If it were done, then 'twere well it were done quickly

German Chancellor Merkel injected a dose of reality over the weekend when she said that the European stabilization plan simply buys time for member countries to get their fiscal houses in order. We agree. And while the austerity plans put forth by Greece, Portugal, and Spain look good on paper, we believe massive fiscal retrenchment within a recessionary environment simply cannot be done. If markets no longer have faith in the adjustment plans, failure may become self-fulfilling. Given recent price action in the bond markets, we think patience is running out already. While the recent European Stabilization plan has (for now) addressed short-term liquidity concerns, we do not think it has removed questions about long-term solvency for the peripheral countries.

We won't know definitively for some time, but we believe that some sort of debt restructuring will eventually be needed for the weaker euro zone credits. German officials seem to be acknowledging this, with CEO of a major German bank doubting Greece's ability to continue servicing its debt, and now German Economy Minister Bruederle calling for a mechanism that allows euro zone member states to enter into an orderly debt restructuring process. We believe a bold effort at debt restructuring and structural reforms needs to be seen in Europe. How realistic is this? Well, it was done in Latin America two decades ago, and that region is now enjoying the strongest fundamentals in a generation. But quick action is needed, or else Europe risks a protracted period of slow growth and simmering social tensions. To quote MacBeth, "If it were done, then 'twere well it were done quickly."

Spreads Have Not Yet Normalized

Look at Greek 2-year spreads to German bunds. Sure, the current +668 bp looks pretty low compared to the +1800 bp highs during the panic. But don't forget that Greek spreads were in single digits back in Oct 09. When the Dubai debacle hit around Thanksgiving, sovereign debt concerns took off and Greek spreads rose steadily from Nov 09 onward. That spreads remain elevated even after the Greek rescue and European stabilization plans were announced tells us that default/restructuring fears remain in play. Greek 5-year CDSs are trading around 665 bp. Again, low compared to almost 1000 bp during the panic, but high compared to 125 bp or so back in Oct 09. Similar trends have been seen for Ireland, Portugal, and Spain too.

Euro Weakness Justified….

Given all the underlying doubts about Greece and the peripheral countries, it's not surprising that the euro continues to grind lower. It's the path of least resistance, and we think weakness is also dictated by the underlying fundamentals. Certainly, a weaker euro will provide some relief to those peripheral euro zone countries that would normally have devalued out of predicaments, but to us, euro weakness is not a panacea. At the margin, it will help Europe, but it is no substitute for much needed structural reforms in the peripheral countries and should not be viewed as one.

….But Reports of the Euro's Death Have Been Greatly Exaggerated

As our readers know, we do not ascribe to the notion that the current crisis spells the end of the euro experiment. Monetary union in Europe has first and foremost been a political experiment, and as long as the political will is there, the euro will continue. Indeed, wasn't it just a year ago that markets were talking about the imminent demise of the dollar? Let's move beyond the hyperbole and look at past history. While the euro is only a decade old, European integration was a process that began in the aftermath of World War II. This is not a fly-by-night experiment that will be abandoned quickly. The original European Economic Community was created by the Treaty of Rome in 1957, and we would view the current euro experiment as simply another step in a multi-decade process of integration. Indeed, we are hopeful that out of this crisis, the final goal of true political union may finally be realized.

Recall that when the euro was first introduced back in 1999 at around 1.18, it proceeded to sink during its first two years to almost .80 vs. the dollar. There were various reasons behind this move, but one major factor was that the markets doubted the credibility of the newly-formed euro zone's policy-makers. Investors were surely wondering whether such a disparate group of countries could work as a monetary union. Those concerns are in play again, but we will resist the siren's call of forecasting the end of the euro.

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Under floating exchange rates, doubts about a country's policies or economic outlook are typically manifested in a weaker currency. Surely, those who were just a year ago predicting the structural decline of the dollar were not looking for a break up of the United States. Why extrapolate current euro weakness into a one-way decline into non-existence? Despite all its problems, the size of the euro zone economy is close to $14 trln and puts it on a par with the US.

Given that the euro is still considered over-valued by most models (PPP, FEER and REER), we are not alarmed by the current euro decline. European policy-makers are unlikely to resist in word or deed a decline in the euro as long as the move is orderly. Just as it has spent the past six years being over-valued, policy-makers and investors should be prepared for an extended period of time that the euro is under-valued by those same models. This would be similar to the period from 1999-2003, when the euro traded cheap to fair value.

Latin America Redux?

Let's look back for some historical context with regards to the debt woes of the peripheral euro zone. When Latin American was booming in the 1970s, it took on huge external debt to finance infrastructure spending and development projects. Things were good when the global economy was booming, but when the global recession of 1981-1982 hit, those Latin American borrowers simply could not service that debt any longer. Mexico in 1982 was the first to declare a moratorium on external debt payments. Creditors from the developed world pulled the plug on Latin America, and capital flows to the region dried up. As banks pulled out and refused to roll over debt to other countries, default became self-fulfilling and contagion spread that eventually led to default by Argentina, Brazil, Chile, and Venezuela.

The 1980s has since been dubbed the Lost Decade for Latin America, as growth stagnated and living standards plunged. Ad hoc restructurings took place throughout the 1980s, but a comprehensive solution remained out of reach. Eventually, out of that crisis, Brady bonds were born under the Brady Initiative of 1989. Net capital flows to Latin America finally turned positive in 1991 as confidence returned and bank balance sheets healed.

Indeed, an extremely intelligent and well-versed market contact of mine whom I've know since the late 1980s (and by the way was there on the ground as one of those early traders of distressed EM debt before there was even a real market) has suggested that some sort of Brady plan for the peripheral euro zone be put in place. Not too many workable solutions have been heard with regards to the current crisis, but this is one of them and bears serious consideration. And given Economy Minister Bruederle's recent comments, perhaps this proposition is not so far out of reach.

Why Put Off The Inevitable?

This brings us back to the title of this piece. We stress again that the biggest lesson that was learned from the Latin American debt crisis was that if a comprehensive debt restructuring is needed, it's much better to do a big one right from the start. Dragging out the process simply doesn't do anyone any good, neither the creditors nor the debtors. We also note that the Brady deals were done within a context of massive economic restructuring plans under the auspices of the IMF and the World Bank. Does this sound familiar? This seems to be exactly what the peripheral euro zone countries need as well – massive debt relief coupled with deep structural economic reforms. No one can argue with the success of the Brady plan. Sure, Mexico experienced some hiccups in 1994, Brazil in 1999, Argentina in 2002, but for the most part, the region is viewed as a success story now.

Lost Decade For The Euro Zone?

Why not think about a similar plan for the peripheral euro zone? Let's try to avoid a Lost Decade for these countries, which becomes more likely if the Europeans continue trying to simply muddle through. As we noted in "Stark Revelations", the euro zone grew by an average pace of about 1.25% per annum during the first part of the past decade, but grew at a rate of only about 0.75% per annum in the second part. A long and protracted debt crisis risks pushing the euro zone closer to outright stagnation for the next decade, and so policy-makers should think long and hard about what they can do to avoid this. While we cannot take credit for the notion of a Brady-style plan for peripheral euro zone, we would like at least to have a hand in promoting the idea. Such a severe crisis demands bold policy action, and we truly believe that this is the way for Europe to finally get ahead of the curve.

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