



## **UPDATE ON THE SITUATION IN EUROPE**

This note provides an update on recent developments in Europe ahead of key meetings to be held by policymakers this week. Much of the commentary about Europe remains pessimistic, however developments in the last week or so have helped clarify what the Europeans are seeking to achieve and provide some reassurance that the crisis can be resolved, although not without further challenges.

Our opinion of the European crisis to date can be summarised as follows:

- The Europeans do not want the Euro to collapse; that means no defaults and no departures;
- Achieving the fiscal integration Europe needs to support monetary integration will happen but through such a slow process that the ECB and issuance of Eurobonds would have to pick up the slack and buy time for the longer run policies;
- The Germans are playing a dangerous game of brinkmanship by letting speculative market forces pressure European governments and banks into supporting policy concessions that the Germans want.

Latest developments confirm much of this assessment, but the second point needs to be revisited. Specifically, the Europeans are moving more quickly to fiscal union than had been expected. The current phase of the process will still take another 6-12 months according to the timetable set out in the communiqué from the October Summit, but it is still a faster commitment to the path of fiscal union than the markets had believed possible. This is what Merkel has been referring to recently.

The Germans are adamant that the ECB and Eurobonds will not be used to let the other nations off the reform hook. This is not just a matter of the Germans being obsessed with their experience of hyperinflation between the wars, but also reflects their belief that supply-side reform and fiscal policy coordination to reduce productivity differences between the member nations is absolutely essential. Until this is achieved, or meaningful progress is made to moving down that path, the markets should not rely upon the ECB printing money or Eurobonds being issued as easy solutions to the debt problem.

In pure policy terms this approach makes sense. The Germans are right that if Europe does not solve this problem properly now it will only be confronted with it again down the track. The problem with the “fiscal first” approach is whether the financial markets believe it can be done and have the patience to let it happen in an orderly manner. The markets want a solution here and now, which is why they have been pushing for the ECB and Eurobonds. The crisis has become a battle of wills between the Germans on one side and the markets on the other. Caught in the middle of this battle is the European banking system. A key part of

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the markets' strategy for forcing change in Europe (and for creating opportunities to pick up distressed assets at cheap prices) has been to threaten the solvency and liquidity of the banks. The key question of the crisis then becomes not whether the Europeans have the will to keep the zone together or whether they have the policies to achieve it, but rather whether they will have enough time to do what they want to do before the markets undermine the solvency of the banks.

The policy announcements and statements by key officials over the past week have addressed this problem in a very positive fashion. First, although the ECB does not have the authority to act as a lender of last resort to European governments, it does have explicit responsibility for the stability of the European financial system. This is something the markets may not have fully appreciated, so that they were caught by surprise when the ECB and other major central banks announced increased funding at more favourable terms for the banks. As long as the central banks are prepared to do what it takes to protect the banking system then they have a better chance of buying enough time for the European policy agenda to be completed over the coming 12 months. Further support from the IMF would also help.

In addition, recent statements from the ECB suggest that as (what appears to be an inevitable) recession in Europe unfolds next year then the ECB will be ready to ease monetary policy as required. The ECB has also hinted that when fiscal integration is underway then the ECB may indeed have scope to provide more liquidity to support the government bond markets. However, the issuance of Eurobonds may be delayed until 2013 at the earliest. Ultimately, it would appear that Eurobonds and the ECB (as a proper regional central bank) must be part of the new institutional framework.

Recent comments by the Bank of England about contingency plans for the breakup of the Euro seem both unnecessary and unhelpful. The UK is in a difficult position as a result of what is happening in Europe. On one hand, if the Eurozone did break up then the economic consequences for Europe would be catastrophic. Economic growth would collapse far more than is currently expected and the Euro would depreciate dramatically. Both those forces would impart a huge negative growth shock onto an already feeble UK economy. The UK simply cannot afford to have Europe collapse. However, the path of fiscal and political integration which is at the heart of the European solution is anathema to the UK. There is significant pressure within the UK political establishment to move further away from Europe rather than closer to it. Although the UK is not enmeshed in the European structural problems as the member states are, this is nevertheless a significant moment in history from which the UK could ultimately be put at a further competitive disadvantage to the nations in Europe.

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It is important to remember that the global growth environment will be very important for helping determine whether the European policymakers' approach is successful or not. The stronger the growth in Europe's trading partners, especially the US and China, the more support the European economies will have from external sources to offset the negative growth shock from their internal fiscal tightening. Conversely, weaker global growth makes the European problem all the more perilous. In this light, recent economic data from the US which continues to show the economy performing better than the markets had expected and the easing of monetary policy announced by China, along with clear indications that Brazil will continue to ease policy, all amount to better news for the world economy. We continue to believe that the US economy will avoid a double dip recession and that the Fed will act aggressively to offset the negative impact from any automatic fiscal policy tightening. We also believe that emerging market nations will ease policy significantly in the coming year. On balance we expect the global environment to be more growth-friendly next year than this year.

In view of all this we continue to believe that the European problems will be resolved but acknowledge that the process of getting there will not be smooth sailing. Considerable risks remain:

- The Germans may overestimate their ability to manage the situation and just push things too far;
- Merkel is not the best politician for the job – she is more concerned with consensus than with strategy;
- We may yet see a French and/or German bank nationalised;
- The French Presidential election next year may strain the French/German relationship; and
- Fiscal contraction in the US may prove overwhelming.

Markets will remain volatile, but as we have recently seen, there will be significant rallies for equities as well as further sell-offs. The magnitude of some of the daily rallies in equity markets seen in recent weeks argues for caution in taking positions against the policymakers. Risk assets are cheap at the moment as the markets have priced in scenarios which seem to us to be too bearish. We will continue to monitor developments very closely and to manage the portfolios in a prudent fashion.

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