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European Endgame

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If you owe your bank a hundred dollars, you have a problem. But if you owe it a million, it has a problem, the saying goes. Today we can add that if the governments of Italy, Spain, Portugal, Greece and Ireland owe your banks one trillion dollars, we're all dead. And that might be where the Euro-zone is headed.

Instead of fixing the financial crisis, the EU postponed it with a get-poor-quick pyramid scheme, by sending the debts of households to banks, who sent it to governments, and governments passed it on to the Euro-zone. Now the Euro governments find that they are at the end of the chain, with a crushing burden. Markets are beginning to price in a small risk that the entire European financial system can collapse -- and reacting accordingly.

Debts that were unsustainable in 2008 aren't more sustainable just because they were transferred from banks to governments. Especially when those governments overspent in good times, and have few reserves to deal with bad times when the budget of big welfare states suffer more than others when tax revenue is down and benefits expand automatically.

In a way this is 2008 again, with the same toxic mix of misguided regulation and moral hazard at work. Back then, it was banks and mortgage securities; this time, it's euro states and government bonds.

Basel regulations categorizes sovereign debt as risk-free, and a bank's exposure to sovereign debt in its own currency has zero risk weights when capital requirements are calculated. And right now, banks are actually preparing themselves for Basel III, which forces them to build bigger liquidity buffers, and most of it has to come in the form of sovereign debt.

The ECB also subsidized government debt because banks could buy short-term government bonds from weak states and deposit them with ECB as collateral for loans. It was a way to make a decent profit from the margin between bond yields and lending rates -- which they invested in more bonds.

Poor Euro economies used the implicit guarantee that Germany would bail them out, to lend cheaply and increase spending and wages as competitiveness collapsed. This is what made it seem like a good idea to retire at 55 and give Greek engine-drivers a bonus of $5,000 a year if they washed their hands.

The Euro-zone has now had to bail out Greece, Portugal and Ireland, but this just creates larger problems in the future. If someone can't pay his debts, you don't help him by giving him a larger loan. It expands the total debt burden and creates a need for more bailouts.

It also undermines the strong economies that have to pay up. Italy and Spain have already gone from being trusted life-savers to becoming potential drowning victims. The €440 bn European Financial Stability Facility (EFSF) was enough to deal with small, peripheral countries. But it will be difficult to bailout Spain, and impossible to deal with Italy. Hence the proposals to double its size.

But the EFSF can only borrow cheaply on capital markets as long as it is backed by rich triple-A countries. The second biggest is France, but after more than 35 years of deficit spending, bigger guarantees could result in a downgrade. If France goes, the whole burden ends up with Germany, which would have to contribute with guarantees amounting to a quarter of its GDP. We think of Germany as indestructible, but it already has a public debt of 82 percent and growth of 0.1 percent in the second quarter of 2011. Trying to save more drowning victims could end up sinking the life boat.

The assumption that the European Central Bank can always step in is dangerously flawed. It has already lent around $700 billion to weak Euro countries and their banks. It is grossly leveraged and it wouldn't take large losses on those loans for the central bank's capital base to be wiped out -- and in need of a bailout itself.

Hope is fighting a losing battle against arithmetic. Sooner or later Europe has to stop throwing bad euros after good euros. Hopefully it can be done in an orderly way, with debt-restructuring, far-reaching long-term debt reduction plans and reforms to get back to growth.

The alternative is a chaotic end game, where reforms are postponed and more money is sent to mismanaged economies until strong economies are also on the brink. Sooner or later the bailouts will end -- either when states are out of money or when voters are out of patience. Then the markets would also flee big euro economies and we would see a series of defaults and banking crises around Europe.

That would probably end with the ECB abandoning all the pretense of being a strong, independent central bank, and starting to print money on a massive scale, and erase debts by also erasing savings and retirement funds. One day, Europeans might wake up and realize that the euro did not become the new D-mark, it became the new Italian lira.