

Themes on the Global Markets™

Europe Steps Up: Policymakers move towards a solution

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Prelude

In recent weeks, European policymakers have shown renewed urgency in addressing the economic and financial crisis that still engulfs the European Union and its common currency. Could this be a sign that the crisis is escalating further? Should we prepare for the fiscal collapse of a handful of problem countries, the demise of the euro and, eventually, another “black swan” for the global economy? Or is this the proof that, on the edge of the precipice, Europe is finally taking the necessary steps, no matter how painful, toward a comprehensive solution of its fiscal and financial challenges?

In this report we will discuss the current developments in light of these possible alternatives. Despite our deep-seated skepticism about much of what Europe has done, or failed to do, we believe that recent steps point in the right direction. Based partly on discussions and meetings during my two trips to Europe in less than a month, we now expect Europe to proceed with greater fiscal integration, the recapitalization of the banking system and a plan to ensure the fiscal viability of the weakest members of the monetary union. We expect this process to be long and controversial, but we are increasingly optimistic that a worst-case scenario, albeit still possible, is unlikely to occur and that the Europe Union will ultimately survive as a political entity with a common currency.

“...leaders of the euro area have reconciled themselves to the inevitability of such an outcome (a Greek default), so they are now discussing the size of the haircut for bondholders...”

Two speeches...

In the last few weeks, we had the good fortune to listen to two economic heavyweights discussing the prospects for the euro area. It is hard to fathom two more radically different characters than Ken Rogoff and Axel Weber. Rogoff, a Harvard professor and leading scholar on financial crises, spoke in Dallas with great skepticism about the outlook for the euro, during the National Association for Business Economics annual meeting. Axel Weber, the former president of the German central bank, is a punctilious central banker who addressed the Chicago Council on Global Affairs with frankness and realism, as well as a dose of unexpected optimism.

Interestingly, the scholar and the banker agreed on a discouraging short-term outlook for the European economy: “It will get worse before it gets better.” Nonetheless, their views differ about what will be the resulting endgame. According to Rogoff, financial history is not kind to fiscal irresponsibility: the catalyst for change in Europe will be the disorderly restructuring of the government debt of three or four countries, followed by severe damage to both the economy and to the fabric of the society. In the end, Germany will indeed

guarantee whoever is left standing, but the process will be protracted and very political.

Weber didn’t shy away from unmasking the giant challenges that Europe faces. He was almost acerbic in criticizing the dilatory tactics thus far employed to bail out Greece, calling them “an attempt to kick the can down the road.” Yet, his ultimate message was optimistic. Politics being politics (and this being European politics!), it is hard to escape prolonged discussion of a twisted, impenetrable, Byzantine nature. A deal will likely come at the very last minute. But, make no mistake: a deal will eventually come. Germany, France and their European partners will find a solution to reform their shaky union.

It is unlikely that a deal to rescue Europe will come out of an economic textbook, because reality is always messier than that. But it will be a deal grounded in the deep bonds between European countries, bonds that are political, cultural and historical before they are economic. For Axel Weber, as well as for the other policy makers in Berlin, Frankfurt and Paris, it is incomprehensible to question the basic foundations of the last sixty years of European history.

... And a meeting

Whom should we trust? The pessimism of the American professor, backed by the unforgiving precedents of past financial crises, or the qualified optimism of the stern German banker, who understands the instincts and history of European policy makers?

We break in favor of the German. And as exhibit A, we point to the recent meeting between the French president Nicolas Sarkozy and the German chancellor Angela Merkel. There is nothing exceptional about the leaders of France and Germany meeting; they do it all the time, seldom eliciting more than a yawn by a public grown accustomed to such theatrics. But what Merkel and Sarkozy accomplished on October 10, 2011 does amount to a shift in gears. Gone is the perfunctory claim that "Greece is solvent." Gone is the travesty of "strong capitalization" of the European banking system.

Instead, we see realism and real progress. Credible steps are being taken to establish a common rescue fund for the embattled economies of the euro area, to inject fresh capital into the banks and to put a safety net underneath the inevitable default of Greece.

Progress will not be linear. There will be quick accelerations and sudden stops. Politics will work at a pace that appears too slow for markets; markets will try to impose a timetable that is unrealistic for

politicians. But as Tolstoy wrote, "the two most powerful warriors are patience and time." We believe that patience and time will prevail.

... And three challenges

The euro area is facing a threefold challenge: Greek insolvency, insufficient bank capital and the risk of contagion spreading throughout the continent. For too long, policymakers denied any trouble in Greece, deeming it fully capable of paying off its entire debt. This denial blinded authorities from recognizing the banking crisis stemming from the sovereign debt situation and the rising risks that more countries could suffer from the market's deep skepticism.

First of all: Greece. The country carries a massive public debt (a debt-to-GDP ratio of 160%), very large fiscal deficits (negative 10.5% of GDP in 2010) and a contracting economy (GDP is expected to fall 5.0% in 2011 after declining 4.3% in 2010). Clearly, there is a lot of reform, restructuring and belt-tightening that is well past due for the Greek economy. But repeated austerity measures can only go so far. It should have been obvious from the very onset of the crisis that the only credible way out of such an unsustainable fiscal position is a managed default of Athens' obligations, in order to reduce the size of the debt burden. Finally, leaders of the euro area have reconciled themselves to the inevitability of such an outcome, so they are now discussing the size of the haircut for bondholders (expected to be close to 50%), rather than refusing to acknowledge such a possibility.

Second: the banks. Many bad decisions have been taken on this front. It has turned out that shoring up bank capital with government bonds in the aftermath of the 2008-09 financial crisis was not such a great idea after all. Nor did it help to exclude government bonds from the banks' balance sheets when performing two stress test exercises by European regulators. But

the day of reckoning has arrived: the policy agenda now includes, as a cardinal point, the recapitalization of the European banking system. The details are still being discussed: will each individual country inject capital into its banks on its own terms? Or will the European stabilization fund be tapped? And, how will European countries deal with the temptation by banks to improve capital ratios by shedding assets and exacerbating the credit crunch? Much can still go wrong, but at least the existence of a capital shortfall in the European credit system is no longer denied.

Finally: the threat of contagion. To a very large extent, this is a problem arising from the two challenges just addressed. An orderly management of Greek default and bank stabilization might alleviate the risks of a disorderly flight out of Portugal, Italy and Spain; at the very same time, the heavy burden imposed on Greece in terms of economic, social and political cost should partially defuse moral hazard and the odds of a rush by other countries toward additional defaults or bailouts. And, although we may not like the speed of the adjustment, there is no doubt that Portugal, Italy and Spain are committed to making significant improvements toward more solid fiscal positions.

Conclusion

It may take time for analysts and investors, especially in the Anglo-Saxon world (which has been skeptical of the European common currency endeavor from the start), to recognize the progress that European leaders are slowly making in stabilizing the fiscal and financial situations. And, for sure, we do not expect the trajectory out of the current crisis to be linear. There will be setbacks - small and large - along the way, as the partial rejection of the European rescue fund by Slovakia reminded us last week. But at the end of the day, we do not bet against the will of European leaders to save the euro. After all, this is just one economic piece of a larger political project which has no alternatives.

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