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The Baseline Scenario
What happened to the global economy and what we can do about it

French Connection: The Eurozone Crisis Worsens Sharply

Posted on June 4, 2010 by Simon Johnson | 140 Comments

By Peter Boone and Simon Johnson

The big news is France. With sentiment worsening across Europe, France has lost its relative safe haven status – credit default swap spreads on French government debt were up sharply today.

The trigger – oddly enough – was Hungary's announcement that its budget is worse than expected (blaming the previous government; this is starting to become the European pattern) and in the current fragile environment discussed yesterday, this relatively small piece of news spooked investors. But these developments only reinforced a trend that was already in place.

It did not help that the Irish Minister of Finance announced Ireland has 74.2bn euros of guaranteed bank loans, bonds, and systemic support falling due between now and Oct 1. This is around 55% of GNP. It sounds like everyone backed by the Irish government had the "clever" idea to roll over their debts to just before the guarantees expire.

The big losers are Portugal-Ireland-Italy-Greece-and-Spain as always, but Belgium is now in the line of fire, and France is clearly under pressure. The spread between French and German credit default swaps (measuring the relative probability of default) is up – yesterday this was 40 basis points, today it stands at 44 (up from just 5 basis points at the end of 2009; most of the increase is since mid-March, with a sharp acceleration recently). French bonds have become illiquid, with wide bid-ask spreads; not what is supposed to happen in a safe haven. This is going to make the French angry – watch for more market slanders from top French politicians over the weekend; you know they would just love to ban trading in something.

Earlier today the French Prime Minister came out with a quote for the ages:

> *"I only see good news in parity between euro and dollar".*

Be careful what you wish for – such statements will drive the Germans crazy as they see further evidence that inflation lovers are clearly winning influence and might just gain control at the European Central Bank (ECB).

This has the potential to become a run on most non-German bonds in the euro zone. Next we will see pension funds and reserve managers stepping back and waiting to see what happens – there is no profit in buying French bonds for a 40 basis point spread over Germany given the risks and illiquidity that we have seen in other markets.

The eurozone leadership may be tempted to address the short-term issues by providing much greater Quantitative Easing (i.e., putting a lot more money into circulation through buying government bonds) than the ECB has already promised. However, the ECB does not have the fiscal backing necessary to take that sort of sovereign risk, as this is ultimately a mix of a bank run and serious private and public sector solvency problems.

These solvency problems will worsen as they are allowed to fester. And if the ECB announces it will buy French bonds, investors will probably step further back and just let them buy. We are beyond the point where mere expressions of intent-to-support will lead to a private sector rally.

Investors increasingly fear that it is simply unsustainable – economically and politically – for the ECB to support the rollover of public and private debts. If investors – acting on this belief – refuse to rollover bonds, the entire policy disintegrates into uncontrolled money issue. Quantitative Easing on this basis will fail.

The ECB is going to be forced to show a deeper hand, potentially along three dimensions.

First – the euro authorities have to let the euro truly collapse, e.g., below parity with the US dollar. This reduces solvency issues across the eurozone. Ironically, by doing nothing, and bickering within Europe as Rome (and Madrid and even Paris) burn, this is one measure that Europe seems set on delivering.

Second – if the euro devaluation does not come fast enough (or does not promise enough immediate future growth), the ECB and others will push for a "Plan B" within which at least some of the weaker eurozone countries implement "voluntary" debt restructurings (of the kind more common and not necessarily so traumatic in emerging markets; see Kazakhstan) – in which they make offers to bondholders to restructure and threaten to default if they are not accepted.

This will end rollover risk among these sovereigns – particularly as the banks will be forced to follow suit. European bank regulators need to work with each major European bank to ensure it is adequately capitalized post-restructuring. This is a good time to change management/directors and look at imposing losses on at least some unsecured creditors, although the fear at such moments is always that systemic panic will set in; vulnerable financial structures induce bailouts (and future moral hazard, as President Obama can attest). The ECB will need to provide liquidity to prevent bank runs.

Third – the eurozone nations that remain without a restructuring will need G20 support to roll over their public debts while rolling over or – failing that – restructuring some private financial sector debts. This includes France.

Progress on steps 2 and 3 require consensus within Europe and determined actions with international support. This remains nearly impossible until nations face the obvious risk of national financial collapse.

We are not there yet but this is the dangerous glide path. As the bond market moves towards a buyers strike and with Europe's leaders doing nothing – simply hoping all their problems will melt away by themselves – the path of least resistance is to spiral downward.

Pressure from other governments will quickly mount and offers of international help will appear without any difficulty. The G20 will soon be desperate, again, to get Europe to seriously sort itself out.

And think of the diplomatic coups that await China when it figures out how to throw its more than $2 trillion of reserves into the fray.

Surely the White House finally understands what is going on – they must lift their heads from the compelling tragedy of the Gulf coast and determine whether American global economic leadership rises or falls.

Update (revised): the exact quote from the French PM is “”Je n’ai pas d’inquiétude quant à l’actuelle parité entre l’euro et le dollar”. ~~He may be referring to the current euro-dollar rate but there is some potential ambiguity here.~~ Saying this on a day when the euro is collapsing, he is clearly condoning further collapse.

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140 RESPONSES TO “FRENCH CONNECTION: THE EUROZONE CRISIS WORSENS SHARPLY”

Nemo | June 4, 2010 at 1:11 pm |

Default, dear Brutus, lies not in our stars, but in ourselves.

However, the ECB does not have the fiscal backing necessary to take that sort of sovereign risk,

Who needs fiscal backing when you have a printing press? If you really want to weaken the Euro…

charles | June 4, 2010 at 1:49 pm |

Simon is correct: German commentators brought up the looming ECB’s problem: its equity capital is 70 billions euros, it has purchased at least 40 billions

In what was a decisive step for finance ministers of the Western World, most notably Tim Geithner (U.S.) and Wolfgang Schauble (Germany), the G20 has outlined two courses of action for the group that are by definition mutually exclusive.

Under article #2 of the Communique released after the meeting in Busan, South Korea, the group somehow pledged to "safeguard [the] recovery and strengthen prospects for growth and jobs", while promising to "deliver fiscal sustainability [by accelerating] the pace of consolidation". (G20 Communique)

Sure, it makes since for surplus nations with strong balance sheets to cut costs, and for deficit nations with a deep pool of sovereign bond auctions to stimulate, but what for the countries that really matter. How then should Portugal, Spain and Ireland proceed? And still further, what path should the less developed nations of the group take.

In our analysis (Korea Economic Slice @ http://bit.ly/crFXxw), which is also a weekly outlook on the economy in the Republic of Korea, we delved into the messages being sent from this G20 and analysed how Korea might respond. In our opinion, and apparently the opinion of the BOK who today voted to keep their base rate unchanged, it may be best for the host of the 2010 G20 to fold a few hands and wait to see how the chip leaders make their bets.
