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Europe's long-term vision needs a short-term ECB lifeline -- but prejudice and politics block it.

We warned that following the Euro area's October summit there would be a test of the currency union's ability to withstand contagion (see "Not Crazy, Still Cheap" October 31, 2011). It's on the verge of failing the test, with yield spreads in Italy, Spain and even France blowing out to euro-era highs -- and this morning a nearly "failed" German bund auction. The institutions capable of combating this contagion seem to have absented themselves.

So it's time for a reappraisal of Europe's debt crisis. As we begin, we can't help recalling Winston Churchill's famous remark that "America will always do the right thing, but only after exhausting all other options." Today the Euro area is rapidly exhausting all its options, and at this point we have to wonder whether it will ever do the right thing.

- It's the right thing -- *long term* -- for the Euro area to continue its pursuit of deeper economic integration, and the restructuring of its economies toward less debt and more competitiveness. *This* right thing the Euro area is doing with surprising rapidity.
- But it's the right thing -- *and in the short term, the utterly necessary thing* -- for Europe to use in a bold and meaningful way the two institutions with the firepower to fight the contagion: the European Financial Stability Facility (EFSF), and the European Central Bank. *This* is where the Euro area is miserably failing at the moment.
- The failure to do the right thing in the short term renders the long term moot, as it means starving European governments of funding, strangling growth, and -- potentially -- causing the break-up of the euro currency (see "Europe Gets MAD" November 15, 2011).

Let's start by reviewing what progress has been made toward the long term goals of integration and restructuring.

- There has been a change of government in every one of the PIIGS countries this year. There have been three in just the past three weeks -- new technocratic administrations appointed in Greece and Italy, and a new government in Spain elected last weekend.
- There have been promises of austerity from every Euro area administration, including balanced budget targets.

Update to strategic view

EUROPE MACRO, EUROPE BONDS, ECB: The chances of a worst-case outcome in Europe are rising, with yield spreads even in the core countries rising alarmingly, and a nearly failed bund auction this morning. The EFSF and the ECB, the two institutions with the power to set things right, are sitting on the sidelines in confusion and dogmatism, respectively. The ECB is ideally positioned to buy the Euro area time for its many long-term reforms to take hold and pay dividends, but German prejudices and politics are staying its hand. We are watching the spread between US Treasuries and bunds. Germany will be forced to let the ECB act if its own debt markets came under pressure. We expect (and hope) that some form of policy relief comes before that becomes a fatal tipping point.

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- Germany and France are leading the way in economic integration with strong bilateral commitments on tax rates and budget processes (see "Two-Tier Europe is Born" August 17, 2011).
- There has been implementation of the so-called "Six-Pack" of economic governance measures across the Euro area -- measures that include greater oversight of national budgets by the European Commission.
- Coherent financial regulation has been put in place with the establishment of the European Supervisory Authority (ESA) approach. The three ESAs are: the European Banking Authority (EBA), the European Securities and Markets Authority (ESMA), and the European Insurance and Occupational Pensions Authority (EIOPA). Systemic risks are now overseen by the newly formed European Systemic Risk Board (ESRB).

Euro area integration will pay dividends by decreasing policy imbalances across the currency union. And tighter regulation and oversight of both banks and budgets -- a response to the lack of either in the run up to the crisis -- must also be viewed as positives. But all of these need one thing to make them effective -- time.

- For example, results so far from the first of the new governments -- Ireland's, elected in January -- are promising. But rebalancing budgets that have run into large deficits will take years. Ireland plans a return to the public debt markets in late 2012 at the earliest -- and in context, that will be considered quite a success.

One institution that could be giving Europe the gift of time -- that was designed to do so, but is laying fallow -- is the EFSF. We can't disagree with the scathing critique of the EFSF by new ECB president Mario Draghi in a speech last Friday (though momentarily Draghi and the ECB will come in for their own share of our scorn):

> We are more than one and a half years after the summit that launched the EFSF as part of a financial support package amounting to 750 billion euros or one trillion dollars; we are four months after the summit that decided to make the full EFSF guarantee volume available; and we are four weeks after the summit that agreed on leveraging of the resources by a factor of up to four or five and that declared the EFSF would be fully operational and that all its tools will be used in an effective way to ensure financial stability in the euro area. Where is the implementation of these long-standing decisions?

