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Europe: The Final Countdown

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In 1986, a neuvo-Swedish rock band, named Europe[1], released their sole smash hit, “The Final Countdown.” Replete with ominous, heavy and highly-synthesized percussion beats, front man Joey Tempest expressed emotional incongruity when he sang….

I guess there is no one to blame....
We’re leaving ground;
Will things ever be the same?
It’s the final countdown.

While far from a rock-n-roll aficionado, the irony of the ambiguity of these lyrics, the name of the band and ultimately the title of their smash hit could not have struck me in a more pronounced fashion in regards to the current state of the European Union. Let’s break it down:

1. ***“I guess there is no one to blame….”*** The varied issues impacting several European countries (namely Greece, Italy, Ireland, Spain and Portugal) and their financial markets (bond and stock) are sicknesses with the same symptoms – an inability of governments to finance their obligations with tax revenues[2]. How come? a) Obligations are very high as governments intend to honor social and healthcare promises (social security and Medicare equivalents) in addition to backstopping the balance sheets of banks that were adversely impacted from the global property bubble that burst three years ago. Intended to immunize depositors from the consequence of capitulating capital, bureaucratic buoys that socialize risk can be floated only so long as revenue revives; b) Revenue has not revived. Global economic weakness has befallen many developed countries around the world and those in Europe have not been spared. Gross Domestic Product (GDP) measures are anemic or negative[3] and resuscitation is tricky: given that most of Europe’s trading partners are its sister-countries, a viciously negative spiral can postpone prosperity as symbiosis suspends superfluity.
2. ***“We’re leaving ground….”*** A common question (and comment): “If the aforementioned issues deal solely with the governments in Europe, why is the US market being held hostage, I mean this volatility is incredible….what gives?” There is little doubt and much evidence that the financial world is very global – so many domestically domiciled financial companies have considerable international operations making cross-border transactions customary. It is more than fair to say that when international markets sneeze, the US catches a cold. Examples abound, but perhaps the most recent and relevant was last week’s bankruptcy filing by MF Global – a boutique investment firm that invested client and company capital in derivative securities and foreign-exchange products. MF Global (MF) filed for Chapter 11[4] after purchasing European sovereign debt with excessive leverage. In plain English: they increased their purchasing power with tons of borrowed money and the foreign government bonds that they purchased declined in value to the point that the net market value of their purchases actually resulted in liabilities in excess of their assets, rendering the firm insolvent. So here

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begins the trail of collateral damage that loops back to the US financial markets:

i) MF is based in New York City and employed roughly 1,066 people;
ii) MF borrowed money from US investors;
iii) MF invested that borrowed money (they bought) in bonds of foreign countries and the value of those bonds declined considerably;
iv) MF was unable to pay interest to its bond holders due to their bankruptcy filing elevating the perception (and reality) of the risk that remains in some foreign countries;
v) This realization of risk at the sovereign level extended to the corporations that exist within those issuing countries;
vi) These foreign companies do business with and employ entities back here in the US;
vii) Any suspension or reduction of business dealings with companies in the US may put US profits in jeopardy (not to mention the out of work employees at MF in addition to the well-founded suspicion that MF was not the only company engaging in such transactions) and;
viii) As the realization of this risk became more evident, the attraction of less risky investments (mostly US bonds) elevates commensurately, boosting US stock market volatility.

As I mentioned, this is but one example as to why the Euro-centric sovereign snafus have made their way across the Atlantic, and here is one other: In 2010, exports comprised 12.5% of US GDP[5], a large part of which makes its way to Euroland. In the absence of a clear indication of persistent demand, this figure is vulnerable to a downward revision at a time when the US can ill-afford disruption in our own recovery. Sensing a susceptibility to such will send shock waves throughout our financial markets.

3. ***"Will things ever be the same?"*** When conceived, the European Union (EU) and its 27 member nations, 17 of which operate under the common currency of the Euro (€) and the monetary policy oversight of the European Central Bank (ECB), held the promise of peacefully integrating along political, economic and legal lines[6]. Not since its founding has a member country seceded from the EU and the contemplation of such is unsettling given the inelegant unforging of economic alliances that would surely follow. However, the stress that the weakest members (economically speaking) of the EU are disproportionately placing upon the strongest risks jeopardizing the viability and unity of the Union. The ECB has already orchestrated financial bailouts for Ireland and Portugal, with serious concerns that Greece and Italy will follow. Utilizing the European Financial Stability Facility (EFSF) the EU member nations have funneled capital in the form of bond purchases to these struggling countries to assist in buying them time to reignite their economies. The recourse of these loans is ambiguous at best and may prove to be both accounting and literal goodwill. And so change is afoot within the EU: just last *week*, Greece and Italy installed new governmental leaders; just last *month,* ECB President Jean-Claude Trichet transitioned his office to Mario Draghi[7], previously a governor of the Bank of Italy and before that a principal at Goldman Sachs; and just last *quarter,* Christine Lagarde was named

managing director of the International Monetary Fund, succeeding the infamous Dominique Strauss-Kahn. Prior to this appointment, Ms. Lagarde held several ministerial posts in the French government and was ranked as the 9th most powerful woman in the world by *Forbes* magazine[8]. Will things ever be the same in the EU….I doubt it, and that is not a bad thing. I think that many of the fiscally troubled European countries were enabled for years by strong global financial markets and subtle safety nets sewn by denial-doused ideologues. However, as the day(s) of reckoning approaches, the perils of economic asymmetry are prevalent. Addressing these with an emphasis on accountability eliminates the temptation to again travel down the well-worn path of moral hazard.

4. ***"It's the final countdown."*** There has been no shortage of media proclamations that the countries in the EU need immediate assistance to, frankly, survive the current state of economic affairs. And the fundamental question comes down to this: "Who is going to bail-out the bailer-outers?" Given the extent of the extensions that European governments have extended to banks, corporations and citizens, their cup runneth over. Therefore, I think that one of two (or both) things must happen: i) behavioral modification (the dreaded "austerity" initiative), whereby countries and their citizens accept less in entitlements than had been anticipated, lightening the load of the benefit providers. This will allow a redirection of capital to the government creditors (mostly other EU governments or the ECB) in an effort to restore confidence in credit markets and fortify their future borrowing power and; ii) a plan for an elevation of revenue must be plotted – in the form of stimulating economic growth and/or a fair and enforceable system of taxation. I think that the ability for countries to live beyond their means has come to an abrupt conclusion. Europe has been the poster child of the problems of such a fiscally profligate existence, but they by no means exist in isolation. As I mentioned above as it relates to MF Global, the financial world is very flat, and without a willing and adequately liquid backstop, deleveraging is very destabilizing. This destabilizing has manifested itself in heightened market volatility, which is tolerable to the point that is produces responsible realignment. We'll stay in touch as developments unfold with the hope that the continent of Europe produces many more hits than their namesake 80's rock band!

[1] http://www.elyrics.net/read/e/europe-lyrics/the-final-countdown-lyrics.html
[2] http://articles.sfgate.com/2011-10-28/news/30335334_1_greek-debt-european-government-bonds-greece
[3] http://epp.eurostat.ec.europa.eu/tgm/table.do?tab=table&init=1&plugin=1&language=en&pcode=tsieb020
[4] http://www.reuters.com/article/2011/10/31/us-mfglobal-idUSTRE79R4YY20111031
[5] http://trade.gov/press/press-releases/2011/export-factsheet-February2011-021111.pdf
[6] http://www.politonomist.com/the-evolution-of-the-european-union-002465/
[7] http://en.wikipedia.org/wiki/Mario_Draghi

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