PERSPECTIVE

Craig Alexander
Senior Vice President & Chief Economist
TD Bank Group

EUROPE'S SLOW MOVING TRAIN WRECK STILL MOVING DOWN THE TRACKS

The European debt crisis is like the Energizer bunny. It keeps going, and going, and going. Financial markets remain gripped by events in Europe; and, this is entirely appropriate. If Europe loses control of the situation the resulting government debt defaults could lead to European bank failures that could, in turn, create a global financial crisis akin – if not worse – to that in late-2008. In light of the importance, it is worth providing an update. There have been two key developments in Europe.

First, contagion pressures have increased. Whereas markets were braced for an orderly debt default by Greece and were fretting about the possibility of debt problems for several small- or medium-sized economies, concerns regarding Italian debt sustainability increased materially in late-October and early November. As a result, Italian bond yields have risen above 7% – a level that is fiscally unsustainable if they persist for an extended period of time. Make no mistake, a Greek default could be managed; but, a default by Italy could not. Italy is the third largest debtor country in the world with an outstanding issuance of close to 2.2 trillion euros. As one might expect, the escalation of the fiscal fears contributed to gut-wrenching volatility in markets. Given the deteriorating situation, the need for political leadership to restore confidence is essential.

This leads to the second major development, which is leadership change in Europe. Prime Minister Papandreou of Greece was forced to resign after indicating he would call a referendum to decide whether Greece would leave the euro zone. French President Sarkozy and German Chancellor Merkel disliked the referendum idea. They signaled they would not grant more financial aid to a country that was not sure of its commitment to the euro zone. Markets had speculated about euro zone exit for some time, but the fact that European leaders raised the possibility shows how badly conditions have deteriorated. The escalation of the crisis also forced the resignation of Italian Prime Minister Berlusconi.

Ultimately, the change in leadership is a positive development as the incoming politicians should have more scope to push through needed reforms. They are also viewed as technocrats that have backgrounds that hold greater promise for dealing with the fiscal challenges. However, the outlook remains unclear, particularly given the risk that the domestic populations are not providing support for the fiscal austerity and the economic reforms that have to happen.

There was also a change in leadership at the European Central Bank (ECB), after Jean-Claude Trichet reached the limit of his 8-year mandate. Incoming Italian governor Draghi started office with a new stance, surprising markets by quickly cutting interest rates. This is a positive development that reverses a past policy error. In many months, the ECB has been instrumental in reducing the risk of a fiscal calamity by buying bonds of governments that were experiencing rising yields. However, the ECB has not assumed the role that some are calling for as the "lender of last resort". This expression means that the ECB could take the pressure off governments by making a public commitment to buy an unlimited amount of the bonds of the at-risk-of-default countries so as to ensure no default occurs. For example, the ECB buying could bring Italian interest rates back below 6% if the ECB was prepared to do so. Governor Draghi appears unwilling to take the ECB down this path.

If there is such an easy solution, why doesn't the ECB do it? There are several reasons. First, if the ECB made a commitment to be the lender of last resort, there would be no pressure on the politicians of the fiscally-challenged countries to push through the needed painful reforms to restore fiscal health and improve the long-term competitiveness of their nations. Second, the central bank role as lender of last resort providing liquidity for its domestic banking system is made possible by the central bank obtaining solvency from the sovereign. In other words, if the central bank were to incur financial losses as a result of its extraordinary intervention during a crisis, the market would expect the sovereign to recapitalize it. However, a central bank cannot act effectively as lender of last resort for sovereigns when it is precisely the solvency of those sovereign that is being questioned. Simply put, if there were a series of sovereign defaults in Europe, who would recapitalize the European Central Bank after it realizes losses on its sovereign bond holdings? Third, unlimited buying would mean the ECB would have to print money, which runs the risk of creating an enormous inflation problem in the future.

So, the current policy being pursued by the ECB is aiming to take some pressure off governments with ECB buying of debt, but not enough to bail them out entirely. And, the ECB is taking offsetting policy actions to eliminate the inflationary implications from their bond purchases.

The recent developments leave the end game for Europe still unclear. A default by Greece is inevitable, but that is old news now. The worry last month was about contagion, and the risks on this front have clearly intensified. European leadership still appears to be lacking. Despite announcements of new plans to address the crisis in mid-July and late-October, implementation of those policies has not occurred. Progress needs to be made urgently. The most likely scenario is that Europe will continue to muddle along in a constant state of financial crisis. While Italy cannot afford interest rates above 7% indefinitely, the borrowing requirement in the coming year will not cause a default if rates remain at current levels. There is still time to manage the default by Greece, limit contagion and recapitalize the banking system. However, the clock is counting down, so progress needs to be made sooner rather than later. There is a high probability that France's sovereign credit rating will be downgraded. In truth, financial markets need to come to terms with the fact that government debt in much of the advanced world is no longer risk free. It seems the final outcome in Europe will be some form of a fiscal union and the launch of Eurobonds - but this will not happen soon. If the political system cannot deliver this end game and conditions start to spiral out of control, the ECB will step in and act as lender of last resort. This would arrest the financial crisis but also create a new set of economic and financial problems. We've gone from a world of banks too big to fail, to a world of countries too big to fail. The implication is that three of the top financial themes will be volatility, volatility and more volatility.

Craig Alexander
416-982-8064
craig.alexander@td.com