The EFSF seems to be going the way of the US's Troubled Asset Relief Program (TARP). After a bitter and suspenseful legislative battle during which it was advertised as essential to saving the banking system, once enacted, it was then not deployed for weeks. It underwent a series of seemingly *ad hoc* changes in its mission and design, while US stock markets plunged (see "Death by Rescue" November 17, 2008). It wasn't until the following year that TARP was deployed with sufficient clarity and

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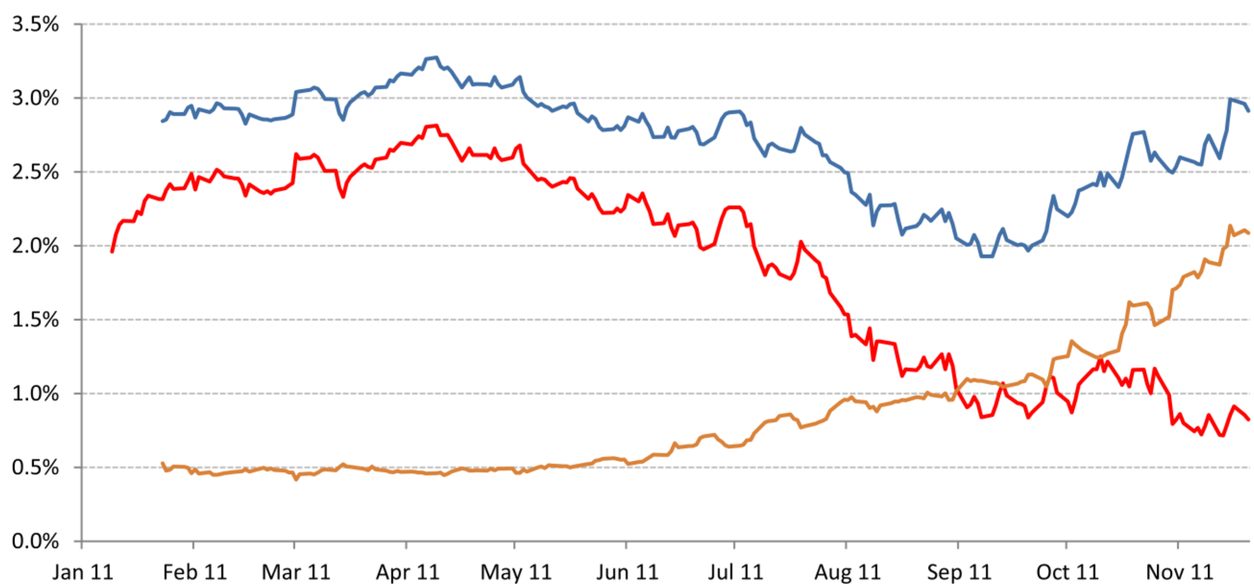
power to resolve the banking crisis (see "The Stress Tests' Hidden Mickey" May 4, 2009).

Originally the EFSF was a straightforward program of "virtual eurobonds" issued on the joint guarantee of all Euro area nations, to fund interventions in Ireland and Portugal -- and other nations as necessary. After an extensive legislative round-robin that even included the German constitutional court, it was expanded and made more flexible in its mission (see "On the German Court EFSF Decision" September 7, 2011, and "Greece: Down to the Wire" September 20). It was supposed to be the great salvation of the Euro area's sovereigns and banks. But now it has been deformed into an over-complicated monstrosity of structured finance -- and while the Euro area faces its greatest threat so far, the EFSF seems to have rendered itself incapable of action.

Markets have begun to repudiate EFSF debt, with the success of early issuances not being repeated since, and the spread over safe haven German debt increasing since June (see the chart below). In part this is because the nations that guarantee EFSF debt have themselves seen the spreads on their bonds widen alarmingly. But more fundamentally, with no clarity on how the "leverage" achieved in the EFSF's complicated structure is really intended to work, markets have insufficient information to buy into the EFSF as a solution.

