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Europe Gets *le TARP*

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A painful lurch toward European federalism, but it's not clear it will restore confidence.

It's €700 billion, not $700 billion, but we can't help noting the numerical coincidence between the European Union's shock-and-awe attempt Sunday to restore confidence in its weaker sovereign credits, and the US's similar move in October 2008 to restore confidence in its banks with the Troubled Asset Relief Program. TARP ended up eroding confidence rather than restoring it, because it was applied so unpredictably and so lawlessly. Europe's version now starts out with lawlessness -- despite rationales to the contrary, such bail-outs are flatly prohibited by the Treaty of Maastricht (see "Greece Gets TARPed" April 12, 2010). And unpredictability seems baked in the cake, too. At this moment no one really knows what nations will be eligible for what credit support, under what decision regime, and on what terms. And one senses this implicit lurch toward European federalism is being done more in anger than in sorrow. In press photos, France's Sarkozy and Germany's Merkel look less like they are celebrating the salvation of the Euro Area and more like they are passing kidney stones.

French President Nicolas Sarkozy and German Chancellor Angela Merkel at a euro-zone summit in Brussels Friday.

Source: Reuters, from the *Wall Street Journal*

Update to strategic view

US DOLLAR: As with TARP in 2008, the devil is in the details for Europe's lawless *ad hoc* plan to restore confidence. The sovereign debt crisis may be stabilized by throwing French, German and IMF money at it -- but the euro remains hobbled by the continued erosion of the credibility of its institutional framework.

GOLD: The ECB calls it sterilized intervention, but its purchase of sovereign debt can't help but be a form of policy easing. At the same time, the Fed's reactivation of currency swap lines will take its balance sheet to new highs. After a brief reaction, we expect gold will reflect the inflationary risks of these developments and successfully challenge its December highs.

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As painful as it evidently is for Europe to do this to save itself, it nevertheless revalidates the robustness of our baseline strategic conception: "ongoing commitment by the Fed and all the world's monetary and fiscal authorities to massive liquidity support will continue to flatter lesser credits, so buy dips in distressed situations, and don't pay up for quality…" (see "The Scariest Chart in Economics" April 27, 2010).

The most painful step here is the one being taken by the European Central Bank, forced by circumstances to announce Sunday that it would for the first time buy the sovereign debt of individual nations (until now, ECB open market operations have consisted entirely of transactions with banks). This step is being characterized as an "intervention" to stabilize disorderly markets, rather than a policy to monetize debt. The ECB says purchases will be sterilized, and will therefore not affect monetary policy. In one sense this can be likened to the Fed's purchase of $1.25 trillion of agency MBS and $200 billion of direct agency obligations, sterilized by excess reserves and by the Treasury's Supplemental Financing Program. But the Fed never pretended that this program had no monetary policy implications, just because it was sterilized. Indeed, the Fed has stated repeatedly that its aim was to lower long-term interest rates, which has profound policy implications. The ECB's similar actions will have similar implications. Its claims to the contrary are alarmingly disingenuous.

Will Europe's bail-out work? As of this writing, world markets are acting like it will. And on paper, it should. In essence, it is simply the federalization of existing debt, not the creation of new debt. And seen as a federal whole, Europe can afford it, even ignoring the component of IMF assistance contemplated in the announced plan. Europe's government debt is 75% of GDP, not importantly greater than the US's 63%. Probably more important is the Euro Area's aggregate deficit of 6.8% of GDP, which compares well to the US's 10.6%. Strictly economically, the composition of Europe's debt as between its constituent countries doesn't matter, any more than the composition of the US's debt as between states. What matters is the combined capacity to service it.

But "strictly economically" ignores many critical elements that come into play when Job One is to restore confidence. In the US, confidence was not restored by TARP money -- quite the contrary. It was restored six months after TARP tried and failed -- not until March 2009, after new Treasury secretary Tim Geithner announced he had issued a free put on US bank equity capital (see "Geithner Gets a Do-Over" March 24, 2009). Following that announcement -- which was mere words, not money -- not a penny of Treasury money has had to be invested in banks. We think it's unlikely that a fractious non-federal Europe will be able to act with such generosity or such simplicity, no matter how much money they say they'll commit. Confidence may well remain quite difficult to restore, because their ambiguous commitment will always need to be tested and re-tested.

We also note that on Sunday the Fed announced the reactivation of currency swap-lines with the ECB. This marks the first time on the Fed's many emergency facilities put in place during the credit crisis of 2008, now long since deactivated, has had to be started up again. It's not clear to us

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why the ECB would especially need dollar liquidity in the present crisis. But to the extent it does need it, this facility enables its acquisition without further trashing the euro's exchange rate in forex markets. But for the Fed, assuming the ECB draws on the new line, this means printing more money. It will take the Fed's balance sheet to a new all-time high. The swaps will show up as a new asset -- the euro's acquired with the newly printed dollars. Assuming with near perfect certainty that the Fed won't fund this new asset with sales of existing assets, it remains to be seen what new liability *will* fund it. Whatever it turns out to be, this represents a ratcheting up of the dangerous game the Fed has been playing with its enormous balance sheet for going on two years. Exit strategy? Quite the contrary.

Bottom line

As with TARP in 2008, the devil is in the details for Europe's lawless *ad hoc* plan to restore confidence. The sovereign debt crisis may be stabilized by throwing French, German and IMF money at it -- but the euro remains hobbled by the continued erosion of the credibility of its institutional framework. The ECB calls it sterilized intervention, but its purchase of sovereign debt can't help but be a form of policy easing. At the same time, the Fed's reactivation of currency swap-lines will take its balance sheet to new highs. After a brief reaction, we expect gold will reflect the inflationary risks of these developments and successfully challenge its December highs.