Analysis: Big Greek risk morphs into more economic uncertainty
Mon, Jun 18 2012
By Alan Wheatley, Global Economics Correspondent

LONDON (Reuters) - Greece's election has averted the immediate threat of a euro break-up, but it does nothing to restore the magic ingredient missing in the European and global economies - confidence.

Investors and corporate executives are paid to calculate risk. But they cope badly with uncertainty, and the poll has swapped one big fat risk - a victory for radical leftists opposed to the bailout program keeping Greece afloat - for a fresh dose of uncertainty: what changes to the plan will be sought by Greek conservative leader Antonis Samaras, the narrow election winner, and how will the rest of the euro zone respond?

Add in sluggish growth in the United States and China, which are also in a year of political change, and it is no wonder that animal spirits, or confidence, which Keynes identified as the intangible elixir of growth, is conspicuous by its absence.

"Undoubtedly the outcome is better than it could have been, but all of the issues about renegotiations, fragile coalitions and uncertainty about growth programs are still there," said Andrew Milligan, head of global strategy at Standard Life Investments in Edinburgh.

He said the euro zone's travails were like Britain's weather of late - dark and depressing interspersed with the odd ray of sunshine.

"Businessmen want to feel that the world economy is growing and that they should be thinking optimistically about how to expand, hire and invest," Milligan said.

Instead, companies are hunkering down.

World No. 2 truck maker Volvo (VOLVb.ST: Quote, Profile, Research, Stock Buzz) is having second thoughts about ramping up output in Europe. "Given the current economic development in Europe, we are evaluating if the announced increases in production rates will be implemented as planned," the company said on Monday.

Volvo was echoing another Swedish industrial bellwether, SKF AB (SKFb.ST: Quote, Profile, Research, Stock Buzz). The world's leading bearings maker said last week that the euro crisis, coupled with a slowdown in China, was sapping confidence and demand. Consistent with their gloomy assessments, car sales are falling not just in France but also in more-resilient Germany.

"The global economy is slowing and is slowing at a time when you have got such policy indecision that it's making investment very difficult," said Sean Darby, Hong Kong-based chief global equity strategist for Jefferies, an investment bank.

WHERE'S THE GROWTH?
China is easing some policies but keeping a tight grip in other areas, the United States faces a fiscal tightening next year and the euro zone is wedded to austerity, Darby said.

"I cannot find an economy at the moment where there's a natural pro-growth policy. There isn't one."

Investors are struggling to price in the implications of competitive currency devaluations that many governments are encouraging, while Madrid's abrupt admission this month that it needed outside help to clean up its banks has compounded uncertainty over the extent of the euro zone's woes, Darby said.

"The fact that a country like Spain can deny how bad the problems are and suddenly get a bank bailout for 100 billion euros must worry participants that there's a whole lot of other stuff that's being covered up as well," he said.

The owners of German chemical company Evonik RAGES.UL on Monday blamed the high level of market uncertainty, especially in the euro zone, for their decision to scrap what could have been Europe's biggest initial public offering in more than a year. <ID:nL5E8HICRQ>

Motor sport racing company Formula One and London luxury jeweler Graff have also put their IPOs on ice.

So what is needed to revive confidence?

Beyond evidence that Greece is finally addressing its deep-seated problems and regaining the trust of its creditors, markets are clamoring for a roadmap leading to the closer fiscal, banking and political integration needed to underpin the single currency. That's why the European Union summit on June 28/29 looms large.

Without an assurance that the euro zone is contemplating some way of eventually mutualising the debt issued by the currency bloc's members, bond investors may well continue to flee Italy and Spain and propel yields on their debt to levels at which they cannot refinance themselves in the market.

At that point, Europe's third- and fourth-largest economies would have to ape Greece, Portugal and Ireland and turn to the International Monetary Fund and the European Union for emergency loans.
Yields on Spanish debt surged on Monday to a euro-era high as a post-election relief rally petered out within hours. Italian yields also jumped.

WHAT'S TO BE DONE?

Ian Harnett, managing director at Absolute Strategy Research, a London consultancy, expects Greece will still be in the euro at the end of 2012. It was time, he said, for markets to recognize that the political will exists in the euro zone to do all that is needed to keep the single currency intact.

To that end, Harnett believes the minimum requirement over coming weeks is to flesh out the idea of euro-wide bank deposit insurance to forestall the risk of destructive bank runs.

"It strikes us that if you don't have deposit insurance you will have to have capital controls. Which would you prefer?" Harnett asked.

Willem Buiter, chief economist at Citi, agreed that a blueprint for a banking union, of which a deposit guarantee scheme would be one component, could emerge as soon as at next week's summit.

He also expects the euro zone in due course to beef up the role played by its embryonic rescue fund, the European Stability Mechanism, so it can help reschedule euro zone government debt. But Buiter, who coined the term "Grexit", still thinks Greece is headed for the euro exit at some point.

"Ultimately we anticipate that a mixture of banking union and expanded ESM and a sovereign debt restructuring mechanism should be enough to keep a 16-nation euro area on the road," he told a conference call.

Buiter favors granting the 500 billion euro ESM a banking license so it has more financial firepower, but he said there was not yet enough support for the idea.

"It will probably take another couple of panics to get that implemented against continuing German and European Central Bank opposition," Buiter said.

That comment goes to the heart of the frustrations of many academics and policymakers outside Europe: not until the euro zone is staring into the abyss do its leaders contemplate radical steps to put their currency on a solid footing.

"In the euro zone and other advanced economies, politicians seem unable to come to terms with the need for decisive policy actions, instead settling for half-measures and defensive policy interventions when backed into a corner," said Eswar Prasad, a Cornell University economics professor and senior fellow at the Brookings Institution in Washington.

To rebuild credibility and revive growth, Prasad urged politicians to summon up the resolve to tackle powerful vested interests and implement structural reforms to product, labor and financial markets.

This would then create some space for back-loading measures to bring the rise in public debt under control.

"The global economic recovery is being held hostage by political brinksmanship that has created policy paralysis, undermined confidence and stymied the effectiveness of macroeconomic policy tools. In the absence of political leadership to undertake decisive and concerted policy actions, it is hard to see the recovery gaining traction," Prasad wrote in a Brookings article.

(Reporting by Alan Wheatley; Editing by Peter Graff)

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