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Central Banks to the Rescue

In the past five months, global stock markets were marked by extreme volatility brought about by the uncertainty in Europe. We had wild rallies and plunges depending on whether the news flow was a positive or negative surprise. This was also due to the indecisiveness of the European leaders. The weak US economy plus threats of a China hard landing further exacerbated the panic sweeping the markets, making it a very difficult environment to invest, be it in equities or fixed income.

China Eases for the First Time Since 2008

While we were on holiday break last November 30, China pleasantly surprised the gloomy global market when it decided to cut its required reserve ratio for banks by 50 basis points to 21%, the first time it did so since October 2008. This may add about $55 billion to the country's financial system. With exports accounting for about 30% of its GDP, China recognized that it had to take action to cushion the impact of the imminent slowdown in developed markets on its own economy. While many central banks have begun easing, the red giant's actions were closely watched due to the large impact it had on the world economy.

Central Banks Saved the Market

On the same day as China's announcement and just when the market was plunging again because of disappointments with the European program of action, the central banks of Canada, UK, Japan, Switzerland, US, as well as the European Central Bank, announced coordinated actions to enhance their capacity to provide liquidity support to the global financial system. In addition to lowering pricing on dollar swaps by 50 basis points, the central banks also established temporary bilateral liquidity swap agreements so that they will able to provide liquidity in other currencies if market conditions worsen. These twin announcements electrified markets, sending European markets higher by as much as 5% while the Dow Jones jumped nearly 500 points.

Don't Fight the Fed

Recall that in October 2008, China cut interest rates within minutes of reductions by the Federal Reserve and five other central banks. Five months after that coordinated action, the markets bottomed in March 2009. While it may pay to be bearish in times of uncertainty, it pays even more to adhere to the adage "Don't fight the Fed." Not only can the Fed and world central banks change rules as they see fit, but they also have unlimited ammunition because they can print as much money as they need to. Even if fundamentals are still bad, central banks can alter the financial setting to improve the fundamentals. While world leaders may be far from resolving this crisis, the sense of urgency with which the central banks acted are reminiscent of the way they combatted the 2008 financial crisis assures us that they will do their utmost to prevent the worst from happening. Thus, if the Fed wants the markets to go up, it is prudent not to be on the other side of the Fed.

Too Little, Too Late?

Prior to last week, there were already other positive developments in the Euro region, such as plans to recapitalize banks and increase the firepower of the European Financial Stability Facility (EFSF). The ECB also cut interest rates while purchasing bonds of Italy and Spain. At the same time, they also aided their smaller, troubled neighbours like Greece, Ireland and Portugal. Greece and Italy also replaced their political leaders with technocrats who are best suited to cure their countries of their economic malaise. Even the International Monetary Fund (IMF) is stepping in by helping European central banks give loans to troubled countries without violating rules on direct financing. However, all these plans seem to still be inadequate to solve the European crisis. Some analysts have said that by the time all these proposals take full effect, it would be too late to save the Euro region.

Fiscal Union First, then the Bazooka

With all these solutions apparently still lacking and the Eurobonds proposal all but dead, the markets have looked to the ECB for additional firepower in staving off the crisis. However, ECB President Mario Draghi has signalled that the ECB would be willing to unleash its bazooka only if European leaders implemented far-reaching economic reforms. He called for European governments to implement a fiscal compact that combines fiscal policies with mutual fiscal commitments. Only the creation of a genuine economic union can restore the Euro region's credibility and assure its long term survival.

Marathon Crisis to Go the Distance

While Draghi, French President Nicolas Sarkozy and German Chancellor Angela Merkel are in agreement that setting the parameters for a fiscal union is the priority, they also recognize that this crisis will take years to solve. While the long process of treaty change is likely needed to achieve this, Draghi mentioned that faster processes are also conceivable. Thus, the sequencing of each step out of this crisis becomes even more crucial. Before any bailout or Eurobond is implemented, each country must have its books and policies in order, otherwise, the same problems will come back to haunt them, spawning yet another crisis. It has never been profitable to throw good money after bad, just as was the case for early investors in troubled American banks. When this fiscal compact is in place, only then will the ECB, France and Germany go "ALL IN."

If Europe Moves in the Right Direction, So Will the Markets

The long term nature of this proposed solution have some analysts saying that it might also be too late for the Euro region if the ECB steps in only at the last moment. They say it might be too late to save anyone by then. While that point is open to debate, what is clear is that this solution is a step in the right direction. With a long term solution being galvanized instead of the previous band-aids, the question now is execution.

Last Few Innings

Just like in a baseball game, we are already in the last few inning of the European financial crisis. It has been more than 2 years since the Greek problems surfaced. In fact we have written about the contagion effect almost 2 years ago (see *The "IPIS" Theory*, 22 February 2010). Unfortunately, this has dragged out because of the enormity of the problem. The contagion has gone from smaller countries like Ireland and Portugal to their larger neighbours, like Italy and Spain. Now it is at the doorsteps of Germany and France, threatening to engulf the whole of Europe. Thus, the central banks already had to act. However, many pundits still believe that the enormity of the problem is too big for Europe to settle.

Act or Get Punished

Many doubt the December 9 Euro region summit will be able to solve anything because they believe that it is not a liquidity problem but a solvency problem. Fortunately, European leaders already seem to have grasped the problem. As Merkel said, it will take years to resolve the crisis. Although the stock market will continue to be volatile, with world central banks coordinating with each other, we are confident that the European crisis will eventually be resolved in due time. However, if they do not provide a solution, the market will plunge again, forcing them to act, just as we saw last week.

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