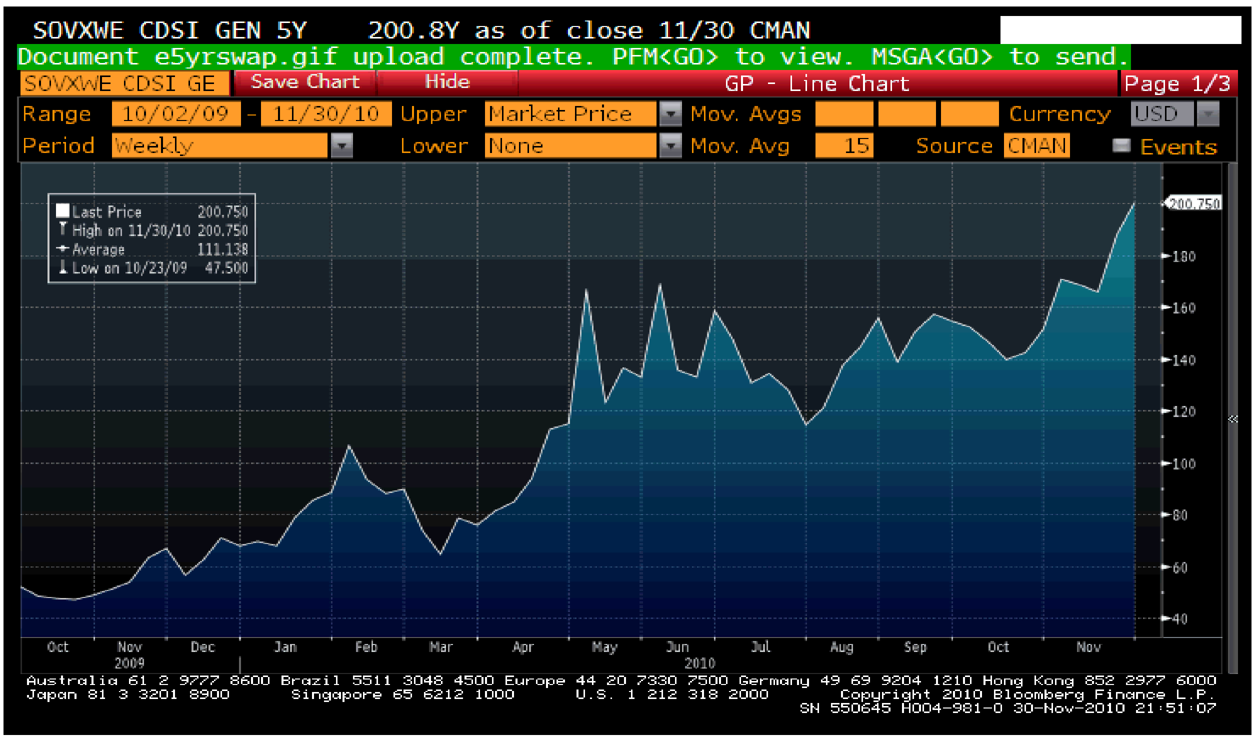
Europe—More Back-door Bank Bailouts

In August, I mentioned that “The problems in Europe are not fixed; they are just on hold until “holiday” is over.” Well, holiday has ended as can be seen by the recent move in the Markit SovX index of CDS on 19 Western European sovereign bonds. As you can see this index has risen from below 60 to 200 in the last 12 months. Its rise means that the cost to buy collateralized debt swaps CDS (insurance against the default of these government bonds) has surged and the market is becoming more and more uncomfortable with the state of the European Union.



Markit SovX Index of CDS Source: acting-man.com, Bloomberg

Wall Street has a saying that “it doesn’t matter until it does,” and the debt crisis in Europe didn’t seem to matter for awhile until panic over Irish bonds hit in November. Much of Europe is in terrible shape and it is only a matter of time before the market panics over the situation in Portugal, Spain, Belgium, and Italy. The game plan for the last two bailouts has been to soak the taxpayer so that the bankers will not have to recognize losses on the debt they bought.

Let’s take a look at some background and where the mess in Europe is most likely headed. History has shown that “the Road to Serfdom” is paved with central planning.[1] There is no person or group

[1] http://mises.org/resources/2402

that is smarter than the feedback of the market. The worst ill of central planning is controlling the most important price in any economy—the interest rate. Even though history is replete with examples of central planners failing, every generation has a group of academics that are arrogant enough to think that they will be the ones that are smart enough to pull it off. Europe's planners were certainly full of hubris when they made the decision to go onto a common currency in 1999 and allow one group of planners to set the short-term interest rate for member countries. The planners should have seen that it would be a disaster to prescribe the same monetary policy to so many different economies that would be operating their own fiscal policies.

When they introduced the Euro, some economies like Spain and Ireland were growing rapidly and other economies were very stagnant. Because Germany was the biggest economy, all members were essentially force-fed Germany's monetary policy and this helped create housing bubbles in the fastest growing economies. These bubbles burst in 2007 and have brought about depression to the PIIG countries.

