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Germany's Choice & the Fate of Euro

What's happening in euro-zone?

"The euro area's six AAA rated countries are among the nations to be placed on a negative outlook, and their credit ratings may be cut depending on the result of a summit of European Union leaders on Dec 9." S&P said in a statement on Monday. Germany's rating could be cut by one level, while other countries, including France, Italy, Ireland, Portugal & Spain could be cut by up to two notches.

As we mentioned before, the downgrades of Germany and France would affect the rating of the European Financial Stability Facility (EFSF), which has funded rescue packages for Greece, Ireland and Portugal partially through bond sales. The downgrades of EFSF will certainly damage the confidence of its bond buyers. As a result, EFSF may not be able to provide as much funding for the indebted nations.

The S&P move is another signal that euro area countries must take decisive action to deal with the crisis or else the problems will spread from Greece to the rest of the euro zone. Seeking to restore confidence of euro, the leaders of France & Germany jointly called for changes to the European Union treaty.

Merkel and Sarkozy discussed several broad changes for the EU treaty, but failed to provide much detail. The changes included:

- 1) Introducing an automatic penalty for any government that allows its deficit to exceed 3% of GDP.
- 2) Pledging that any future bailouts would not require private bond investors to absorb a part of the costs, as was the case for the Greek bailout. Germany had earlier insisted that Europe's permanent bailout fund would demand private investors take losses if a country in the future needs rescuing.
- 3) Promising to not criticize or otherwise comment on the work of the ECB. This is intended to ensure the bank's independence and its ability to act without pressure from European leaders.

Meanwhile, Federal Reserve, together with other 5 central banks, announced coordinated actions to enhance their capacity to provide liquidity support to the global financial system. Stocks rallied, commodities surged & yields on most European debt fell afterwards. So, what next?

Our View

First, EU treaty changes could take months, if not years, to implement and don't wipe away the mountains of government debt dragging down Europe's economy. Sarkozy pledged to have a revised EU treaty ready for signing by March. It would then need to be ratified in each country, which could mean lengthy parliamentary debates or national referendums in some cases. The United Kingdom has opposed to the financial transaction tax, it may not sign up to further fiscal integration. So, uncertainty remains in the stock market.

Second, the central banks' action could ease strains in money markets in short run, however, it could not reduce the debt burden of the indebted nations. It also falls short of some calls for the ECB to step up and act as lender of last resort for the governments of the 17-member euro area and buy unlimited amounts of government bonds. Germany has resisted the idea, arguing it isn't the ECB's job to do so and would only be a temporary fix.

The option that Germany cut itself loose from the euro-zone and reintroduces the DM is no longer taboo. Dirk Meyer, an economic professor of the Helmut Schmidt University of Hamburg, calculated that leaving the euro would cost Germany over 200 billion or approximately 10% of its GDP (to be paid once only).

On the other hand, saving the euro will cost Germany 60 billion euro (on annual basis). In other words, from the fourth year onwards, the cost of leaving the euro would be more advantageous than remaining in the euro.

According to the calculations from Ifo Institute, Germany alone risks losing up to 560 billion euro if PIIGS are to be bailed out by their euro-zone partners. If 60 billion (Meyer's estimation) will be used to bailout PIIGS every year, it needs more than 9 years to settle the problem. It's not surprising that Germany decide to leave the currency union at the end of the day.

We expect the EU policy makers will announce the details of the leveraging of EFSF, seeking help from IMF (increase its resources either by raising its capital or by bilateral loans so that it can lend more money to euro-zone countries in need) and the changes to EU treaty on the coming Friday. But, don't expect too much.

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