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MACROCOSM

Rome Makes Athens Look Good

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Lorcan Roche Kelly

Greece moves along the road to political stability, and Italy grudgingly steps onto it.

Greece's debt drama went into market-rattling overtime last week when Prime Minister George Papandreou threatened to put the proposed rescue to a referendum (see "On the Greek Referendum Surprise" November 1, 2011, "On the Greek Referendum Surprise, Volume 2" November 2, and "Papandemonium!" November 3). Thankfully, that threat disappeared with Papandreou's resignation. Now, finally, after several days of opaque politicking, today brought clarity on the new interim Greek government. Lucas Papademos has been appointed interim prime minister, his administration set with the task of implementing the decisions taken at the October 26 European Union summit (see "On the Europe Summit" October 27, 2011).

- Papademos is a career central banker. After completing his PhD at MIT in 1977 -- new European Central Bank president Mario Draghi finished his doctorate there a year earlier, and Ben Bernanke was in the same cohort -- he spent some time at the Boston Federal Reserve before joining the Bank of Greece. He spent most of the past decade as vice president of the ECB under Jean-Claude Trichet.
- His task is to form a government that will implement the changes demanded by the so-called "troika" -- the EU, the ECB and the International Monetary Fund. His immediate must-do is to get the agreement of the troika for the disbursement of the outstanding payment to Greece under the 2010 bail-out that has been delayed since the end of September.
- European economic commissioner Olli Rehn has requested that the Greek government agree in writing to implement the October summit decisions before the payment will be disbursed. So first thing Papademos has do is simply to write that letter. Euro Group President Jean-Claude Juncker made clear after the Euro area finance ministers meeting on Monday that agreement to the payment could be made by telephone conference, so it would seem that -- pending the letter -- Greece could get approval for the payment in a matter of days.
- The real test for Greece's new technocratic government -- that is, one appointed for particular expertise, rather than necessarily directly elected -- will come with the implementation of the austerity policies called for by the troika. With that unpleasant work in the

Update to strategic view

EUROPE MACRO, EUROPE BONDS, ECB: Political stability may be breaking out in Greece and Italy, but stable government is only the first step for these countries. The policy implementation test still has to be passed and, with markets watching every move the stakes could not be higher. The ECB, as the Italian bond buyer at the margin, has been willing to intervene -- or not -- to let its demands for austerity be known. The ECB has now gotten its way in Greece -- Italy's parliament will decide this weekend whether to comply. The new Greek and Italian governments will be right to expect more ECB support for their compliance. And we will be right to expect calmer sovereign debt markets.

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foreground of the public's mind, the legitimacy of the government could be tested in the coming months, especially if the date for promised elections is not confirmed quickly. Unelected technocrats play well with the troika, and seem to play well with the markets -- but if the support of the Greek people is missing, policy implementation will be impossible. History has shown that it is nearly impossible in any event.

These developments in Greece are all strong positives. But they've been overshadowed by Italy this week. Prime Minister Silvio Berlusconi announced his resignation -- but like St. Augustine, not quite yet -- on Tuesday. He has promised to step down after a new budget law is passed in parliament. Passage of that budget law now seems likely to be achieved by Sunday at the latest. If, as expected, Berlusconi resigns over the weekend, it seems that Italy will follow in Greece's footsteps and appoint an interim government. It will likely be led by Mario Monti, who was appointed a senator for life by the Italian president late on Wednesday.

- The only party that has come out against a technocratic government in Italy -- so far -- has been the Northern League, the right-wing nationalists who have been stalwart supporters of Berlusconi's administration. The Northern League control less than 10% of either house of the Italian government, so they are not in a position to force their view.

So with Greece heading towards stable government, and Italy finally getting rid of the unpredictable Berlusconi, it is tempting to see peripheral Europe as a political problem that is nearly fixed. Unfortunately, a respite from political chaos does not mean deep structural problems have been fixed in either country.

- If either government is to have any hope of succeeding in any meaningful way, it will need outside support to get it through the coming months. Greece has the advantage here, as it already is a "program country" -- that is, it has already gotten a bail-out -- and so does not need to rely on market access for funding. Also -- critically -- it is small enough to save.
- Italy -- as bond market action on Wednesday shows -- is still totally reliant on markets for funding. This is where the main drama will be played out over the coming weeks. If Italian debt costs can be reduced to sustainable levels -- the next major test comes on Monday, when a 5-year bond is due to be auctioned -- then Italy has a chance to fall off the radar. However if bond yields remain elevated, the constant calls of "unsustainable!" will be a self-fulfilling prophecy that will require action.
- While reliant on market funding, Italy has been assisted significantly by the ECB, acting as marginal buyer of Italian debt under its Securities Markets Programme (SMP) since early August (see the chart on the following page). But recent purchases have not been enough to keep yields on Italian debt from blowing out alarmingly. The ECB, now led by Italian Draghi, seems to be acting very carefully to limit moral hazard here, and indeed to use its

