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Mad Frau Disease

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The crisis in Europe has now moved into a new phase. Greece has become a small part of the problem as the focus has moved on to Spain, with Italy under increasing pressure. The crisis is soluble, but the political mess in the EU is compounding it. We believe the chance for a purely European solution has passed, since this monster is now too big for Europe to handle alone.

Frau Merkel's insistent emphasis on austerity, without mentioning any clearly defined growth measures to provide some amelioration and hope to the suffering periphery, where unemployment exceeds 15%, will be seen as the major political failing in this crisis. Her constant fear of her own electorate has meant she has lost the opportunity to manage this crisis effectively.

Throughout the crisis she has shown minimal vision or statesmanship. Conrad Adenauer or Helmut Kohl would have managed this situation with much more savoir-faire. She has pandered to the prejudices of her electorate and failed to mention the considerable benefits which accrue to Germany as a result of the current European structure. These include an undervalued currency and a ready export market for German goods in the rest of the EU.

The Germans had adequate warning that Sarkozy would lose the election and they would be left as the sole proponents of austerity, yet they prepared no convincing response besides their mantra of mutual impoverishment. This failure will now cost them and the Europeans very dearly. The moment of truth has finally arrived. The European experiment will either blow up in the laboratory or move on to greater integration. The next few weeks will prove to be crucial.

The markets have noticed this subtle change in the high stakes of this game and the yield on German bunds, along with other euro area bonds, has begun to rise as the doubts creep in about Germany's capacity to handle this crisis. German resources, both monetary and political, are finite and this week the markets started to doubt whether they would be sufficient.

Frau Merkel grew up under communism, where nothing was rationed by price. It seems she still needs to understand and appreciate the dynamism of markets; they move very rapidly and are unforgiving. Every time there is another phase in the crisis the mob from Berlin, particularly The Chancellor, blame the "speculators", proving they have failed to understand the basic dynamics of markets. These, "speculators" would not bother UNLESS they had noticed a definite inconsistency or logical fault in the system. Frau Merkel has failed to grasp this fundamental point.

No proper research has been done on a euro break-up, or the exit by one particular country; the idea was not even considered credible until last summer! Nor has there been adequate consideration of the real psychological effects of casting Greece adrift. This will not only hit the Greeks, but will send a clear message to the other nations on the periphery. The Greeks are going through a fearful crisis; hospitals have run out of medicines, pensions (where they are still being paid) have been cut and the economy has now shrunk by at least 25% tipping many businesses and former employees straight onto the rubbish heap.

Berlin and Brussels, along with the IMF, must show some recognition of the enormous human cost resulting from the failure of the euro experiment in the PIIGS nations. The fact that these respective governments allowed enormous excess demand to be funded with OPM (other people's money) does not really resonate with the unemployed and the homeless who are sleeping out rough and rely on soup kitchens for any regular daily food.

All these countries feel very isolated. A simple review of the coverage of Greece's problem in the press of any other periphery country will confirm this sense of almost helpless isolation. So we desperately need the announcement of a stabilization initiative, which injects some growth and hope into these devastated economies. It is a pivotal part of any broad solution. Fundamentally there are huge human resources going to waste.

Doctors with no drugs or availability of hospital beds, builders and architects with no projects and many other skills which could be utilized just for stabilization and maintenance of the existing social fabric. Otherwise the young and the qualified will leave in droves and the population balance of these national economies will be blighted for years to come. Already Irish emigration is at the highest level since the potato famine of the 1840's!

Massive support needs to be arranged for the euro-zone, not just Greece. The problem is now truly systemic. The Greeks, Spanish, Italians and now even the French, thought they could dupe the markets without sufficient decisive action. This unwillingness to face reality has meant that the crisis has now placed a large question mark over the whole European experiment.

The resources of Germany alone will now be insufficient; all of the European nations including those outside the euro will have to put their hands in their pockets. In addition they will need to call in help from other countries and international institutions. The resources of the IMF will be severely tested by this latest turn of events. The newly industrialised countries in Asia, Latin America and the Middle East will all need to contribute.

Furthermore the European Investment Bank must be involved. The Europeans need a truly massive response because we are seeing capital leaving the euro-zone periphery countries at an alarming rate. As the capital is withdrawn the expected decline in economic activity becomes a self-fulfilling downward spiral.

