

## Special Report: "Shock and Awe" galvanises EU

**As US regulators were still investigating the precise causes behind the 1000 point drop in the Dow Jones Industrial Average last week, finance ministers from the European Union announced an emergency rescue package believed to be in the order of US\$1 trillion in an attempt to support the ailing Euro, prevent the Greek debt crisis from spreading to other European nations and ease rampant fear throughout global financial markets.**

The US\$1 trillion package consists of a 440 billion Euros in guarantees from Euro-zone states, plus 60 billion Euros in a European instrument and a 250 billion Euro contribution from the International Monetary Fund. Both the IMF and the EU have already approved a 100 million Euro package and the European Central Bank announced last year that it was to buy covered bonds but the details of the purchases have yet to be determined. Support from outside Europe came from the US Federal Reserve which re-opened currency swap lines with several central banks and, G-7 and G-20 Group finance ministers have weighed in with their backing for the measures. The move appears to be a forceful attempt to defend the Euro by whichever means necessary: the rhetoric is similar to that used by finance ministers in response to the 2008 global financial meltdown triggered by the Lehman Brothers collapse.

The 1000 point drop in the Dow may well have been catalyst that galvanised European Union finance ministers into a unified response to the crisis that was threatening the Euro. Financial problems with a group of European countries euphemistically called the "PIIGS" (Portugal, Ireland, Italy, Greece and Spain) have been brewing for a number of years and since coming to a head this year, have been met with disunity and political wrangling among EU member nations. The loudest voices came from France and Germany whose banks, according to the Bank for International Settlements, carry a combined US\$119 billion in exposure to Greek borrowers alone and more than US\$900 billion to Greece and other countries in the infamous group, Portugal, Ireland and Spain. The DJ Stoxx European Bank Index has fallen 12.5% in the past month, with Germany's Commerzbank having dropped 15% over the same period and France's BNP Paribas 14%. Both governments have feared that their banks could fall victim to Greece's debt crisis and have steered away from politically unpopular rescue deals.

Other French banks that are most likely to be exposed are those that own Greek banks; Crédit Agricole which owns Emporiki and Société Générale which owns Geniki.

As the Euro tumbled below US\$1.26, traders flocked to the relative safety and the US dollar.

US and European markets surged on the news of the "shock and awe" EU-IMF rescue plan. The Dow Jones Industrial Average gained +3.90%, the S&P 500 +4.40% and the technology-heavy Nasdaq +4.94%. Financials, Information Technology and Commodities led the advance: Shares in Apple (AAPL) leapt +7.69% and Peabody Energy (BTU) +8.97%. India's Ilici Bank (IBN) gained +10.61% and Russia's iron and steel producer Mechel (MTL) +17.61%. Not surprisingly France's CAC Index spiked nearly 10% while French bank stocks climbed upwards of 15% on the day. Only gold dropped as June futures experienced a US\$7.00 per oz decline.

The EU action has taken place against the backdrop of important political change: Britain's Labour Party leader has said he will step down as the Liberal Democrats continue to negotiate with both major parties and German Chancellor Angela Merkel's Christian Democrats (CDU) have been defeated in recent regional elections held in Germany's industrial heartland of North Rhine-Westphalia; this loss will threaten her tenuous hold on power. The region is Germany's largest constituency, has a population of 18 million and is widely regarded as a weathervane for German politics.

Huge "relief rallies" though very rarely have too much steam and there are many economists who believe that the action taken by EU finance ministers is just a matter of 'kicking the tin down the road' and they are in fact creating a bigger problem by solving the present one in such an extravagant manner. Similar fears arose after the Lehman collapse and hindsight has shown the "shock and awe" tactic worked in the USA. Hyper-inflation did not ensue and the US major banks which took huge write-downs, have to date staged a solid recovery. Perhaps European banks will now be able to follow suit? What has become clear from this episode is that the European Union is in need of a continued unified response to the broad economic issues that threaten the region as disunity will surely be a far greater threat than any individual country's woes.