Madame No says Yes

The Greece and Euro-zone bailout may not end their solvency problems but it signals that EU policymakers remain committed to global financial stability

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An anxious fortnight in which financial markets grappled with the consequences of a spiralling debt crisis in Europe and the prospect of a default by the US treasury (with the continuing impasse between the Democrats and the Grand Old Party over the sovereign debt ceiling) ended with a collective sigh of relief. European authorities finally set their bickering aside and announced a comprehensive package both for Greece and other fiscally-stretched countries. The Euro jumped as a result climbing by what currency traders call three "big figures" against the US dollar from of 1.415 to 1.4421 and led a rally in a large basket of currencies including the rupee.

In a nutshell, here's what the new rescue package is about. Greece will get additional support of €160 billion (over and above the €110 billion assistance announced in 2010) with €109 billion coming from Eurozone governments and the rest from the private sector. Private participants might have to swap short-term securities that are due for redemption for longer ones. Other economies such as Portugal and Ireland will also see interest rate reductions and maturity extensions while mechanisms such as the European Financial Stability Fund (EFSF) and European Stability Mechanism (ESM) have been made more flexible to prevent default or a liquidity shortage. They can now, for example, recapitalise financial institutions, provide precautionary credit lines and intervene in the secondary markets. The European Central Bank on its part has said it will accept Greek debt as collateral in its liquidity operations even if it is downgraded to selective default. A Marshall Plan-like revival programme for Greece also seems to be on the cards. This might help address the nexus between fiscal austerity and slower growth that in turn hurts rather than helps the ability to service debt.

What is the big deal about the new "rescue package"? To answer that, it might make sense to take stock of what the markets had been fretting over. For one, they were worried that Greece's attempts to raise money from the markets for 60 per cent of its fiscal funding for 2012 (that the 2010 bailout package stipulated) would come a cropper. That would mean a certain default on its sovereign debt that could send shockwaves to the European banking sector that have significant exposure to Greek debt. The new rescue package takes Greece's funding requirements off the market for the next couple of years and thus minimises the possibility of default.

The bigger concern both for EU policymakers and the markets was about a contagion spreading across all the other fiscally-stressed states, including the bigger economies such as Italy or Spain. Sovereign yields were rising across the board, setting off an explosive spiral of higher interest bills, bigger deficits and larger borrowing needs. Italy, which has a massive stock of debt and roll-over needs, saw the markets mercilessly batter its bonds over the last few weeks. By expanding the package to address the problems of other economies and expanding the scope of mechanisms like the EFSF, this risk of contagion is also likely to reduce.

Is this the end of Greece and the Euro-zone's problems? Perhaps not entirely. The fact remains that even with interest rate reductions and "rescue funding" the debt levels of some of these peripheral economies remain extremely high. At some stage later, apprehensions about their long-term solvency will surface. It also remains to be seen how the private sector responds to the attempts to restructure debt and how rating agencies view this. That said, the European initiative does two things. In the near term, the fact that it addresses some immediate uncertainties should encourage risk-taking. Thus, not only will non-dollar currencies gain but other assets such as commodities (traditionally considered risky) should see a rally. The default "safe-haven" currency, the dollar, that attracts flows when risk-appetite declines is likely to lose steam. The rally could sustain until other risks such as the prospect of a slide in global growth come back on the table.

There are long-term implications as well. The fact that European heavyweights, particularly the notoriously tight-fisted Germany (Chancellor Merkel is widely referred to as Madame No) could reach a consensus on a rescue plan and actually loosen their purse strings should signal that EU policymakers remain committed to the Euro project and to global financial stability in general. In specific terms it could set a floor to the Euro at levels of over 1.30 to the dollar and reduce the intensity of the market's response to the flow of bad news from the region.

There is another key reason to be dollar-bearish in the near term. Focus will now shift to whether the US debt ceiling is raised in time to avoid a default. Markets have two sets of demands from US policymakers: (a) to raise the debt ceiling before August 2, 2011 and (b) the preparation of a long-term fiscal consolidation programme that averts the possibility of the US losing its prized AAA rating. The most plausible outcome is one in which the debt ceiling level is raised by a small amount to avert another financial crisis but the issue of long-term fiscal consolidation is put off for a later date. This impasse will work against the dollar until another set of risks unfold that would send markets scurrying back to the greenback. That could well happen by the next quarter if there is more evidence that the global economy is losing traction.

The writers are with HDFC Bank. These views are personal