

Will Europe defend its periphery?

Markets are in the process of testing the financial and political commitment of the core European countries, primarily Germany and France, to the euro project. For the spreads of Greek, Portuguese and Spanish government bonds to stop widening and reverse course the peripheral countries need to not only have credible plans in place to cut their budget deficits, but markets also need to believe that they have the political will and social cohesion necessary to implement very painful measures. Given that they probably don't, the most likely outcome is a bailout. This would probably involve the other eurozone countries guaranteeing the debt of the peripheral countries that are coming under pressure. Unfortunately, given the complexities of Eurozone decision making processes, such a guarantee may be some time coming. Markets are not known for their patience.

The peripheral countries need to import credibility, by having their fiscal adjustment plans overseen and underwritten by a credible third party, if they are to avoid being forced out of the eurozone by the markets. This could be the IMF or other eurozone countries. For the time being, the eurozone has made it clear that it would rather sort out its own dirty washing than call in the IMF. Consequently, markets are in the process of forcing European politicians and policy makers to either put up or shut up.

Once investors are confident that the core will act to bail out the periphery, this should be a buying opportunity. Greek, Portuguese and Spanish government bond spreads will narrow, delivering capital gains on top of an attractive yield pick-up over French and German bonds.

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Will the core bailout the periphery?

This is about politics rather than just economics. The generation of European leaders who were the driving force behind the European project had been traumatised by the Second World War and would have been willing to maintain European unity at almost any cost. The current generation of leaders is probably less strongly wedded to the euro project. Whereas German Chancellor Angela Merkel and French President Nicolas Sarkozy were born ten years after the Second World War ended, Francois Mitterrand was born in 1916 and Jacques Chirac and Helmut Kohl were both born in the early 1930s. Consequently, the ravages of war will have coloured their outlook on life and made them committed to avoiding another war in Europe. This desire was one of the origins of closer European integration.

The bottom line is that it will probably take more signs of contagion spreading to the core, perhaps in the form of French and Italian spreads over German bunds widening, before a bailout can be sold to the voters of France and Germany. This would be particularly true if Spain needed bailing out as well as Greece, Ireland and Portugal, given Spain makes up 12% of Eurozone GDP. That is substantially more than the 2-3% that the other countries each account for.

What form might a bailout take?

There are three main ways in which the Europeans could organise support.

I. A European Monetary Fund: based on the model of the IMF, Europe could establish a European Monetary Fund, funded by the EU countries, which could disburse loans to other EU countries in case of emergency and with conditions

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attached. Although this seems like a good idea, this is not a viable solution because it would take too long to set up.

2. European Community bonds: the EU countries could issue a joint bond fully guaranteed by each state. The funds raised could then be made available to a country being bailed out, with the condition attached that the issuers are compensated for both interest and principle by the country being bailed out. The bailed-out country would benefit from being able to access funds at a lower interest rate than if it went to the market itself.

3. Guarantees: this seems to be most likely approach, because it would probably be politically easier to implement and “sell” a guarantee for the bonds of the bailed-out country than to issue joint bonds to fund a bailout. Unlike the case of a joint EU bond, the EU countries would not directly raise funds and could point out to their citizens that they have “only” entered into a contingent liability.

How easily can a bailout be arranged?

A bailout will not be easy, given the complexities of eurozone decision-making processes. The last time the markets played chicken with policy makers was following the failure of Lehman Brothers in September 2008. Despite the fact that only one country and three institutions (the Fed, US Treasury and US Congress) were involved it took policy makers months and more than one attempt to come up with a convincing systemic solution to the ensuing financial crisis. Europe is unlikely to fare much better with its myriad of finance ministries, conflicting views on the ECB Council and hard to understand and untested rules and regulations. In the meantime, given the uncertainty, markets are likely to keep pushing spreads to greater heights. The markets and Europe's policymakers are on different timelines, with the markets screaming that something has to be done, and soon, and Europe's policymakers acting as if time is on their side.

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