The ECB will have to slash rates and put in place a massive dose of Quantitative Easing (QE). In a situation like this there is no danger of immediate inflation; just the absolute priority to restart growth. The authorities must ensure that a strict programme of international monitoring is imposed on all EU banks. The last set of stress tests was considered a joke by most market participants and unfortunately this view has proved to be horribly correct.

All of these proposals are not new requirements; they have been used in every financial crisis since the Second World War. It is just that the Brussels and euro elite truly thought that their system of international integration was enormously superior to any other that had preceded it. The time has come for them to wake up and smell the coffee.

The Brussels bureaucracy is a massive self-perpetuating clique which is overpaid and if they have not done a sufficient amount of homework for this extensive crisis many should be sacked. They have been appallingly complacent as this financial storm has raged, but the biggest question remains how to implement effectively any announced containment programme.

This need for tight monitoring will mean a considerable loss of sovereignty for most of the nation states in Europe. The idea of the original Treaty of Rome was less nationalism and more integration; but the result of this crisis will mean a loss of European national sovereignty, not to Brussels, but to their new international creditors! Such is the extent of the failure of this monetary union.

The rallying cry of the American colonists was, "No taxation without representation" many of the European nations have lied, cheated, prevaricated or just failed to face the facts. As a result their pride and sovereignty will suffer as non-Europeans play a prominent part in the bail out.

The notion of German control of this process carried too many memories for such enormous financial coercion to be acceptable. Frau Merkel's constant reminders of no quarter on austerity did nothing to sweeten the bitter pill. The very idea of being answerable again to Berlin was too difficult for many Greeks and Italians.

A new international initiative needs to be launched which includes high profile involvement by the Americans, Chinese and a number of other wealthy nations such as the Saudis, Gulf States and Russians. A new form of Bretton Woods is required to save the international economy. Nothing less will do; the sums are so large that no one will trust the Europeans with another penny without a framework of strong governance for this new super bail out. There will be no assistance without full accountability.

This is a massive leap into the unknown, but many well informed policy makers should have seen this situation coming. Even the Bank of England and the UK Treasury have made a modest effort to try and get ahead of the curve; hopefully the IMF, the FED, the World Bank and the Chinese Authorities are also geared up to announce a comprehensive programme at the G20 summit or soon afterwards.

Frau Merkel has failed; with the result the Europeans are no longer in sole charge of managing this crisis. They neglected to run their own affairs in a responsible and prudent manner. They have totally lost this economic war and MUST now pay the price; which is ceding the task of crisis management to a much wider group of decision makers whose price will be much stronger control over the whole process.

Effect on the markets

1. It is clear that the primary response will be a further large dose of liquidity, which will quickly leak into asset prices; some of this cash should be used to help banks sensibly write down serious non-performing loans.

2. The measures announced by the Bank of England have provided the UK banks with additional funds to lend on to the broad economy. This will improve their profits and should increase the pace of lending and economic activity.

3. More importantly the Sunday Times has reported that the Bank has relaxed the size of the cash buffers needed by the banks and this will allow them to lend more easily. This means that credit should flow more freely to the SME sector and this should be good for profits and increased employment over time.

4. Most economists expect a further £50 billion in Q E as a result of this programme; consequently gilt prices should rise as the money is spent. Alternatively the Bank might buy Residential Mortgage Backed Securities and this should affect the cost and availability of these mortgages.

5. We expect significant monetary easing from a number of other Central Banks and this extra cash will most probably support the current prices being obtained for prime property in Central London. In addition a number of foreign government bond markets should benefit from increased funds being made available.

6. The increased funds will leak into equity markets, but this part of the stimulus seems to be subject to the law of diminishing returns. Nevertheless it should lead to a spike in equity prices, but the duration of such a fillip is uncertain.

7. The housing market in the UK should start to improve as the government relaxes planning rules and the monetary stimulus increases mortgage availability. The critical factor here will be a modest fall in loan criteria and a downward movement in mortgage rates which is still necessary to kick start this market.

8. Credible steps toward resolution of this crisis will bolster confidence in continental Europe. That will be a key requirement of any rescue package and be of vital importance to the UK given the continued dependence of our exporters on European markets.

9. An announcement of a concerted programme of easing in the Far East would also provide some measure of relief for the European manufacturing industry; as demand from this area has slowed considerably over the last few months.

10. Finally we should always remember that politicians got us into this mess. Their meddling will be a constant source of concern. The economic measures described above should be sufficient, but the ability of the politicians to sink sensible agreements should never be underestimated.

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