

# Economic Insights

## Europe's Confidence Game

September 19, 2011

*Milton Ezrati, Partner and Senior Economist and Market Strategist*


Of the three big issues dragging markets up and down these days—Washington's ongoing budget uncertainties, the threat of a second recessionary dip, and Europe's sovereign debt crisis—the latter is most dangerous. It not only carries a direct risk of wealth destruction but also of bank insolvency and, consequently, the prospect of a return to the liquidity shortages of 2008. It is also the least definable of these issues, for behind the crisis lies the always the critical but also always nonquantifiable issue of confidence, or rather, in this case, the lack of it. Probabilities suggest that Europe will work its way through this mess, not without pain, of course, but more successfully than many now fear. Until it does so, however, risks remain.

It is fairly clear that matters would never have gone as far as they have had the Europeans shown more resolve sooner. When the crisis first broke in spring 2010 and fears centered almost entirely on a Greek default, European Union (EU) member nations easily had the resources to handle things. After all, Greece is a small economy, at only 1.9% of the EU total, and the country's total outstanding debt amounted to a mere 0.8% of the outstanding assets of the greater European financial system. But for all the initial manageability of the situation, investor confidence suffered two serious blows. First, the EU clearly had no mechanism in place to deal with the situation—hardly a recommendation to investors for the foresight or insight of Europe's financial leadership. Second, the more powerful nations in Europe, rather than demonstrating a commitment to deal with the matter, first dithered, and then, each nation, Germany in particular, moved to protect its particular finances—hardly a resounding commitment to European unity.

These failings immediately prompted European and global investors to search for weakness and, consequently, risk elsewhere in the union. They found it in Ireland, Portugal, Spain, Italy, and Belgium. All these countries carried relative deficits and outstanding debt levels well above EU guidelines and well above normal gauges of financial prudence as well. Had the members of the EU managed the Greek matter forcefully, investors no doubt would have fretted less about losses in these other countries. But instead, investors' fears expanded and so did the crisis. Had there been no EU, of course, investors would have braced for currency devaluations and perhaps a workout arrangement from some of these countries. But since such options were complicated by the membership these nations had in the EU and the euro, circumstances became even less definable, not the least because the rest of the EU seemed to feel no responsibility to resolve the matter.

This contagion of fear first centered on Ireland and Portugal. They, too, were manageable. Their economies were only 1.3% and 1.4%, respectively, of the EU total, and their relative debt burdens are comparable. But by 2011, as Europe continued to argue over a second round of Greek budget problems and the EU's stronger members still avoided a full commitment, investor fears became much more inflamed and extended. Credit spreads on Italian and Spanish bonds widened. Questions arose about the ability of these governments to finance themselves. With this extension, the crisis moved beyond the easily manageable. The economies of Spain and Italy were 8.7% and 12.6%, respectively, of the EU total, with debt burdens of comparable relative size. Additional talk of Belgium raised questions of whether member EU states, including Germany, have the budget power to answer the needs of the situation, especially since some contend the rescue fund may ultimately take up to €1.0 trillion. The erosion of confidence had reached crisis proportions.

Now that this damage is done, the nations of Europe and the institutions of the European Union will have to work twice as hard to regain it. Especially since the contagion has already spread and questions have arisen about abilities of these nations to raise a sufficiently large rescue fund, it also has become clear that the effort will have to include the European Central Bank (ECB), which, to date, has held back its vast financial resources from the fray. Though the Europeans now clearly face an uphill battle, two changes offer hope that they can regain control. One is a favorable shift in official German attitudes and the other is a more accommodative ECB posture.



