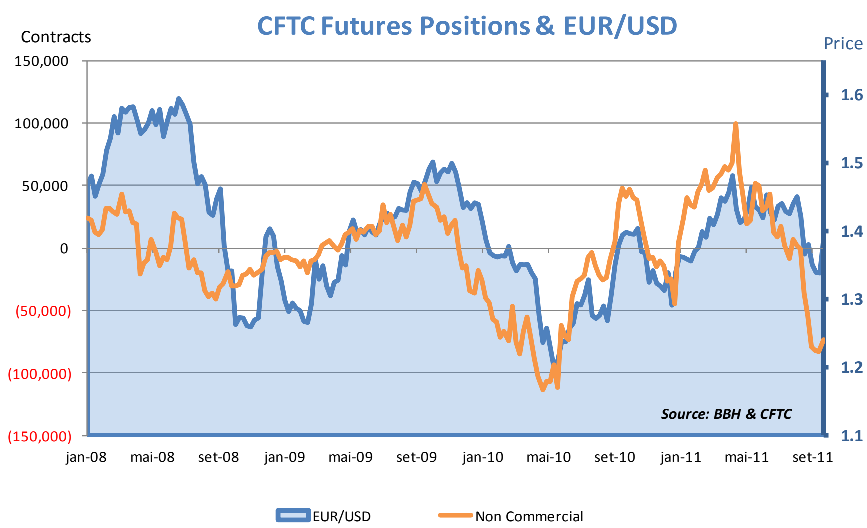
The Outlook for a European TARP

What Winston Churchill said about America, that it can be counted on to do the right thing after it exhausts the other alternatives, seems equally applicable to Europe. It is slowly but inexorably moving toward its own version of TARP—the U.S. "toxic asset relief program". Rather than sub-prime mortgages and related derivatives, the toxic assets in Europe are sovereign credits, which in some cases – namely, Ireland, is a function of the nationalization of private sector debt.

Although Slovakia provided some last minute drama, policy makers and investors were already anticipating the approval of the reforms of the European Financial Stabilization Fund (EFSF) and looking beyond, toward implementation and a boost of its firepower. The shift in the focus has helped spur a bout of position-adjusting.

Euro

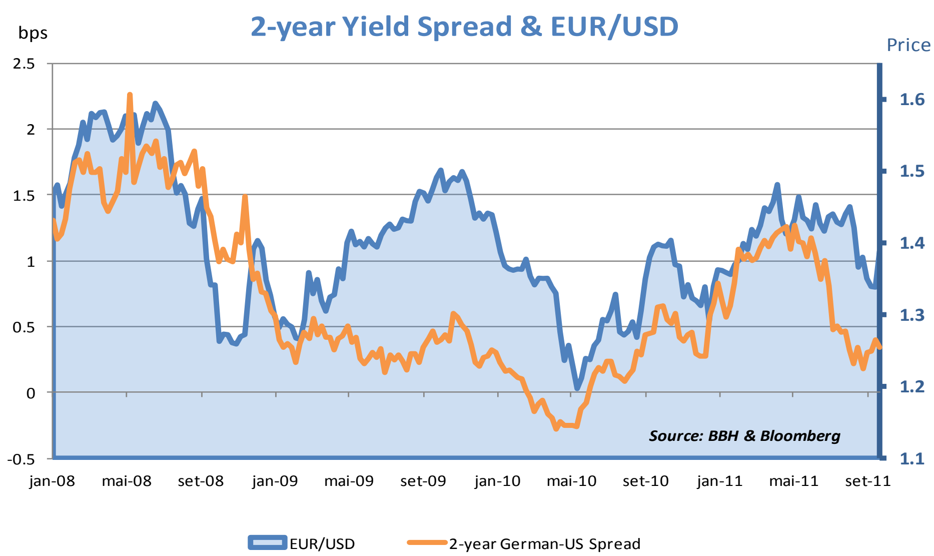
As illustrated by the net non-commercial positions at the IMM, the short-term momentum and trend-following market had amassed a large short euro position from late August through early October (the largest in a little more than a year) (Figure 1). For the better part of two weeks, the euro has been trending higher as these shorts have been covered.



As noted in an earlier post, the euro-dollar exchange rate is the most correlated (rolling 60-day, percent change) with the S&P 500 as it (or its synthetic) has been since at least the early 1990s. The euro-dollar exchange rate is also near its highest correlation, with 2-year U.S.-German interest rate differentials as well. The Fed's promise to keep rates low until at least mid-2013 takes some volatility out of the U.S. 2-year yield, so the spread has tended to be more a function of the German side of the equation.

There are two main drivers of short-term German interest rates. The first is economic data. The euro zone economy has slowed down markedly from Q1, including the German economy. The unwinding of at least one of this year's two rate hikes is likely by the end of the year (we suspect December when the new ECB President will have revised staff GDP and inflation forecasts to guide the decision). This has arguably helped lower 2-year German rates.

The second force, investors' embrace of Germany as a safe haven, seems the stronger of the drivers. As the debt crisis increased in intensity in September and early October, the demand for German paper grew. The German 2-year fell to record lows in late September near 32bps. During the bout of position adjusting, the German yield has more than doubled and the premium it offers over the U.S. has doubled from 20bps to 40bps.



There is scope for additional positioning in the coming days, ahead of the October 23 EU summit. The next technical objectives are found around the $1.4000-50 area. Given the extreme market positioning and the right noises coming from European officials, the data stream suggests that the world's largest economy has accelerated since mid-year rather than slowed further. This could propel the euro and overshoot these technical targets.

