

There Will Be Haircuts

It's puzzling why Europe is more an issue now than it was a few months ago. It seems the market has finally come to grips with the fact that their economy is stagnating, and hopes for growth are diminishing. Disinflation remains a central issue to their economic union. Youth unemployment levels remain disturbingly elevated. And the structural reform and fiscal discipline that many had been looking to member governments to implement and abide by are still yet to be seen.

Even more alarming is that Europe's second and third largest economies, Italy and France, are disregarding the fiscal agreements made with member countries to rein in their debt levels. The required ratio is to move debt to GDP back towards 60 per cent. France's debt to GDP ratio is estimated to be near 96 per cent by yearend, and Italy is faring worse at 135 per cent and continuing to grow.

As troubling as the increasing debt levels seen in Europe have become, it's the latest commentary on the region that represents a fifth of the world's output that stems concern. The norm seems to suggest with certainty a likely scenario would be a stagnating Japan style economy for the years to come. Some mainstream media has gone even further to suggest something as drastic as a significant debt restructuring. But these really should not strike as anything new, as the ongoing problems have been evident all along. The fact of the matter is with Europe nothing has changed since 2008, and debt restructuring or defaults and the threat of deflation are just becoming that much more of a reality.

Deflation is the central fear in Europe as it could be the contributing factor to their third recession in six years. Some are quick to cite a similar Japan style situation where their economy moved past a deflation episode in the 1990's, but the dynamics of the two economies are much different. Where with Japan, as the Economist notes, it was a "homogenous society" that was somewhat isolated from the rest of the world, whereas Europe is much more linked to the global economy through emerging markets, and thus contagion once again rears its ugly head.

The greatest fear though is whether their economies will attract new investment going forward. It seems inevitable that growth levels will have trouble measuring up against the debt overhang of the majority of their economies. Thus, the resulting question is how much of that debt could ultimately be subject to restructuring or haircuts. Already in mortgage markets in countries like Ireland, lenders are offering non-recourse loans that prevent lenders from pursuing the borrowers personally. Reckless lending practices are already coming back into place, where mismanagement of debt was the problem in the first place.

With a lack of coordination between fiscal and monetary policy, the negative outlook for Europe continues to weigh on financial markets. If the ECB were to embark on a QE style stimulus where they were to purchase sovereign debt, the question becomes whether that would make a difference and actually address some of the structural problems in their economy. As former Fed Chair Ben Bernanke remarked regarding his own experimental monetary policy, they would have to weigh the "benefits, costs and risks."

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