Yield — European Financial Stability Facility 2-3/4% of 7/2016 — German 2% of 2/2016 — Spread

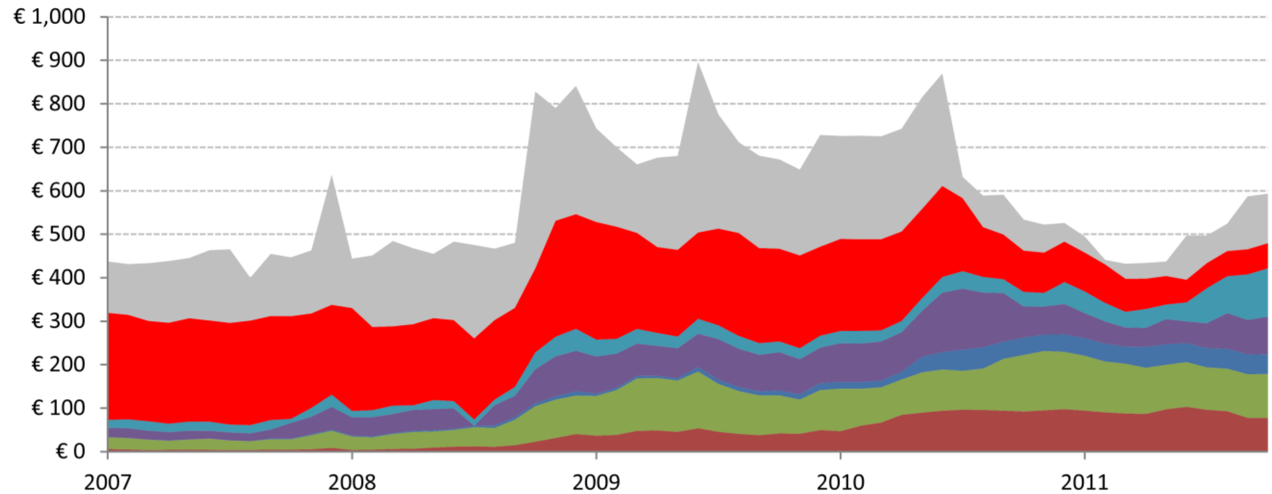


Source: Bloomberg, TrendMacro calculations

We now turn to the ECB. Throughout the debt crisis it has always done just enough to support the banking system. Its provision of liquidity on a fixed rate full allotment basis to the banks in the peripheral countries -- which now take up the majority of ECB refinancing balances (see chart on the following page) -- has helped these banks replace liquidity that has fled.

ECB refinancing operations, EUR billions

Greece Ireland Portugal Spain Italy Germany Other

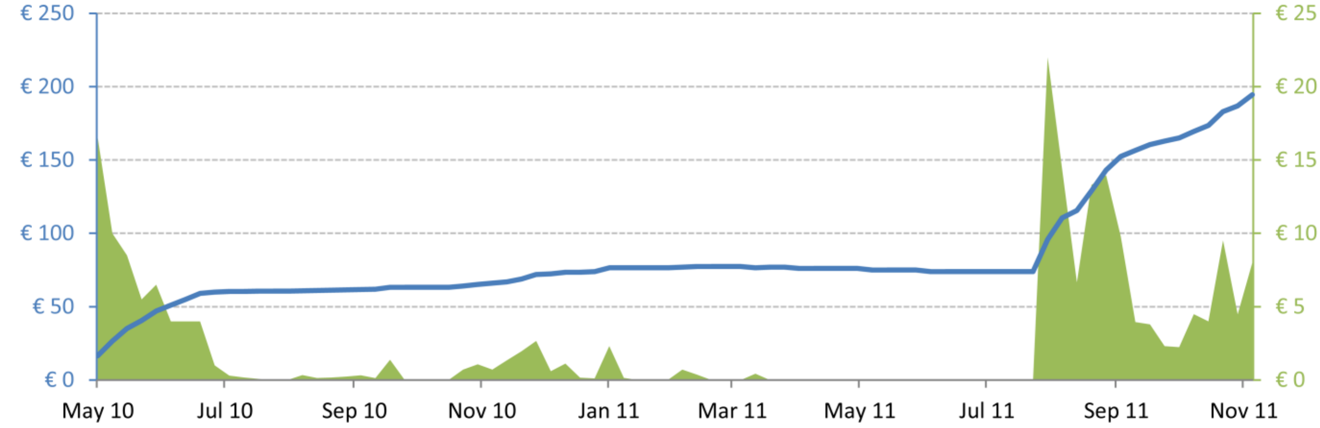


Source: ECB, TrendMacro calculations

But other than that, the ECB has done too little to ease the Euro area's debt crisis, and has done much to make it worse.

