

Europe: Your Rope

The financial crisis has shown the lies of transparency, disintermediation and risk management. The former maestro, Alan Greenspan, suggests that the crisis reveals a flaw in his thinking that bankers would act in the interests of their shareholders. At the same time both friends and enemies of the United States say a function of excesses and inadequacies—excess consumption, excess borrowing, excess financial engineering—and insufficient supervision and regulation, created the crisis.

If the US is the epicenter of the crisis, then it is ironic, or “unfair” according to Niall Ferguson, that the situation has manifested more ferociously abroad. The Japanese economy contracted at an annualized pace of almost 13%, while Germany’s diminished at an 8% pace.

Double Bind

The economic contraction does not come close to capturing the challenges that Europe now faces. Unlike many US financial institutions, most European bankers did not lend to home buyers on terms that seem simply ludicrous. However, many of the same forces which led Americans down their own fallacious path, found expression in Europe. Corporate and emerging market loans at razor thin spreads, displayed a profound under pricing of risk. What’s more, these errors were done with greater leverage than the fouls of the US Banks.

Europe’s economic and financial emergency is every bit as severe as America’s, yet its ability to cope with the crisis is significantly less. First, most countries in Europe are relatively small. Bank assets are often a multiple of countries’ GDP. In the US, the issue is often cast as “too big to fail”, in Europe it is that some financial institutions are too big to be rescued, at least by any individual country.

Second, and more profoundly, the European Union and the euro zone lack the institutional capability to fully address the situation. The crisis has revealed the significance of a critical fissure in the very foundation of the European project: monetary union without political union. The original drivers of European integration conceived of eventual political unification, but such a vision has been jettisoned by the current generation of leaders.

Euro zone countries face a double threat. Internally, few members can maintain competitiveness with Germany, who has managed to contain unit labor costs better than their neighbors. Typically under the exchange rate mechanism, countries such as Spain, Portugal, Italy, Greece, and even France would devalue their currencies, when faced with this loss of competitiveness. With the advent of monetary union this course has been blocked and the alternative path of enacting the structural reforms necessary to level the playing field lacks political will.

This was tolerable when the tide was high, and capital flowed like lager. As Warren Buffet once quipped, “It is when the tide goes out that you see who is swimming without a suit”. That time is now. Along side a liquidity premium, the lack of competitiveness and failure to enact structural reforms is a major factor behind the widening of bond spreads within the euro zone.

If the first threat to euro zone countries comes from the loss of competitiveness within this still exclusive club, the second threat emanates from the fact that the monetary union itself is incomplete insofar as a number of key countries do not participate. The United Kingdom and Sweden, let alone the countries in central and eastern Europe, have seen their currencies depreciate substantially against the euro. This exacerbates the loss of competitiveness that many countries within the euro zone are experiencing.

EMU as Economic Solution to a Political Problem

The dissolution of the Soviet Union in the early 1990s provided the impetus for European economic and monetary union. Under what conditions could France (and other countries) countenance the re-unification of Germany? The deal developed by the Socialist French President Mitterrand and the Conservative German Chancellor Kohl was to intractably tie Germany's future to Europe's. Western Europe would bask in the Bundesbank's credibility and the super Deutschemark. This is economic and monetary union.

Yet with its substantial trade surplus and status as the largest European economy, Germany needed assurance it would not be forced to bail out the weaker less disciplined European countries. Thus the Maastricht Treaty, which created the EMU, specifically prohibits members bailing out insolvent members.

Nevertheless, there does seem to be the basis of a work around, were the political elite inclined to explore it. For example, the EU Treaty allows the issuance of bonds by the EU on behalf of members having difficulty making payments. This option is currently limited to 25 billion euros, almost half of which is already committed to Hungary and Latvia. The Treaty also allows for EU nations to grant financial assistance to member states if a country is "threatened with severe difficulties" caused by "exceptional occurrences beyond its control."

In addition, there are two more institutions that can be drafted for the cause. The European Investment Bank could theoretically set up an emergency lending facility and the European Bank for Reconstruction and Development could also provide assistance. In addition, some countries could buy the bonds of other members that are being squeezed but not collapsing.

WWW—Where in the World is Will?

The signals coming from European officials indicate they lack the will and creativity—innovativeness—to address these challenges themselves. Like politicians everywhere they are attempting to pass the buck whenever possible. On one hand, they are pushing for the IMF to have a greater role. In 2005-2007, the IMF was a large bureaucracy without much of a mission. However, since the crisis mushroomed, the IMF has established a number of programs, mostly for those countries in Eastern Europe, like Hungary, Ukraine, Latvia, Belarus and possibly in the not-too-distant future, Turkey. Although it is not in Eastern Europe, it can be argued that Iceland's IMF program fits into this group as well. That would leave Pakistan as the main exception—receiving IMF assistance but not in Europe.

Central and eastern Europe have borrowed roughly \$1.7 trillion from abroad, the lion's share from Western Europe. Short-term borrowing is particularly heavy. More than a quarter of which needs to be rolled this year, which is roughly equivalent to a third of the region's GDP. In addition, some \$800 billion of corporate loans and bonds are also coming due this year, versus a \$200 billion in the US.

Consider that Austria's exposure to central and Eastern Europe is more than three-quarters of their GDP. Belgium's exposure is nearly a third of its GDP, while Irish, Dutch and Italian exposure ranges between 11% and 16%. Given their exposures to eastern and central Europe, the IMF programs to date are helping to provide a life line to west European banks, and by extension, west European countries. Similarly, the unlimited swap lines that the Federal Reserve made available to the ECB and other central banks in Europe, have also been an under-appreciated element of international support.

Moreover, imagine the ramification for European banks if the US had not nationalized AIG. The American insurance corporation sold more than \$600 billion of credit-default swaps to European banks to help them game their own system, to take on more leverage even as the conventional risk models showed less risk.

The IMF simply does not have the resources to do the kind of heavy lifting that Europe apparently doesn't want to do itself. This is why UK Prime Minister Brown, who is struggling to hold on to the office he coveted for so long, is

proposing that the IMF raises another \$500 billion. Others are recommending a new allotment of Special Drawing Rights, which is IMF created money that can be used to settle bilateral sovereign obligations.

European leaders also are looking toward the April G20 meeting, a broader forum than the G7. They apparently are hoping to convince countries that have accumulated large reserve holdings or sovereign wealth funds to help finance an international solution to their problems. Many European countries have been extremely reluctant to surrender some of their IMF voting shares to make a more equitable distribution for sometime. Now they want these countries, such as China, who have essentially been on the sidelines till now, to play ball.

The European Bank for Reconstruction and Development warns that bad debts in Europe will likely top 10% and may reach 20%. The current mortgage default rate in the United States is near 12.5% and still rising. The US can bring to bear a range of institutions, like the FDIC, the SEC, the Federal Reserve, the Treasury Department, and the Office of the Comptroller of the Currency. It has the constitutional authority to do what is necessary. Europe simply doesn't.

And therein lies the problem with the euro. During the upswing of the credit cycle, some people actually thought the euro was a rival to the dollar. They confused being lucky with being smart. The scale of Europe's financial exposure through corporate and emerging market loans, in combination with the lack of sufficient institutional mechanisms, means that the economic contraction in Europe will likely be deeper and more protracted than America's. These forces will continue to exert downward pressure on the euro in the months ahead. Just as it overshot in 2007-2008 period, it needs to undershoot now. The decline of the euro, which began last July, is not complete. Medium and long term investors may be best served by taking advantage of the occasional euro rally to reduce exposures either directly or through disciplined hedging strategies.

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