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The European bailout in perspective: Q&A with James Swanson

Q: What happened on May 9?
A: The leaders of Europe put forward an immediate plan to buy potentially troubled bonds of countries such as Greece that are under financial pressure. Skeptics doubted that the political officials of the eurozone could act quickly and with enough financial firepower to stem a flood of selling. The skeptics were wrong. Over the weekend European officials put eurozone countries on the line to support purchases of assets on the balance sheet of the European Central Bank. The amount of the plan is close to $1 trillion. This plan has both the **firepower** and **breadth** to be effective.

Q: What will be the result?
A: The credit markets for now will **not** freeze up as had been feared. The immense amount of potential bond purchases and currency support by the European Central Bank assure that the near-term risk of a credit blowup is now much lower.

Q: Who pays for these bond purchases?
A: Mainly the large European countries and their taxpayers and less so the smaller countries. Also, the International Monetary Fund (IMF), which has some U.S. support, will back these planned purchases.

Q: What will be the result?
A: The stronger countries such as Germany will have to buy more debt to repay on their own, and there will be a financial price to pay, probably in the form of higher interest rates.

Q: Is there any silver lining for them?
A: Yes. The euro has fallen relative to other currencies, and for an export-driven nation such as Germany, this could help spur the manufacture and sale of machines and cars.

Q: Why does this crisis affect the U.S. investor?
A: This affects the U.S. consumer and investor because U.S. banks and their ability to lend to U.S. businesses and to Wall Street were hurt last week by rising overnight rates in the world banking system. These rate increases were driven by fears of losses in banks holding Greek and Spanish debt. These interbank lending rates were rising alarmingly before this action by the eurozone; thus, it was clear that another crisis was on its way, jeopardizing banks everywhere. The crisis threatened to shut down the whole credit delivery system. Such an event would have strangled the current world economic recovery now well underway. The plan announced on May 9 buys time for better solutions to be found to the longer-term problems that surround countries such as Greece, Portugal, and Spain in finding ways to repay their bond obligations.

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Q: Is this the end of the problem in Europe?

A: No, these actions prevent, in the near term, a fear-driven market from forcing a default or a Lehman-type world crisis. But these countries — Greece, Spain, Portugal, and others — will still need to cut spending, and this will be painful. These economies have been witnessing rising unit labor costs and thus have become uncompetitive in the global marketplace. Prescription: Their work forces will need to accept lower relative wages and become more productive. We have no idea whether the populations of these countries will be willing to undergo that kind of pain and sacrifice. But at least enough time has been bought with this plan to find out.

Q: What should investors do?

A: U.S.-based investors should review fundamentals, which at this time include rising economic growth, better corporate earnings, rising consumer spending, and many months of short-term interest rates on hold. However, world credit crises can take hold at any time, and sovereign imbalances in developed countries have deteriorated. Short-term investors should be heartened at the current news flow but also should remember that many more countries, including the United Kingdom and even the United States, have not addressed their long-term imbalances in terms of paying for services to their populations. This will create future volatility, and longer-term investors need to look for signs of discipline in the coming years to assure the next business cycle will not be accompanied by a credit collapse. In the meantime, the current economic business cycle is moving in favor of careful investors.

Source: MFS research

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