- The ECB surely contributed mightily to the Euro area's difficulties when it raised interest rates in April and again in July, in the name of squelching an inflation for which there was only superficial statistical evidence (see "EUicide" April 7, 2011). In fact, inflation was lower then -- when the ECB raised rates -- than it is now -- when the ECB is finally lowering rates.
- Liquidity for banks does little to ease funding pressures for sovereigns, especially when banks are not eager to hold more sovereign debt on their balance sheets.
- The ECB's Securities Markets Programme (SMP) -- buying sovereign bonds in the secondary market -- was begun in 2010, to help ease pressures in the most distressed markets.
- SMP buying initially succeeded in bringing Greek 10-year debt, which had climbed above 10%, down to 6.3%. Greek yields never again traded that low, and were back above 10% within six weeks -- and are now far higher, as Greece faces both debt default and descent into the status of a protectorate of Europe (see "Papandemonium!" November 3, 2011).
- Yes, Greece is a special case -- especially bad. Yet so far we have seen a similar story with the SMP's intervention in Italian and Spanish bonds. The point of SMP intervention for those countries in August was 6% on 10-year debt (see "On the ECB Rate and Bond Buy Decisions" August 4, 2011). Even with the SMP still active (see chart on the following page), those levels have been decisively breached for both countries.
- For nations like Italy and Spain -- which are basically solvent, unlike Greece -- the SMP could potentially be effective. Yet it has not been. The ECB has not been willing to deploy it in size sufficient to

ECB Securities Markets Programme purchases — **Cumulative** ■ **Weekly** EUR billions



Source: ECB

> make an enduring difference in those large debt markets. And it is hamstrung by the policy decision to sterilize bond purchases through taking term deposits to ensure that there is at least the appearance of being liquidity-neutral.

To make the SMP effective -- and at the same time to ameliorate its rate-hiking errors of April and July -- the ECB would have to follow the lead of the US Federal Reserve and the Bank of England by engaging in unsterilized quantitative easing. There are three main arguments put forward by the ECB for not doing this.

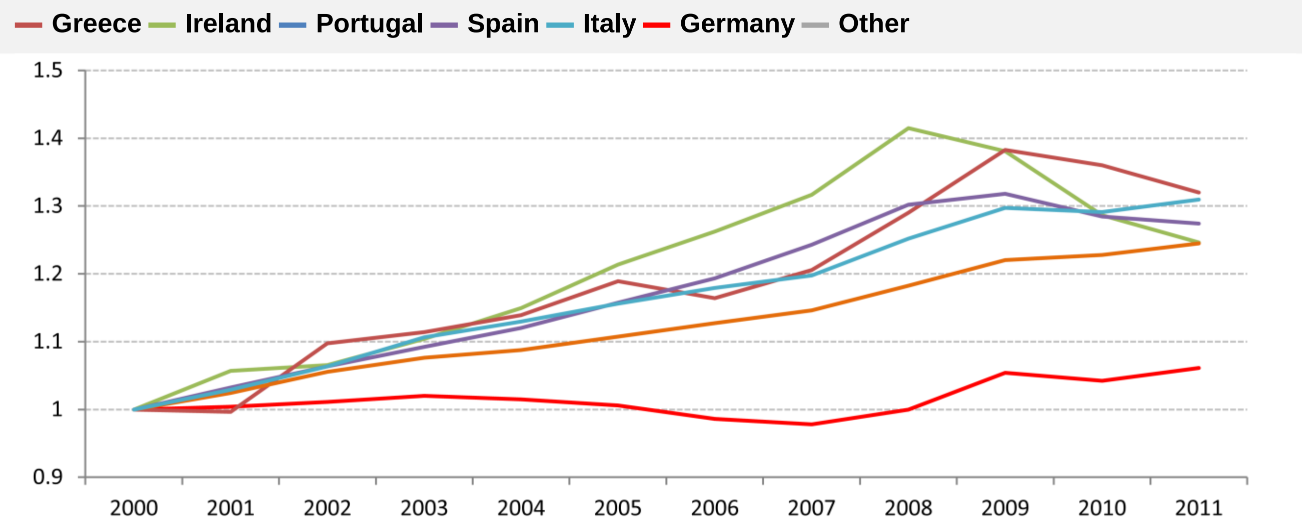
- *It may not be legal.* This argument is a bit weak. The ECB has been buying debt in the secondary market since May 2010, thus technically staying within the four corners of the treaties defining the ECB's powers. If it manages to avoid direct purchases in the primary market, then unsterilized purchases would be no more illegal than current purchases.
- *Moral hazard.* This argument is also weak. No nation is getting a free ride from SMP now. Every peripheral nation's government will have changed this year, and every new government has to implement unpopular austerity measures -- dictated explicitly by the ECB. The ECB has the whip hand over these governments, and unsterilized purchases would likely increase its leverage, rather than reduce it.
- *Inflation risk.* As expressed by Bundesdbank President Jens Weidmann in a recent interview, the ECB's job is only to control inflation -- not to bail out sovereign debtors. This is by far the strongest argument, as the ECB's primary mandate is indeed price stability, and if it were to engage in actions that proved to be inflationary, then it would have failed in its main task.