Europe's Tarp

Germany and France appeared to have a "eureka moment". International pressure/criticism is mounting, investors and businesses fear a financial apocalypse, a political backlash is evident in Germany throughout the year in state elections, and the Socialists winning control of the French Senate for the first time in the Fifth Republic. Merkel and Sarkozy have promised a "durable" fix. Market participants are in effect buying the rumor of new measures and could very well sell when it becomes news

The incrementalism of European officials through the crisis is partly institutional in nature. It is a congenital defect, but one that made the birth possible in the first place. Euro zone members surrender/abdicate monetary policy but have thought they maintained economic sovereignty. This crisis is shattering that illusion. The kind of closure that investors want is institutionally prohibited in the euro zone.

There are three key components of the "durable" and comprehensive plan that Germany and France will likely present at the summit. First, it needs to find a more sustainable solution for Greece. Second, it must come to terms with the fact that some systemically important euro zone banks may need to be recapitalized. Third, it will likely propose ways to bolster the EFSF without members having to go back to parliaments to request more funds.

We have maintained consistently since the crisis began what is now becoming clearer to officials: That bondholders would have to eventually accept 50%-70% haircuts on Greek debt. The 21% haircut plan of July 21 was seen by many as only a partial down payment. Many, but not all, large European banks wrote down their Greek exposures by 50%. Several of those banks that provided reserves for 21% have come under more pressure recently. Some press reports suggest that German banks are preparing for 60% haircuts.

The ECB is the single largest holder of Greek government bonds. However, it refuses to participate in the "voluntary" scheme to make investors share some of the burden of adjustment. This means that the haircut needed in the private sector is actually larger the more that the ECB owns. In any event, European officials hope that the larger haircut can re-establish a firewall around Greece and suggest that there won't be other sovereign debt restructurings. This is one of the Achilles' Heels. If Greece can walk away from 50-70% of its debt, why shouldn't Portugal and Ireland, not to mention Belgium, Spain and Italy, not seek some relief?

The EFSF's institutional successor is the European Stability Mechanism (ESM), which was supposed to allow for orderly sovereign debt restructuring. It is supposed to come online in the July 2013, but there is movement among some euro zone officials to bring it forward by a year.

Recapitalizing Banks

If sovereign bond holders are going to "voluntarily" take substantial losses to avoid a Lehman-like debacle, some assurances are needed that banks will be recapitalized. How euro zone officials do this, given the conflicting positions of key stakeholders, may be another Achilles' Heel and prompt skepticism by the capital markets.

In the United States, banks appear to have been largely told how much capital they were going to request from the Treasury, which provided the same terms to everyone, the innocent and guilty, those that may have needed a capital infusion and those that may not have. It directly injected money into the banks, not by buying the distressed assets as initially conceived, but providing permanent capital in a way that also protected taxpayers. It avoided the ideological problem of the government having a vote on the bank boards, by acquiring preferred shares and long-term warrants.

Lacking sufficient institutional mechanisms, Europe is unlikely to duplicate the U.S. process and results. A greater burden is likely to fall on the members of the euro zone themselves. Of the core members, France is seen as in a particularly disadvantageous position relative to Germany. This helps explain why as the bank recapitalization talk increased and the euro appreciated and the basis swap (price of swapping euros for dollars) fell to four week lows, the spread between German and French 10-year yields widened to new EMU-era highs.

In fact, the correlation between the euro and the 10-year Germany-French spread has been inversely correlated (60-day rolling, percentage change), since the Greek debt crisis first flared up in late 2009. However, since early September inversion has become significantly less (from -0.55 early September to -0.22 in mid-October).

The greater the breadth (number of systemically important financial institutions covered) and depth (size of capital infusion) and more European (federal) the backstop for euro zone banks, the better the chances of success. European officials risk greater instability if a stigma is attached to participation (which is the advantage of forcing all critical institutions to partake). European officials also risk under-whelming the market if the proverbial bazooka turns out to be a water gun and officials fail to commit an overwhelming amount of resources. An ability to lift the burden from strictly national finances risks exacerbating the credit pressures on countries such as France.

EFSF

This is where the EFSF comes in. It can be used to help countries recapitalize their banks. There are various approaches that have been proposed, but the institutional and political constraints suggest that an insurance model may very well be the path of least resistance. By partially guaranteeing some part of new sovereign issuance, the EFSF would achieve the leverage that is necessary to ramp up the 440 billion fund without requiring new parliament votes.

The insurance model likely means that it will not be able to buy sovereign bonds in the secondary market as some have proposed, which would relieve the ECB of this unpleasant task. While some at the ECB may not be pleased, its continued involvement is an important element of support the financial system. Yet, paradoxically, the more success euro zone officials have at next week's summit and at the G20 meeting in early November, the less the ECB's purchases of sovereign bonds will be needed.

At the start of the debt crisis, there were powerful voices in Europe that opposed a role for the IMF. Those voices were ultimately, of course, outvoted and the IMF has played a significant role (and provided roughly 1/3 of the capital in the aid programs). Some European officials now seek an even greater role for the IMF.

The IMF's Lagarde indicated last month that the Fund's $390 billion in current lending power was insufficient for the demands it may face. Yet many key contributors are reluctant at this juncture to agree to a new capital raising exercise by the IMF. This may change if and when new formal requests for IMF programs are requested. Several of the large developing countries reportedly are more interested than, say, the U.S. and U.K. and this could lead to realignment of power within the IMF in the coming years.

Lastly, policy makers seem to believe that by focusing on repairing the financial system, they will win back the confidence of investors. Yet we suspect it will take more than that, while recognizing that it is no simple task either. The real challenge is the underlying source of the debt crisis, and one that remains un-addressed and off most radar screens: Sustaining aggregate demand. Debt allowed aggregate demand to be sustained in the face of weak wage and salary growth. What is going to replace it?

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