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## THE EUROPEAN DEBT CRISIS TAKES A CONTINENTAL SHIFT

The beginning of November is proving to be as financially volatile as it is politically dramatic.

After European leaders finally agreed to a comprehensive plan to reduce Greek debt, inject additional capital into European banks and increase the European Financial Stability Facility (EFSF), the Greek prime minister, George Papandreou, made a surprise announcement calling for a referendum to approve the deal. European leaders, unaware of even the possibility of a referendum, scrambled to respond. The euphoria the markets experienced just days earlier quickly turned into turmoil as equity indices tumbled on renewed uncertainty.

The Greek announcement forced the European Central Bank (ECB) and its new president, Mario Draghi, to postpone an EFSF issuance and a €8 billion scheduled payment to Greece until the political situation had been resolved. European leaders, led by Germany's Angela Merkel and France's Nicholas Sarkozy, took swift action, issuing an ultimatum to Prime Minister Papandreou to either accept the debt deal or to alter the referendum to determine whether or not Greeks would prefer to exit the euro zone. Under pressure, the Greek prime minister withdrew his plan for the referendum. After a confidence vote, Papandreou agreed to step down and an interim coalition government was charged with approving the bailout terms allowing the Greek government to implement tough austerity measures in return for €130 billion.

In a surprise and unanimous move, the European Central Bank (ECB) cut interest rates by 0.25% and stated that Europe is at risk of slipping into recession. The ECB, in an effort to prevent sovereign bond markets from seizing up, continued purchasing Italian and Spanish bonds.

The recent build-up in political tension between Greece and the rest of the European Monetary Union (EMU) has increased the odds of a euro break-up. We see a break-up as a low probability scenario, but the odds have increased. Greece leaving the euro and returning to the drachma would come at a great cost to them. We would expect high unemployment, large cash withdrawals from banks, and high inflation. We estimate that it would cost Greece about 35% of GDP over the first year. The timing for Greece could not be worst as the economy is already deep in recession.

A potential break up would also have an impact on the rest of the EMU. Market expectations regarding the euro zone are already extremely low, and valuations have declined dramatically. As long as concerns about European fiscal stability remain in place, global bond markets will remain well supported and equities will stay stuck in a volatile trading range. However, over the longer term, equity markets have already priced in the substantial pessimism and the bond market's outperformance should come to an end.

The focus of market attention has increasingly turned to Italy as Prime Minister Silvio Berlusconi's future as the country's leader hangs in the balance. The continued widening of Italian-German interest rate spreads, recently reaching a euro era high, is of serious concern as the potential consequences of an Italian fiscal crisis are immense. A firewall, what is being called a ring-fence, needs to be put in



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place before contagion spreads further. To do this, the ECB has to commit to doing whatever is necessary to support the euro. Based on our calculations, if Italian bond yields rise to the 7% to 8% range, the Italian government debt would be unsustainable. Italy has agreed, after lengthy debate at the G-20 summit in Cannes, to allow the International Monetary Fund to monitor the country's implementation of austerity measures to work towards avoiding a crisis. This development should be viewed as a positive.

While gloomy headlines about Europe dominate the financial press, positives for risky assets such as equities are developing in the background. Except for Europe, the global economic backdrop is improving and corporate earnings remain strong, indicating that a global equity bull market could still be on its way. U.S. economic data has been improving gradually, pointing to slow growth rather than the recession that has been anticipated. In the emerging world, central banks have started to loosen monetary policies. This should help counterbalance the European gloom. However, the longer uncertainty prevails in the euro zone, the greater the risk of a deeper downturn as reduced consumer and business confidence finds its way into the global economy in the form of lower purchases, investment and hiring.

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