Let us explore the inflation argument in more depth.

- There is presently no evidence of an underlying inflation problem in the euro area -- with core inflation running at only 1.6% year-over-year.
- If the ECB stands by while the euro currency breaks up, plunging the world banking system into crisis, the result would likely be a world-wide *deflation* like we experienced at the depth of the Great Recession.
- Yet inflation-fighting remains the ECB's policy focus, despite any evidence of an inflation threat and despite the risk of deflation if the ECB fails to act. This reflects the deep convictions of German policy makers, who enjoy dominant influence at the ECB.
- We experienced this first-hand this week in [a meeting] with Jurgen Stark, the recently resigned ECB governor still serving out the residual of his term. In person, we were struck by his utterly rigid single-mindedness on inflation-fighting -- it seemed to be a nearly theological devotion, brooking no possible disagreement.
- There is a general belief that such concerns are driven by Weimar hyper-inflation folk memories in German culture. This may be what motivates zealots like Stark. But it isn't the reason why pragmatic German politicians fear inflation, and therefore appoint true believers like Stark to the Bundesdbank and the ECB.

The political reason is that unit labor costs in Germany have scarcely grown at all over the past decade (see the chart below). This is the result of the mid-2000's program called Agenda 2010, in which labor market reforms made Germany globally competitive. The implicit social contract was that German workers would get little unit labor cost growth, but that in exchange unemployment would be low (indeed, at 7%, Germany's unemployment is among the best in the developed world). Now any German politician who allows inflation will be breaking that social contact, because unit labor costs won't grow to offset it. Inflation is straightforwardly a pay cut for German workers. With the German political position in lockstep with the ECB's policy prejudices, it is clear that the Euro area will

Unit labor costs Indexed to 1 in 2000



Source: Eurostat, TrendMacro calculations have to endure more crisis before we can expect to see the ECB engage in outright QE.

For that matter, a broader view of Germany's political agenda argues even more forcefully for the same conclusion. A continuing crisis is Germany's strongest leverage in driving more extensive economic and political integration across Europe. It is no surprise that as the debt crisis has flared up to new intensity the last two weeks, we hear German Chancellor Angela Merkel speak repeatedly of "treaty changes" that she wishes to see. Speaking last week she even went so far as to volunteer that "to show the markets and the world public that the euro will remain together… we are prepared to give up a little bit of national sovereignty."