Let's pretend that bureaucrats in the US and Brazil decide to create a common currency that is issued by one central bank. The United States is currently growing very slowly and has a federal funds rate of 0%. Brazil's economy is growing much more rapidly and their Selic, or overnight rate, is 10.75%. If Brazil were to take on Bernanke's monetary policy, you would see massive if not outright hyper-inflation in Brazil and their stock market and real estate market would soar. It would be one fun party until the hangover of a great depression would take hold followed by a revolution. Brazil needs the higher interest rate to quell inflation and govern the speed of their growth. Why the academics that created the Euro did not see this is beyond me.

Outside the ECB, Photo by Lars Aronsson

The European Union also reduced the borrowing costs for government debt in some of the least viable economies. Shady governments like Greece were able to use the balance sheet of the collective EU to get artificially low interest rates and they took on even more debt. This allowed these governments to slam the accelerator down even faster toward the bankruptcy cliff. Greece even hired firms like Goldman Sachs to create swaps that helped them cover up the extent of their deficits.[2]

In order to entice countries into the joining the beast that is called the EU, they created some decent rules at the Treaty of Maastricht. It created the European Union on November 1, 1993 and was signed in Maastricht, Netherlands. In order for any union to work, you have to set up ground rules that every party agrees to follow during the union (think vows before you get married). The rules pertaining to government debt were that government deficits/GDP must not exceed 3% and total government debt/GDP must not

[2] http://www.bloomberg.com/apps/news?pid=newsarchive&sid=akqC4y5U7MnU

exceed 60%.

Unfortunately, the political class has been more interested in continuing to centralize power than enforcing these rules. The latest data that I could find shows that Greece has a deficit/GDP just a hair shy of the 3% rule of 15.4% and Ireland's is 14.4%! The entire Euro area had a debt to GDP ratio of 79.2% at the end of 2009.[3] The average country can't even stay within the limits they agreed to. The rule-breakers should have been politely kicked out of the Union as soon as they were outside these guidelines. They weren't and once again the fiscally prudent have been forced to pay for the mistakes of the spendthrifts.

Greece was bailed out in May and the Irish were bailed out on November 29th. The wordsmiths have done a great job of making us all believe that the bailouts are to help the citizens of these broke countries. The reality is that the bailouts are harmful to the citizens and we should be calling these bailouts what they are—more bank bailouts. If Ireland were allowed to default on its debt, it would instantly detonate many banks across Europe. The bankers are in control of the world's governments and they have forced taxpayers to guarantee that bank bond-holders will never lose money. Why should any citizen be forced to guarantee someone else's return on their investment? They invested in bank bonds and knowingly took the risk.

Another thing that needs to be made clear is that bankruptcies are good for economies in the long run and important for cleansing the excesses of the prior boom. When GM went bankrupt it didn't completely go away. They still have their factories, brand, patents, and work force. A bankruptcy or restructuring of the debt allows over indebted organizations to take off the shackles of their debt and move on toward prosperity. The majority of the Irish did not want to accept the bailout just as the majority of Americans did not want to bailout our banks. If they were allowed to restructure their debt, it would be painful in the short term, and many investors in Irish bonds would lose some money. The world would keep turning and Ireland could finally get to a place where they can have long-term sustainable growth. Instead their politicians have forced generations to become debt-slaves.

I was shocked that only 50,000 Irish came out to protest the bailout in Dublin. Unfortunately their 6.2 million citizens have lost more of their sovereignty by accepting the $113 billion aid package at a 5.8% interest rate[4] and have increased their indebtedness by about $18,000 per man woman and child. Unbelievably, the Irish politicians agreed to contribute €17.5 billion of its National Pension Reserve Fund and its own reserves to its own "bailout."[5] The Pension Reserve Fund was set up to provide for social welfare in Ireland after 2025 and was not to be touched until then. Their retirement has been officially raided to guarantee bond holders don't lose a precious Euro cent!

Americans should also be angry about this latest bailout because we are doing part of the lending to Ireland through the IMF. About $30 billion of the Irish Bailout comes from the IMF which the US has a 17.67% quota ($5.3 billion). During the noise of the election and the QE2 announcement, on November 5, Tim Geithner agreed to expand the US's commitment to the IMF from $60 billion to $133 billion. The astute Howard Penney observed:

> Now the press is making a big deal about Obama putting in a pay freeze for government employees, citing the projection that it will save $2 billion in 2011. Where was the manic

[3] http://epp.eurostat.ec.europa.eu/cache/ITY_PUBLIC/2-15112010-AP/EN/2-15112010-AP-EN.PDF
[4] http://www.bloomberg.com/news/2010-11-28/ireland-wins-eu85-billion-aid-germany-drops-threat-on-bonds.html
[5] http://www.moneyguideireland.com/national-pension-reserve-fund-almost-empty.html

> media when the head of the Treasury and Federal Reserve agreed to spend an incremental $73 billion of US taxpayer money on "bailout" money for the IMF?[6]

The IMF also lent about $40 billion to Greece in May of which about $6.8 billion is backed by the US taxpayer as part of the IMF quota scheme. This was cleverly tucked into a $108 billion war spending bill.[7]

The day after the Bailout, world elitist and EU Commissioner, Olli Rehn, said that he didn't want to involve himself in Irish politics, but the Irish should not be allowed to have a general election until they have agreed to a four year budget.[8] How does a Finn named Olli get away with a comment like that? Who does he think he is?

