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Disequilibrium and Disorder: the EU's policy ambiguity underlies market turbulence

Many observers have noted that extremely erratic equity markets of recent weeks indicate the fault lines of the globalization of financial markets. Some see this state of affairs as a defect of globalization. Others see this development as broadly indicative of the need for Government (in the large) to alter the way it conducts the business of the State. Whichever view one takes, current market disorders underline the importance of institutional certainty ----and its chronic absence in recent years, particularly in Europe.

Modern economics recognizes the importance of known institutional responses to economic and political events. When that response is unpredictable, it can lead to a vanishing of trust and a concomitant excess demand for the most liquid and "safe" assets. In a world of mobile capital a shift from relative certainty to large uncertainty can and does have huge impacts on currencies, bonds and equities. No recent event illustrates market distrust more than the current Greek drama over its fiscal deficit, the implication of that deficit for other member states of the EU, and the increasing doubt over the continuance of current institutional arrangements such as the EMU.

It is difficult enough for markets to predict economic outcomes using current macro data, and some uncertainty must always be part of our economic environment. Normally, the range of uncertain outcomes at least in the short run following a "bad" or a "good" number for employment or a manufacturing survey or a current retail sales report is bounded largely by historical precedent and the knowledge that there is persistence in the behavior of economic agents. That is not the case with regard to political events, particularly when institutional arrangements are not fixed. When important political decisions are being weighed, rumor feeds on rumor, and the "news" is contaminated by the uncertainty of voting on a day to day basis. This situation is further complicated by various electoral events that can lead to a rapid alteration in political alignments within any given country. Democratic states with ever-changing political alliances within their polity tell us to expect a high degree of policy uncertainty. That uncertainty in turn creates a wide dispersion of forecasts for markets of all kinds and in that environment, markets can oscillate widely.
Perhaps the most surprising element of apparent market fluctuations is that the presumptive cause---Greece's persistent and growing fiscal deficit and the widening divergence of interest rates on its government debt instruments as compared to more stable countries in EMU----is not a new issue. That divergence has grown over many, many months and while the exchange value of the Euro has depreciated, it has been a relatively smooth path. Not so for bond and equity markets in recent days. What's changed?

In our view, what's changed is the recognition that the EU as presently constituted does not have the policy authority in place to even attempt a serious "fix." Contrast the current miasma with the uncertainty that flowed from late 2007 through the 2008 bankruptcy of Lehman Brothers and the bail-outs of Fanny, Freddy and AIG. At the time, policy in the US was extremely hard to forecast and policy choices were widely debated in public. At the end of the day, however, American political

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institutions had the power to effect clear policy changes. Whether one approved of the "Bazooka" that was fired and not just "seen," or whether one approved of the Fed indulging in a selective credit policy with regard to mortgage lending, the actions by the Fed, the Treasury and the Congress were forceful and occurred in a discrete time frame. Similarly for the fiscal stimuli that came at the end of the Bush and the beginning of the Obama Administrations. Rightly or wrongly, they demonstrated a power to act and act decisively. Accordingly, markets adjusted to the underlying policy certainty, spreads narrowed and equities found a bottom and began to increase. The key to that stability was that markets understood the willingness and ability to act by policy institutions. That policy decisiveness seems lacking in the EU and the EMU.

When markets are searching for some sort of equilibrium, the worst thing is an inability to discern the policy environment. To regain some stability, the gyroscope of a decisive policy authority is needed. Until that policy environment is clearly elucidated and implemented, markets will founder. Apparently, the EMU and the EU cannot get their acts together and demonstrate a decisive political course. Market expectations for the future are widely disordered and the result is seemingly unstable day-to-day market movements.

While the Greek Government appears to have taken a major step with regard to fiscal budgeting over the next few years, markets remain unimpressed. No one knows the "teeth" in these resolutions. Greece may be a singular case, but markets see the Greek situation as the tip of the iceberg and are unable to discern just how big that iceberg may be. Moreover, markets are unable to perceive a distinct policy path by the ECB, the EU's single financial authority. At the same time, markets note the continued disagreement between the nation-states of the EU over what responsibilities the member states have in preserving the Union. If the EU is to be preserved, it must have singular and undivided leadership, but that does not seem possible at this time. There is no "Lincoln" in Frankfurt or Brussels.

Trust and confidence in markets, particularly in the inter-bank market in Europe can be restored only if the policy authorities make absolutely clear that they are willing to take large and continuing steps to prevent lending from shriveling up into a "sauve qui peut" environment. That does not mean that equities will sink into a bottomless pit where no company has value. On the contrary, traders are more likely to put even more stress on "fundamental value," and the appropriate margin of safety on any single equity. Meanwhile, that search for value will be buffeted by rumor and conjecture over forward policy measures. If the policy authorities wish to limit the current instabilility, they must supply the needed institutional certainty. This may not be a sufficient condition for stability, but it is clearly a necessary one.

Even after a clear policy path is laid down, markets have to acquire "belief." A prior history of policy instability or policy uncertainty weakens the acquisition of firm belief. Markets function in the context of known political institutions and forecastable political outcomes. The EU needs to get its act together quickly. More damage to balance sheets will occur until markets gain some measure of confidence and the key ingredient at this point is policy certainty. Forecasting economic outcomes is

a difficult and chancy business….only made more difficult by political bodies that cannot instill confidence and show resolve in their policy determination.

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