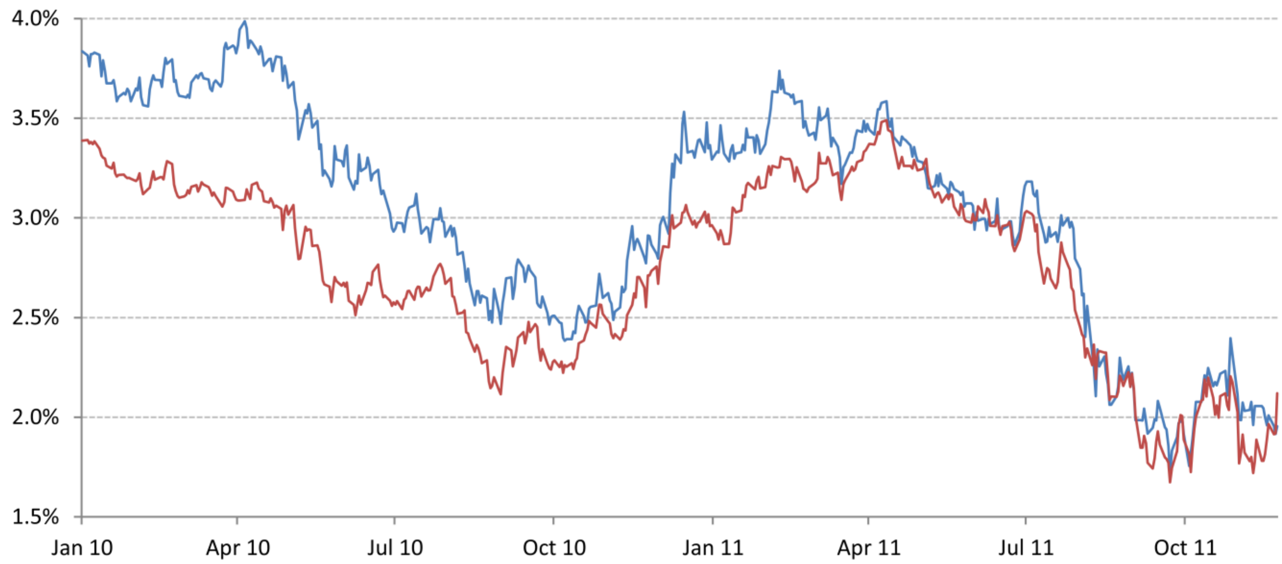
- We note that Germany exercises substantial control over the EFSF, as well as the ECB. As the EFSF's largest proportional guarantor, Germany is first among equals. It happens that staff in the German Debt Management Office in Frankfurt runs all the back-office functions for the EFSF.

So for Germany, the art of the game is to maintain the crisis at just the right level -- but not beyond a tipping point at which events spin out of Germany's control. What would signal to Germany -- and to investors -- that such a tipping point is upon us? We hear this question frequently now from clients.

That signal has started flashing a warning this very morning -- it is German debt. So far, throughout the crisis, German debt has enjoyed safe haven status in the Euro area. While the widening of spreads to other AAA-rated countries over the last several weeks has been mostly driven by rising yields in those countries yields -- at the same time the yields on German debt have fallen, with the 10-year bund weaving around 2% since September.

- That has meant that the dangerous game that Germany is playing -- on the one hand, volunteering its credit to underwrite and guarantee bail-outs, and on the other hand keeping the ECB from aggressively easing -- has been working.
- *We'll get a clue that it's no longer working when German yields develop a spread to US Treasury yields. There is the risk that this began this morning.*
- The US is the only market large enough, liquid enough, and viewed as safe enough to be a comparable to Germany for investors. Conceptually, Swiss debt would be an ideal benchmark -- but in reality the size of it is vanishingly small.
- The US 10-year and the 10-year bund have been within basis points of each other for months (see the chart on the following page). If we see a substantial and sustained break-out of this spread, without a reduction in other Euro area yields -- which would show an improvement in general market sentiment -- then we would start to see a flight of capital from the entire Euro area, not just the periphery.