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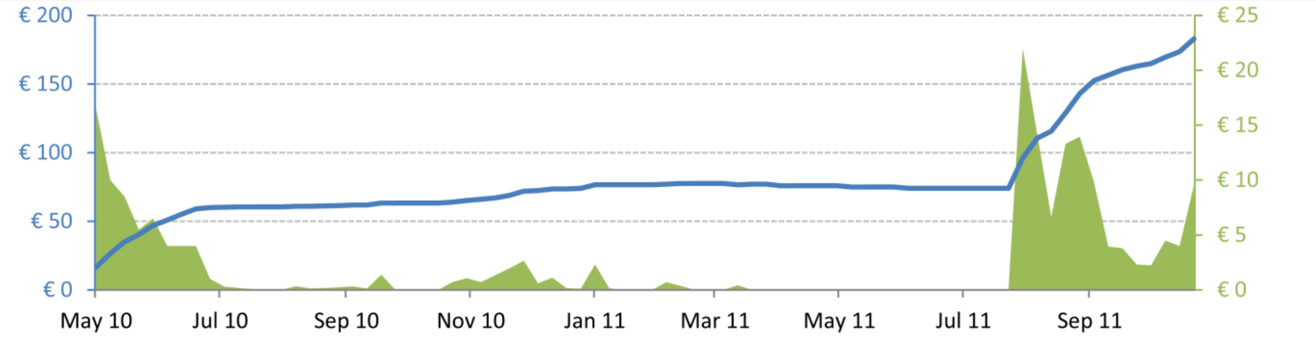
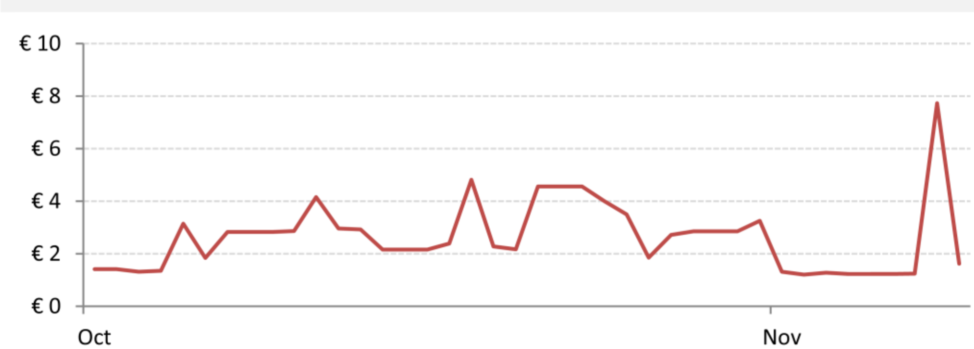


Source: ECB

varying levels of participation in the market as a carrot and a stick to move Italy along the road to fiscal reform. Apparently it is willing to allow yields to reach -- at least for a short time -- unsustainable levels. This is sending a clear message to both market participants and Italian politicians that they cannot rely on the ECB in the absence of earnest efforts at reform.

- We think some of the panic in Europe yesterday was due to some degree of shock that the ECB didn't visibly intervene as Italian yields soared. Last week's ECB rate-setting meeting -- Draghi's first as president, where he cut rates by 25 bp -- left the impression that he would be dovish, certainly relative to his unrelievedly hawkish predecessor (see "On the November ECB Rate Decision" November 3, 2011). Last week, market-implied expectations for next month's meeting were firmly for another 25 bp cut. Yesterday those implications were suddenly cut in half, where they remain despite the prevailing atmosphere of panic.

It's almost amazing that while this pressure remains in the Euro area bond market -- Italy is just the most worrying example of rising yields at the moment -- there is little sign of the Euro area banking system entering panic mode. With very few exceptions, bank stock prices are above their September lows, as are equity indices generally. Use of the ECB's Marginal Lending Facility -- its emergency overnight lending window -- remains low (see chart below). This low usage means that banks are not



Source: ECB

getting caught without funding. We should mention that there is a chance that the low use of ECB liquidity could point to a lack of eligible collateral at the banks -- but recent ECB rule changes that have considerably lowered the bar on eligibility make this unlikely.

Bottom line

Political stability may be breaking out in Greece and Italy, but stable government is only the first step for these countries. The policy implementation test still has to be passed and, with markets watching every move the stakes could not be higher. The ECB, as the Italian bond buyer at the margin, has been willing to intervene -- or not -- to let its demands for austerity be known. The ECB has now gotten its way in Greece -- Italy's parliament will decide this weekend whether to comply. The new Greek and Italian governments will be right to expect more ECB support for their compliance. And we will be right to expect calmer sovereign debt markets.