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Greece Gets TARPed

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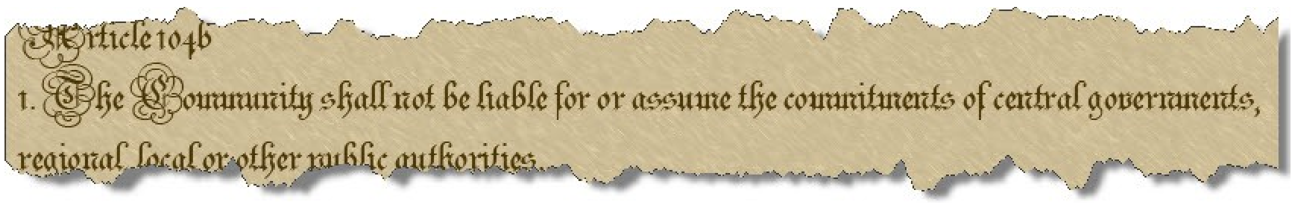
The euro is saved, for now. But a lawless rescue is a permanent blow to credibility.


Article 104b
1. The Community shall not be liable for or assume the commitments of central governments, regional, local or other public authorities

The long-anticipated bail-out of Greece is official. Thus it remains the avowed policy of world authorities that deflation is to be prevented no matter what the cost in institutional credibility. It's just like the bad old days of 2008, only now it's whole countries that get bailed out over the weekend "before Asia opens," rather than just banks. Sunday's announcement by the Euro area Member States of a $41 billion rescue for Greece is even more unlawful than the US Treasury's TARP loan of similar magnitude to Citigroup. The Treasury's lending to banks and automakers was not specifically permitted under the Economic Emergency Stabilization Act, but Europe's support of Greece is *specifically prohibited* under Article 104b of the Treaty of Maastricht.

The rescue of Greece is good news because, lawful or unlawful, it was necessary, just as TARP was. *This* violation of Maastricht was made inevitable in 2002 with another violation of Maastricht, the admission of Greece to the monetary union despite its excessive debt and deficits that have formally violated Article 104c every year since (see "Greek Farce" February 16, 2010).

Update to strategic view

US DOLLAR: The euro is saved with the official rescue of Greece. But this unlawful bail-out compromises its credibility as a competitor for the US dollar. And it signals the end of the anti-inflationist Bundesbank's policy dominance.

GOLD: The deflation threat from the PIIGS crisis has passed with the official rescue of Greece, and inflation-sensitive gold is free to challenge all-time highs.

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Article 104c
1. Member States shall avoid excessive government deficits.

The rescue -- and further rescues of other PIIGS nations as they become necessary -- will save the euro from structural rupture. But the euro will be forever compromised as a credible world currency and competitor for the US dollar. Only a decade old and a novel experiment in monetary union without fiscal union, the euro derived its credibility from rules -- which have now been fundamentally violated. And it derived credibility from the institutional dominance of the European Central Bank by the traditionally anti-inflationist Bundesbank. But facing massive losses in PIIGS sovereign debt for German banks, on investments thought to exceed $700 billion, the ECB blinked. Now the German balance sheet is about to be junked by taking on additional Greek debt at a subsidized rate. The rescue pretends to involve penalty rates -- about 5% for 3-year fixed-rate debt. But no rate can truly be said to be a penalty when the debt involved is not otherwise marketable -- any rate at all is, *prima facie*, a subsidy. Besides, 5% is about the long-run historical average for 3-year fixed rate German debt (and US debt, too). The only penalty is on Europe's credibility. No wonder gold, priced in euros and in sterling, moved to new all-time highs last week, as word of the imminent rescue began to circulate.

The correction in global risk assets that began mid-January was in large part about fears that the world would slip back into the monetary deflation of late 2008. The PIIGS crisis brewed up at the same time as monetary authorities around the world seemed poised to begin tightening, and a populist backlash in the US, following the Senate election of Scott Brown, embodied the global electorate's distaste for more bail-outs (see "A Scott Heard 'Round the World?" January 19, 2010). We said early on that there would be no tightening, and no end to the bail-outs, and that as it became increasingly clear that Greece would be rescued, deflation-sensitive gold would lead risk assets such as stocks out of the correction (see "PIIGS, Panic and Jobs" February 5, 2010). As it happened, the bottom for both gold and US stocks was that very day. Since then US stocks, and stock markets around the world, have moved to new recovery highs. But gold -- even priced in dollars, while the dollar has benefited from the euro's travails -- has done more than that. While the S&P 500 remains 20.2% below its 2007 peak (including dividends), gold has moved back to just 4% below its all-time high last December. That's because while the US economy is surely recovering, reflation remains the dominant theme.

Bottom line

The euro is saved with the official rescue of Greece. But this unlawful bail-out compromises its credibility as a competitor for the US dollar. And it signals the end of the anti-inflationist Bundesbank's policy dominance. The deflation threat from the PIIGS crisis has passed with the official rescue of Greece, and inflation-sensitive gold is free to challenge all-time highs.

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