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European Officials Should Stop the Death Spiral

Last month, Ireland has agreed an 85 billion euro bailout with the European Union and International Monetary Fund, in an effort to prop up the country's banks and prevent the government running out of money. The main points are shown below:

How the financial aid package will be spent?

10 billion euro will go immediately to Ireland's bank to increase the amount of capital they hold.

25 billion will be made available on a contingency basis to the banking system.

The remaining 50 billion will go to the government to cover its budget needs, so the country will not be bankrupted by the size of its budget deficit.

Where the money will come from?

17.5 billion euro will be paid for by Ireland itself, from a Treasury cash buffer and the investments of the National Pension Reserve Fund.

The remaining 67.5 billion will be paid for in 3 equal parts of 22.5 billion by: 1) The IMF, 2) The European Financial Stabilization Mechanism (EFSM), set up by euro zone members earlier this year to allow the EU to borrow money to grant financial assistance to a member states, and 3) The European Financial Stability Facility (EFSF), a 750 billion euro fund set up by the 16 countries in May, along with loans from the UK, Sweden and Denmark.

Why the bailout is being given?

Providing a loan to Ireland is warranted to safeguard financial stability in the euro area and the EU as a whole.

ECB is being held hostage

Euro rebound shortly after the bailout plan released, but later drop below 1.3. The rescue package for Ireland failed to convince investors that policy makers have the tools required to contain the crisis, prompting them to dump Irish, Greek, Portuguese, Spanish and Belgian assets.

With the euro zone's sovereign debt crisis now threatening to engulf Spain, its fourth-largest economy, investors are again looking for the President of the European Central Bank to do something to stop it. "To some extent the ECB is being held hostage by financial markets. As the existing measures are unlikely to be sufficient to solve the problems in the periphery, the ECB probably will be forced to increase its programs substantially." said Juergen Michels, chief euro-region economist at Citigroup Inc in London.

On the last ECB meeting, President Jean-Claude Trichet warned that investors are underestimating policy makers' determination to shore up the region's stability after the bonds of high-deficit euro-area nations slumped. ECB kept the interest rate unchanged and decided to delay the withdrawal of unlimited liquidity support for banks. Euro rebound and market has started to stabilize afterwards.

What European officials should do?

We think that EU is facing the death spiral: 1) some countries have high deficits and were/will be downgraded, 2) the bond price slump and the yield surge, making them much more difficult to get the funds by issuing bonds, 3) these countries seek help from EU, which offer them the financial aid package, they should fix their finance for this.

Although European countries will be facing high deficits for a foreseeable future, there are something that the officials can do to build up the confidence in the market. We believe the following actions can help:

- 1) Delay the withdrawal of unlimited liquidity support (ECB has announced it before)
- 2) Increase the European Union's 750 billion euro aid fund (Rejected by Germany)
- 3) Introduce joint bond sales (Rejected by Germany)
- 4) Significantly ramping up the bond purchases
- 4) Do everything to protect Euro system (at least shortly)

We think that eventually the ECB will be forced to increase its contribution to the rescue packages substantially. And we expect that after another round of market tensions, the European fiscal policy makers will eventually come up with additional measures to fight the crisis.

If Euro system is going to collapse, Germany should suffer, but the market momentum of DAX is still strong. Given that Euro system is not going to collapse, PIIGS will not default soon, the bull market should continue.

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