It is time some country stands up to the bankers. America, how much longer will you allow your central bank to lend $3.3 trillion to US and foreign banks without telling you the recipients?[9] In a free market, you would be getting a much higher interest rate on your savings account. The savers of the world are getting robbed by inflation and low interest rates so that banks can borrow their money for free and lend it out for much higher rates. There is another way—Iceland.

Iceland's economy collapsed in 2008 and it was not possible for the country to bailout the three largest banks on its shores. They let the economy and the currency collapse and it was very painful. It was particularly painful for all of the bureaucrats that lost their jobs, but Iceland has taken its medicine and I believe they will have sustainable growth moving forward. Michael Cembalest, of JPM Private Bank, recently made the comparison between Ireland and Iceland:

> Two years on, Iceland is rebounding: exports and manufacturing are growing by 20%, tourism is back near all-time highs, real wages are rising, unemployment is declining sharply, interest rates fell from 18% to 5.5% and the stock market rebounded 50% from its lows. In Ireland, GDP is contracting at a 9.7% rate; real wages, price levels, the money supply and exports are falling; and unemployment is stuck at 14%.[10]

Defaulting/restructuring your debt is not the end of the world. It is only admitting the truth of you financial situation and a way to free your country from debt that will be impossible to pay back. The Irish citizens did not want to be strapped with this new debt to guarantee a wealthy banker in another country's bonus. Forcing them to sign the Treaty of Lisbon in 2009 wasn't enough? Ireland, like the rest of Europe has given up their national sovereignty to unelected officials in Brussels. The EU is destined for failure because it is creating more cumbersome central planning that never works.

They may be able to bail out Portugal next, but I don't think there is enough money to bail out Spain, its fourth largest economy. It is not clear to me if the most indebted countries will leave the Euro or if the wealthiest countries will leave. The only thing I am certain of is that this bad experiment is reaching terminal velocity and it is only a matter of time before you see real riots in Europe. Nigel Farage, the Ron Paul of Europe, recently had this to say in an excellent interview on King World News:

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[6] http://finance.fortune.cnn.com/2010/12/01/taxpayers-who-has-your-back/
[7] http://dailycaller.com/2010/05/06/u-s-taxpayers-are-helping-finance-greek-bailout/
[8] http://www.kingworldnews.com/kingworldnews/Broadcast/Entries/2010/12/1_MEP_Nigel_Farage.html
[9] http://www.bloomberg.com/news/2010-12-01/fed-will-name-recipients-of-3-3-trillion-in-emergency-aid-during-crisis.html
[10] http://www.zerohedge.com/article/footnote-irish-bailout-plan

> Once people realize that who they vote for in general elections has become no more than a charade, then if they want to change things, all they are left with is civil disobedience and violence, and we're beginning to see this already. In Greece we are seeing small terrorist style attacks that are taking place on EU buildings that are taking place against EU officials...So what happens if you rob people of their rights is they will turn to violence and they will turn to extremism, and that is why I believe these people to be so dangerous.
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> It's an attempt to put in place a unitary form of government for 500 million people, within which, the people that hold the key positions, the Van Rumpoy's and others are not directly electable or accountable to the people. It is the abolition of democracy, and in my opinion it is turning our backs on all of those that went before us did in two world wars, two devastating world wars. Because they fought and died so that we and the peoples of Europe could be free peoples, free from tyranny and living in democracy. Frankly, it is almost difficult to believe that this madness, complete madness has overcome the European Union. It is a total denial of democracy; we are seeing the beginnings of a Euro state that is dictatorial in style and design. It is dangerous, it is mad.[11]

It is only a matter of time before the bailouts of California and Illinois. Will we bailout every single state and destroy the dollar or will we allow municipal bond holders who knowingly took risk to take a "hair cut?" Time will tell.

[11] http://kingworldnews.com/kingworldnews/KWN_DailyWeb/Entries/2010/12/1_MEP_Nigel_Farage_-_They_Will_Turn_to_Violence.html

Markets

As I mentioned last month, “It looks like the dollar is finding a temporary bottom. An advance in the dollar could be the catalyst for a correction in risk assets.” You can see below, that the dollar index has had a very strong bounce that began right after the announcement of Money Printing II from “Helicopter” Ben Shalom Bernanke. This turned out to be a classic case of “buy the rumor; sell the news” where investors sold the dollar sharply at the rumor of money printing and then bought it when Bernanke announced he will be magically creating $60 billion out of thin air to help the government in its profligacy.

Courtesy StockCharts.com

There is a lot of resistance at the 83 level for the dollar index. If the dollar can break through that level, I would expect a much deeper correction in stocks. I am still not convinced that the market only needed a 4% correction from its almost three month buying-binge. I believe there is still too much risk in the market to get very aggressive here.

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