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A Solution to the European Debt Crisis?

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As we write this on October 27, the U.S. stock market is up more than 3 percent, after having fallen more than 2 percent in the previous two days. Apparently, the capital markets are happy that Europe finally seems to have gotten a handle on its financial crisis.

The deal announced Thursday morning does indeed appear to be a significant step forward—the most significant being that European leaders finally seem to recognize certain facts:

- Greece cannot pay back its debts.
- The European banking system needs more and better quality capital.
- There needs to be a credible, funded backstop to stop contagion across markets.

We now have an acknowledgment that these are the key issues, along with a demonstrated willingness from leaders to step up to the plate in a serious way. The proposed haircut for Greek debt is now 50 percent—up from 20 percent and with a bigger bailout fund attached; bank capital is to be boosted by €106 billion to 9 percent; and the stability fund is to be increased from the remaining €250 billion of the original €440 billion to more than €1 trillion.

But there's a lot left to determine

What this agreement is not, however, is a detailed plan of action, much less a firm financial commitment. Left undetermined is exactly where the money to fulfill these plans will come from—and *someone* in Europe is going to have to commit a lot of money. The stability fund, for example, is to be increased four to five times, up to about €1 trillion, via leverage. Where will the leverage come from? China, the International Monetary Fund (IMF), and sovereign wealth funds have all been mentioned, but no actual commitments were reported. Similarly, the sources of capital for the banks were left unspecified.

Also, while the amounts specified in the deal are substantial, they fall short, in many respects, of what others estimate as necessary. Take the Greek debt haircut, for example. While at 50 percent it is sizeable and much larger than the current 20 percent, *TIME* magazine reports that the IMF wanted 75 percent. Moreover, even the 50-percent haircut and larger bailout will not solve the problem immediately; they are only projected to bring Greek debt levels down to 120 percent of gross domestic product by the end of the decade—still a scary level and almost eight years away. Equally, the stability fund, which at €1 trillion represents a substantial increase, still may not be enough. The most common outside estimate for the necessary amount is closer to €2 trillion. Finally, the bank recapitalization amounts depend crucially on their exposure to other sovereigns and how the valuations of that debt play out. If other sovereigns, such as Ireland, default or demand haircuts to their debt, the amounts needed would be even larger.

In the end, then, while this plan certainly is two steps forward, it may well be followed by one step back. We

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have seen several of these plans over the past several months, with the market reacting positively initially and then falling back as the lack of details became clear. Where this plan is superior to previous versions is in its recognition of the scale of the problem and the critical issues that need to be addressed. Where it still needs to be improved is in its level of detail about where the money is coming from.

So, where might the money come from?
There are two ways to fund the plan: directly and indirectly.

First, the direct solution—get someone to write a large check. Germany is the most solvent large European country and the obvious and necessary first source. Much of the current debate has concerned what Germany is willing to do, and past actions have led the German constitutional court to require that the legislature approve any further action. Nevertheless, the advantage of the direct solution is its clarity; the German taxpayers are giving money to the Greek bondholders. The disadvantage is exactly the same; the German taxpayers can see that, too. Because of this, as noted above, Europe is looking to bring in outside sources of capital—China, the IMF, sovereign wealth funds, anyone with the money. This is the outstanding problem with implementing the new plan and the next step in resolving the crisis.

The direct solution has obvious limitations, so the indirect solution is the basis of the expansion of the stability fund. The plan is to leverage the existing money by using it as a base to insure the issuance of new sovereign bonds and to obtain guarantees from third parties. Insurance, though, is only as credible as its backing, and the reason the Europeans are attempting to do it this way is because they do not have real backing, which takes us back to the direct solution. The money has to come from somewhere. Other options are available, but they are not explicitly on the table at this point.

So, in summary, while the most current agreement represents real and substantial progress, we are not out of the woods yet. The plan represents a very good start, but there are many details to fill in and many steps to complete—not the least of which is the ratification of the plan by all governments affected. Based on these factors, this plan is not the beginning of the end, but it may be the end of the beginning. Europe has now admitted and defined the problem, which means that it can now start solving it—and that really is a big step forward.

Disclosure: *Certain sections of this commentary contain forward-looking statements that are based on our reasonable expectations, estimates, projections, and assumptions. Forward-looking statements are not guarantees of future performance and involve certain risks and uncertainties, which are difficult to predict. Past performance is not indicative of future results.*

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