10-year yield — German bund — US Treasury

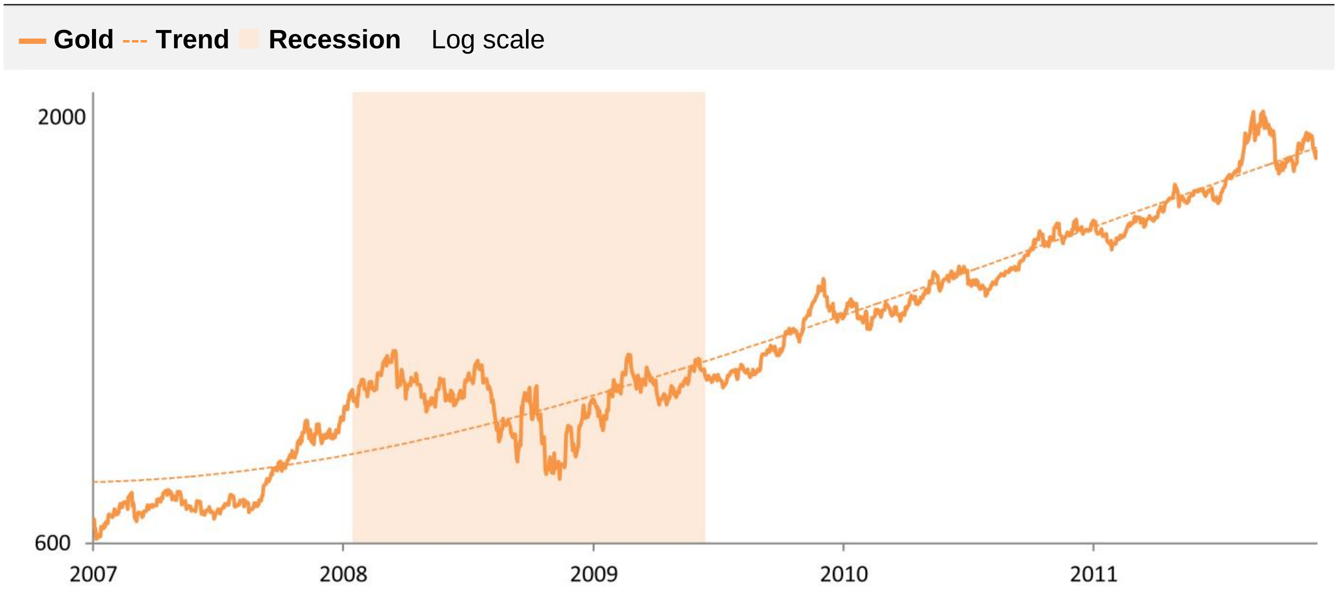


Source: Bloomberg

- At that point, contagion from the periphery would have reached Germany itself -- the core of the core. So surely Germany would act. But the reason we call this a tipping point is that, if we reach it, it will be too late to act. ECB debt monetization from a position of weakness would likely only increase the flight of funds, and add to the instability rather than do anything to restore confidence.
- This morning a €6 billion auction of 10-year bunds was a virtual failure, with the Bundesdbank having to retain as underwriter €2.4 billion of the issue for subsequent distribution. As of this writing, the benchmark German 10-year yield is up 20 bp, with the comparable US Treasury yield up 4 bp.
- This one auction is not dispositive evidence that the tipping point is upon us, but it is a serious warning -- which we expect will duly get the attention of policy makers. So with this warning in effect, now we can observe whether the Euro area authorities will begin to act to save themselves -- or whether the world economy is doomed to watch yet another European march of folly.

We explore these scenarios because, obviously, the risk of a worst-case outcome in Europe has risen considerably in the last several weeks. Acknowledging that, our baseline scenario remains that the ECB and other institutions -- even the EFSF -- will intervene before the tipping point. We think the ECB has little choice but to eventually act to monetize debt to some extent. For all its dogmatic talk, the fact is it always has -- whenever it judges that the intensity of the crisis demands it. That's what brought the SMP into being in the first place, and inspired its re-launching in August.

- Longtime clients know that we regard gold as a highly sensitive indicator of future liquidity trends. While gold is not at the record highs of several months ago when expectations for ECB



Source: Bloomberg, NBER, TrendMacro calculations

> intervention were higher, it is hardly signaling the kind of liquidity crisis that would ensue if there were really no likelihood that the ECB would intervene if truly needed. Gold was a reliable indicator of this risk in 2008, as the banking crisis in the US came to a head, falling almost 35% from the day of the Bear Stearns rescue to the month following Lehman Brothers' failure (see the chart above).

Timing of is the ECB's intervention is impossible to foretell at the moment. All we can do is watch the indicators, decode the Kremlinology, and beware the tipping point.

In the meantime, we have upcoming on December 8 Draghi's second ECB monetary policy meeting as president, at which markets now assign a better than even chance of another rate cut. The following day is the next Euro area summit. According to German Finance Minister Wolfgang Schäuble, it will "give markets a clear signal." Forgive us if we are skeptical. To Schäuble we can only say, "*that* would be a first."

Bottom line

The chances of a worst-case outcome in Europe are rising, with yield spreads even in the core countries rising alarmingly, and a nearly failed bund auction this morning. The EFSF and the ECB, the two institutions with the power to set things right, are sitting on the sidelines in confusion and dogmatism, respectively. The ECB is ideally positioned to buy the Euro area time for its many long-term reforms to take hold and pay dividends, but German prejudices and politics are staying its hand. We are watching the spread between US Treasuries and bunds. Germany will be forced to let the ECB act if its own debt markets came under pressure. We expect (and hope) that some form of policy relief comes before that becomes a fatal tipping point.