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Things Must Change to Remain the Same

The U.S. dollar declined in September and October as the market priced in the likelihood that the Federal Reserve would resume buying Treasuries. From late August through the actual QEII announcement itself, the dollar declined about 7.6% on a major trade-weighted basis and almost 6% against a broader trade-weighted basket. In that same period, the euro, which is widely understood to be the main alternative to the greenback, rose 13.6%.

European officials were always careful about calling the end of their financial crisis after the combination of innovation and institutional reform appeared to prevent a collapse of the financial system, and to contain the problem to Greece. We agreed and often characterized the situation as “smoldering”.

A number of factors conspired to enflame the situation. For one, the market’s pre-occupation with the slowing of the US economy, the uncertainty over marginal tax rates next year and financial reform, and then QEII, ended in early November. While the situation in the Europe's periphery had been disintegrating over the last few months, it was the US situation that dominated, shifting the market’s focus. Additionally, the ECB’s gradual move toward normalization of its liquidity provisions, (upon which many banks in the periphery of Europe are still heavily reliant) coupled with the EU’s formalization of a post-2013 strategy of private sector burden sharing, aggravated a fragile situation.

Nothing Fails like Success

Greece’s problem was an uncompetitive economy masked by government profligacy and deceit. This is true even if, as the evidence suggests, EU officials knew or suspected as much, and that Germany was an unindicted co-conspirator, who loaned Greece essentially 50% of the funds needed over the past decade to purchase German goods.

Ireland was the Celtic Tiger, a robust competitive economy, enjoying a rare trade surplus in the euro zone outside of Germany. Ireland’s woes do not lie with violating the spirit or the letter of the Stability and Growth Pact. The budget and debt blow outs now are the consequence of a crisis.

The crisis did not grow out of competitive failure as it did in Greece, but out of Ireland’s success. Its banks were so successful that they grew bigger than their country. The unbalanced and uneven development lies at the very heart of economics. It is not usual.

There is another financial vulnerability in the core of market economies: borrowing short and lending long. For sure, over the past half millennium or more, financiers have made the game more complicated, but the history of capitalism is strewn with financial crisis. Lenders over-lend.

Memories of past serious financial crises faded. For investors this meant heightened appetite for risk. The bipolar pendulum of emotions swung from fear to greed. For policy makers this meant that over time, the enthusiasm for regulations faded and the incentive structures were such that the risk of over-reaching was preferable to under-achieving.

Ireland is Not Greece

The financial crisis has already cost the Irish government about 33 bln euros ($45 bln). In relative terms this is roughly 20% of GDP spent to support the private banking system. Now there is warning that this might be only two-thirds of the final bill. Like policy makers, and most observers and investors of industrialized countries, Irish officials did not grasp the significance of events as they were unfolding. Irish officials consistently under-estimated the magnitude of the crisis and hence did a poor job of managing expectations.

Ireland's debt office strategically pre-funded roughly half of next year's financing needs. The rise of yields in the secondary market (the 10-year yield has risen almost 200 bp in the past month and 270 bp in the past 3 months) means little directly. However, this has complicated the problems of Irish banks–which already face grave difficulties in raising capital.

They have become heavily dependent on the ECB's lending facilities. Although Ireland is a small country, nearly two-thirds the size of Greece, its banks account for a fully 25% of the ECB's lending. Its private banks, more specifically, account for 40% of Ireland's GDP, around $130 bln euros at the end of Oct. Most recently, Ireland's central bank has also sharply boosted its liquidity provisions to Irish banks.

The situation is not sustainable. However, the funds that are available from the IMF as well as the two lending facilities created earlier this year are only available to countries, not private sector financial institutions. Several countries in Europe, especially Germany and Spain, want Ireland to receive aid even more than Irish officials do.

Weak Political Center

For Irish officials, it likely means an embarrassing end to many careers. Even now the government rests on a slim three seat majority. There is a by-election later this month that it will likely lose, and another two by-elections coming along in the first half of 2011. If the condition for aid is that the government is going to be forced to renege on pledges not to cut civil servant pay any further, it could collapse at any time.

Ireland has already enacted painful austerity measures. During the spring, as Greece was melting down, Ireland was presented as a good case study. There are few things that could be demanded as conditions for aid that
Ireland is not implementing already.

However, there is one that does stick out which has long been a sore point, and that is Ireland's low corporate tax rate of 12.5%. Ireland's European friends would be quite happy if Ireland was forced as a condition of aid to raise the tax, which has been a particularly powerful competitive advantage for Ireland. Irish officials argue that the low

corporate tax is protected under the Lisbon Treaty. At the same time, Ireland's VAT stands at 21%, among the highest in Europe.

Some policy makers and observers seem to think linearly: The wolf came a calling to Greece. An aid package, too slowly delivered, which complicated the situation, ultimately resolved the issue. Ireland is now in trouble, a quicker delivered aid package and the crisis should be over. This is possible, but it seems rather self-serving and a bit too simple.

Pincer Movement

Recent events will reinforce concerns about the sustainability of the debt dynamics in Europe. The fact that Greek, Irish and Portuguese bonds sold off so sharply and the price of insurance against default rose despite the sovereigns being fully funded is powerful evidence that what is happening now is not about liquidity.

In early 2008, some prescient investors compared what was happening in the US mortgage market to a train wreck in slow motion. If that was the case, then what Europe is experiencing is a pincer movement. On one side is the ECB and Germany. The ECB has been providing unlimited amounts of liquidity, albeit for shorter periods (now three months), and lowered its collateral standard. Germany is, of course, the main purse behind the facilities that ensure that creditors remain whole.

Now the ECB and Germany are saying enough. They no longer want to support insolvent institutions. The ECB insists it will exit the extraordinary polices. In late October~~,~~ indicative pricing suggested that the market was discounting a rate hike in Q1 11 by the ECB. Germany's Merkel has led the charge for a permanent debt restructuring mechanism to supplant the EFSF which expires in 2013. No longer, she said, should tax payers take the hit while those that took the risks get off with a haircut.

On the other side is the cruel reality that to truly address the solvency issue requires restructuring of some sovereigns' debt, and some tough decisions about a number of banks. This in turn could trigger collapse of the still precarious experiment of monetary union without political union. Without the ECB's liquidity provisions a number of banks in the periphery would have collapsed. Foreign holdings of sovereign bonds and bank bonds are such that to truly address the underlying issues could spur an existential contagion crisis into the very core of the euro zone.

There is no easy way out of the pincer movement. Both forces are powerful. It is not immediately clear which side will prevail, nor over what time period. However, what does seem clear is that the situation is not sustainable and an aid package to Ireland to support its banks will not be sufficient to stem the tide for long.

Germany's prowess is often not fully appreciated. Its influence and economic competitive position in Europe has been greatly enhanced during the first eleven years of monetary union; first during the expansion and bubble years, and now during the financial crisis. Germany's seemingly new offensive appears to be the result of domestic political pressures and therein lies its own dilemma: it is the major beneficiary of the status quo ante, but that course now leads to its ruin. As Visconti's Leopard said, "Things have to change so they can stay the same."

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