MID·CONTINENT CAPITAL

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*advice; judgment; resolution; wisdom

Our European "Problem"

Key members of the Eurozone - the 17 countries in Europe that use the euro as their currency – have debts that are becoming too expensive to service: either the debt is too high in relation to the size of the economy (GDP), or interest rates being demanded in the capital markets are too high to be sustainable, or both. As long as debt is manageable in relation to the size of the economy – comfortably below 100% of GDP – then higher interest costs are painful but not fatal. But at debt levels above this, when the interest cost on debt is growing faster than the country itself – then a "point of no return" is reached: the country will be unlikely to "catch up" to its accumulating debt, and an accelerating spiral into default is the most probable outcome.

These key countries (notably Greece and Italy) built up their debts in large part through overly generous social welfare and retirement programs, or via excessive real estate speculation and lending (notably Spain and Ireland) that has required their governments, in effect, to assume their banks' obligations. In all cases, the buildup of debt was possible because borrowers had access to euro-denominated capital markets, which provided lower borrowing costs than these countries otherwise could have enjoyed. Simply put, none of these borrowers could have accumulated so much debt had they been forced to borrow in their own original pre-euro currencies. Favorable loans terms would have ended years ago. But in some cases (especially Greece), there is no realistic scenario that would allow them to grow their way out of their debts; in others (especially Spain), the fiscal retrenchment needed at a time of economic hardship (25% unemployment) makes it unlikely that citizens would stand for it.

Who owns most of this increasingly shaky-looking government debt? The European banks. This is no different from the situation US banks faced in 2008-09, except that the bad loans were to home buyers rather than sovereign governments.

A compelling argument can be made that profligate spending is not the underlying cause of these problems - it is the structure of the euro itself that is at fault:

1. Who and/or what stands behind the currency? The euro is "a currency without a country". National currencies are backed by national treasuries with the power to tax and central banks with the power to print money. But the euro is a single currency without a single government, and the European Central Bank cannot lend to sovereigns.

2. How can a single monetary policy (orchestrated by the ECB) be right for all of the continent's diverse economies, where languages, cultures, industries, rates of worker productivity, and inflation can and do differ widely? The assumption at the creation of the euro was that economic performance would converge across the Eurozone, much as it does in the US, and that in effect the Greeks would become more like the Germans.

It didn't happen. Then, an overly strong currency allowed the peripheral European countries to borrow too much, and now Spanish and Italian bond yields are nearing levels (roughly 7%) that have previously signaled "endgame", to borrow a chess analogy. A failure by Italy or Spain - the world's eighth and twelfth largest economies respectively - could set off a domino effect of banking crises that would be, in the words of former Treasury Secretary Larry Summers, "an economic disaster that might define our era". What must, or can, be done?

The euro currency simply cannot work without three kinds of unions:

1. A banking system union – with a common regulator, common rules, and standardized deposit insurance. Without it, bank runs are inevitable.

2. A fiscal union – with taxes and expenditures planned and controlled by a single entity in the European "capital" rather than by 17 different governments. In effect, this would be the end of truly separate and sovereign states in Europe. Without it, no one actually "stands behind" the euro or any potential debt instrument issued by an arm of the Eurozone.

3. A political union – with democratically elected representatives sent to the capital to reflect their constituents' will on the fiscal matters above. Without it, citizens will not support (and indeed, their countries' constitutions might not allow) the creation of a central taxing and spending authority.

Even if the Eurozone integrates, is there a majority of support for responsible policies, and for the massive sums of money required to shore up the system? As Summers himself notes, "not all problems can be solved".

In the short run, all eyes are appropriately focused on Spain, which is literally "too big to fail" because of potential reverberations throughout the European banking system, and because of cascading effects on other government debt issuers. Agreements have already been reached for Spanish banks to receive a capital infusion of up to $125 billion and for the nascent European Stability Mechanism (previously the European Financial Stability Fund) to be able to invest directly in troubled banks.

Individual citizens and businesses are voting with their feet, as billions of euros are fleeing the continent entirely, reducing growth prospects, pushing politicians to extremes, and creating a negative feedback loop. Meanwhile, the IMF is fortifying its finances with a new capital raise of over $450 billion (which, remarkably, includes commitments from Italy, to the tune of $31 billion, and Spain, $19 billion).

Time is running out. EU leaders have become adept at "kicking the can down the road" in short increments, but the markets have become less forgiving of temporary measures. Limited action was taken at the just-concluded EU summit other than to discuss pursuit of fuller integration at the next summit meeting in October.

Last quarter's *Consilium* discussed the looming "Fiscal Cliff" in the US and its predictable consequences. The failure to more fully integrate the EU would have equally inevitable but much more disastrous repercussions. Importantly, both of these scenarios are widely recognized and are clearly unacceptable to political leaders here and in the EU. This is precisely why investors can continue to hold out hope, and should be open to the possibility that lasting solutions could emerge from the fires of crisis. We are investing cautiously and selectively in client portfolios, recognizing that while the "European Problem" and our potential "Fiscal Cliff" will have very significant effects on our markets, we can still find profitable opportunities.

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