to any bailed out economy that becomes excluded for a time from such funding.

The Eurozone authorities also give a "hostage to fortune" when they implicitly (or sometimes explicitly) acquiesce to the widespread view that the viability of the single currency project is ultimately dependent on full fiscal union. Although there may well be some requirement for treaty modifications (at some time in the future) as a quid pro quo for enhanced EFSF powers, these will come nowhere close to full fiscal union and the view here is that any significant fiscal union in Eurozone is a non-runner over any relevant time horizon. However, the view here is also that the long run viability of the single currency is not in fact dependent on fiscal union. The EU authorities would be well advised to enunciate a clear policy and view as to how and why the single currency can thrive within a specific Eurozone architecture that will remain fiscally decentralised.

Measures to more quickly re-establish the competitiveness of the "PIIGS" economies within Eurozone must also be central to plans to contain the Eurozone debt crisis. Apart from the already required structural reforms in various "PIIGS" economies, an explicit policy (acknowledged by the ECB) to encourage domestic demand and to accommodate inflation above the Eurozone average for a number of years in Germany and other super-competitive Eurozone economies, would be particularly constructive. The process and politics of retrenchment in the "PIIGS" economies would become much less fraught if supported by the growth that can derive from improving net external demand from the stronger Eurozone economies.

In conclusion, the Eurozone debt crisis is nowhere close to going away in the fundamental sense of the imperative it creates for ongoing progressive retrenchment in the "PIIGS" economies. Any hopes for a "magic wand" solution with Eurobonds and fiscal union are unrealistic. The best we can expect is that its peak negative impact on equity markets has now been seen, given the evidence from history that markets discount a debt crisis and then move on, long before the crisis itself is resolved. The demonstration effect of adequate potential funds availability from within and without Europe is of central importance to this in limiting the contagion to the key sovereign bond markets of Spain and Italy. Yet **the imperatives of politics and moral hazard dictate that the availability of funding must remain highly conditional on ongoing progressive retrenchment, and that any persistently erring economy would in fact be cut adrift from funding. So the real challenge for the authorities is to confront the inevitable reality by demonstrating adequate funds availability for conforming economies while also demonstrating that the system (i.e. the economy, the financial system and the Euro single currency project) could in fact survive the cutting adrift from funding (and likely related sovereign default) of any member that persistently deviates from fiscal targets.** A more aggressive policy to redouble the rate at which competitiveness is rebalanced between the "PIGS" and other Eurozone economies would also help to allay fears in markets that the retrenchment demands on the former will prove too much to bear.

Equity markets discount financial crises and move on



Source: NCB, NBER, Datastream

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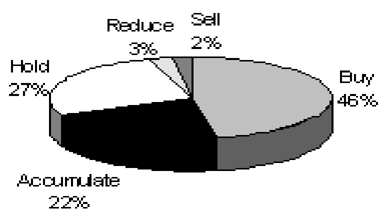

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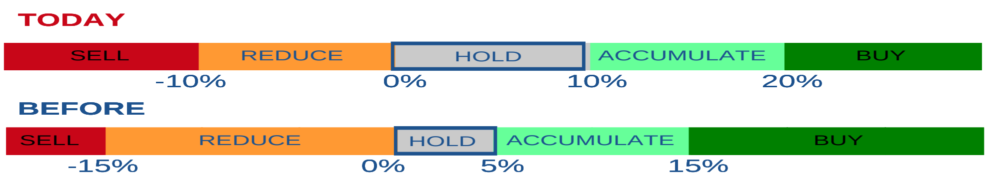

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