The Germans initially showed great reluctance, even hostility, to any relief for Greece and other debt-burdened nations. German chancellor Angela Merkel played to the German taxpayer, who wanted to avoid spending anything for a Greek rescue or a European rescue of any kind. At the time, she echoed the popular expression that Germans should not have to work so that Greeks can retire at 50. But in the interim, it seems, her financial advisors explained that Germany really cannot avoid paying in this situation. It will either bail out the Greeks and the rest of Europe's weak periphery or it will have to bail out its own banks, which hold much of the debt of these nations. Failing either, Germany will suffer a severe recession. Faced with this Hobson's choice (that is, a free choice in which only one option is offered), Merkel, no doubt, concluded that the national bailouts may offer Germany its least burdensome alternative. So after once dismissing matters almost out of hand, she has of late offered active support for Europe's bailout fund, quite a change from a year ago. Of course, she faces an election at the end of December, but the policy trajectory is clearer now.

At the same time, the ECB has at last begun to engage the problem. For much of the time since the crisis broke, the ECB has kept its distance, leaving it, almost as a matter of principle, to the elected leaders of the member nations to decide a course of action. Indeed, so divorced was ECB policy from the matter that the bank, far from providing markets with extra liquidity, as the Federal Reserve has done in American markets, actually raised its benchmark interest rate in April and then again in July. In late 2010 and early 2011, it actually withdrew reserves from the European financial system, only slightly, to be sure, but hardly the kind of liquidity support circumstances seemed to demand. Now that fears of contagion have spread, however, the ECB has begun to inject some reserves into the system. It has offered further support by reassuring markets that it has no intention of raising interest rates any farther. Most significant of all, ECB policy makers have directly eased the pressure on Italian and Spanish bonds recently, buying amounts outright for its own portfolio. The bank is not quite engaging in the quantitative easing favored by the Fed. It still speaks of neutralizing the effect of these purchases elsewhere in the market. But at least the ECB, belatedly, seems to have decided to help.

Major risks remain. It is still not clear how committed Germany will remain to the process after its late-December election. It also is far from certain how far the ECB is willing to go. But there is at least some comfort in these recent policy changes, enough to tip the probabilities in a more favorable direction than some months ago.

Milton Ezrati, Partner and Senior Economist and Market Strategist, has been widely published in a wide variety of magazines, scholarly journals, and newspapers, including *The New York Times*, *Financial Times*, *The Wall Street Journal*, *The Christian Science Monitor*, and *Foreign Affairs*, on a broad spectrum of investment management topics. Prior to joining Lord Abbett, Mr. Ezrati was Senior Vice President and head of investing in the Americas for Nomura Asset Management, where he helped direct investment strategies for both equity and fixed-income investment management.

**Note:** The value of investments in equity securities will fluctuate in response to general economic conditions and to changes in the prospects of particular companies and/or sectors in the economy.

Investing involves, risk, including possible loss of principal.

*The opinions in the preceding commentary are as of the date of publication and subject to change based on subsequent developments and may not reflect the views of the firm as a whole. This material is not intended to be legal or tax advice and is not to be relied upon as a forecast, or research or investment advice regarding a particular investment or the markets in general, nor is it intended to predict or depict performance of any investment. Investors should not assume that investments in the securities and/or sectors described were or will be profitable. This document is prepared based on information Lord Abbett deems reliable; however, Lord Abbett does not warrant the accuracy or completeness of the information. Investors should consult with a financial advisor prior to making an investment decision.*

**Investors should carefully consider the investment objectives, risks, charges, and expenses of the Lord Abbett funds. This and other important information is contained in a fund's summary prospectus and/or prospectus. To obtain a prospectus or summary prospectus on any Lord Abbett mutual fund, contact your investment professional, Lord Abbett Distributor LLC at (888) 522-2388 or visit us at [www.lordabbett.com](http://www.lordabbett.com). Read the prospectus carefully before you invest.**

Copyright © 2011 by Lord Abbett Distributor LLC. All rights reserved.

Website: [www.lordabbett.com](http://www.lordabbett.com)

**NOT FDIC INSURED—NO BANK GUARANTEES—MAY LOSE VALUE**

LORD ABBETT® 