**PRIMER ON EUROPEAN DEBT CRISIS**

**<u>European Basics</u>**
Alex, I'll take Europe for $200.
A –Europe's largest city
Q – What is Moscow?

Europe is the second smallest continent, but the second most populous. It includes everything west of Russia's Ural and Caucasus Mountains as well as the rivers that flow west, north or south from them. So Russia as a country is included in Europe even though the vast majority of its land is in Asia. Add in the island nations of the United Kingdom, Ireland and Iceland. All told, there are 50 countries in Europe.

Europe's population is about 730,000 – about double that of the U.S. The ethnic and cultural diversity is wide, especially with the increased immigration of Africans and Asians. The increased immigration of Muslims is a hot topic and not entirely welcome.

**<u>European Union (EU)</u>**
The European Union is a group of 27 countries within Europe that have agreed to close cooperation on a number of levels. Cooperation started in 1949 with 6 countries and more have been added along the way.


Click on map & pull corners to enlarge
Source: http://chartsbin.com/view/1266

**<u>Governance of EU</u>**
According to www.Geography.com (edited for brevity):

> Treaties and laws are created by the "institutional triangle" that is composed of the <u>Council</u> representing national governments, the <u>European Parliament</u> representing the people, and the <u>European Commission</u> that is responsible for holding up Europe's main interests.
>
> <u>The Council</u> . . . is the main decision making body . . . [with] a Council President . . . each member state takes a six month turn in the position . . .the Council has the legislative power.
>
> <u>The European Parliament</u> is an elected body representing the citizens of the EU and is . . . directly elected every five years.
>
> Finally, the <u>European Commission</u> manages the EU with . . . one Commissioner from each member state. . . . The EU also has courts, committees, and banks which participate on certain issues and aid in successful management.

**Euro Currency/European Central Bank (ECB) Members**

Of the 27 countries in the EU (some as small as Cyprus, Malta and Latvia) 17 have adopted the Euro as their currency, managed by the European Central Bank (ECB). See chart at right. You can enlarge it in the same as all my inserts – by clicking on it, putting your mouse over a corner and dragging the corner.

When you read about European economic cooperation and banding together to bail out the struggling countries it is these 17 countries to which this news refers, commonly called the Eurozone. These must approve such packages unanimously.


Source: European Central Bank

**Bailouts**

To understand the problems facing the 17 ECB countries one must understand two concepts – power and diversity.

Compared to the U.S. whose central government power has steadily increased over 200 years to where it dominates the states in many ways, the ECB central government is very weak. Everything must be approved by the member states. Because the group has repeatedly insisted that they will not let any member nation default on its debts nor kick it out of the union, individual countries have even more power

**Economic Comparison**

The economic output of the total EU bloc is slightly larger than that of the U.S. Each accounts for roughly 20% of the world economy with China following at 14% and Japan at 6%.

Within the EU there is a great deal of disparity in economic prosperity. Greece and Germany differ widely not just on culture but on the role of government, unions, debt and measures of financial health.

Here is a chart of GDP (economic output) for selected ECB countries:

| **GDP as PCT of ECB Total** | |
|---|---|
| **Largest Economies of the Strong ECB Countries** | |
| Germany | **20%** |
| France | **15%** |
| Netherlands | 5% |
| **Troubled "PIIGS" Nations** | |
| Portugal | 1% |
| Ireland | 1% |
| Italy | **12%** |
| Greece | 2% |
| Spain | **8%** |

The top 5 countries for economic size are Germany, France, Italy, Spain and the Netherlands. The UK is not listed because while it is in the EU, it is not in the ECB. Two of the top five for economic size unfortunately fall in the troubled countries category commonly called by the rather ugly acronym PIIGS. Greece, the country over which most of the fuss has been made is only 2% of the ECB.

The real trouble bankers worry about is whether the economic malaise of Greece spreads to Italy and Spain which as you can see, are much larger. It is hard enough bailing out Greece at 2% of the ECB economy. Were Italy and Spain to go bad that would overwhelm the resources of the stronger countries.

**Greece**

When new member countries join the European Union they must qualify by meeting certain economic standards of financial health. When the whole world was borrowing like there was no tomorrow, fueling worldwide economic expansion, then the countries with big debts and extremely generous governments could get away with their largess. But the Great Recession hit hard. European growth, which had lagged the U.S. for years because of its big government/strong unions/high tax culture, fared worse than the U.S.

Greece was a particular problem. It was discovered that the Greek government, had lied about Greek financial conditions on a regular basis, cooking the books. When the markets found out, the price of Greek bonds collapsed, sending interest rates skyward. The government found itself unable to refinance its debts as they rolled over. The ECB rode to the rescue with loans, i.e. more new debt. Lenders insisted on financial austerity as the price for this rescue but the combination of lower government spending and more debt and their high rates has kept Greece in a downward spiral, causing deficits to be larger rather than smaller and demand for new debt increasing instead of decreasing.

Source: http://economylessons.blogspot.com

**Germany & France**

Germany is the power player in the ECB, followed by France. Germany typically has good export growths relatively good finances, low inflation and lower taxes than most. Angela Merkel, Chancellor of Germany, Jean-Claude Trichet of France who is president of the ECB and Nicolas Sarkozy, prime minister of France are the big three personalities. The International Monetary Fund also plays a role in Greece.

**Trouble Brewing**

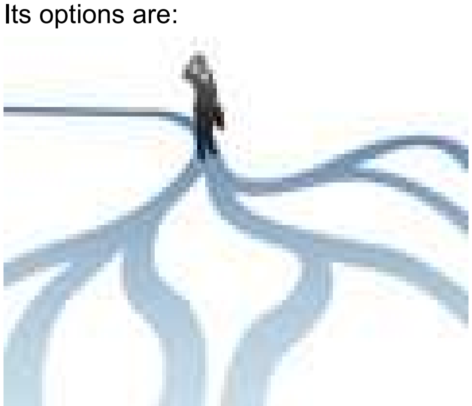
German voters have become increasingly frustrated with bailing out the free-wheeling Greeks and have been handing Ms. Merkel a series of defeats in local elections. She no longer has the backing of enough members of her own party and must make deals with minority parties. However, she did get a boost from the German Supreme Court ruling today that the 2009 bailouts were constitutional. Still, future actions must now be approved by the German Parliament, slowing and complicating the process from here.

Finland has been balking at more bailouts without condition like Greece putting up collateral. Slovakia is refusing to vote on more bailouts at all.

**Options**

If Germany, Finland and/or Slovakia will not keep agreeing to bailouts of Greece and whatever other ECB members need help then the ECB is really in trouble, lending some doubt as to the future of the ECB.

Its options are:



1. Let Greece default on its debts but stay in the ECB
    a. Calling into question the strength of the ECB as a whole
    b. Likely raising interest rates for the rest of the ECB countries
    c. Risking similar fates for Spain and Italy, countries to big to rescue
2. Boot Greece out of the ECB, failing to hold it together or grow into its vision of closer unity
3. Replace Greek debt with new bonds backed by the whole ECB, something entirely new and needing agreement by all 17 countries
4. Keep kicking the can down the road, but how?

**Italy & Spain**

Italy and Spain might be the next dominoes to fall. Interest rates on both Italian and Spanish debt shot upward this summer and have been lowered artificially by heavy buying of their bonds by the ECB.

Italy has a huge debt, more than any country except the U.S. and Japan -- far larger countries, at least economically.

Spain is still in recession, its unemployment rate is 21% and local governments and savings banks are in poor financial condition.

**European Banks**


You knew they had to figure in here. Europe's banks, especially those in France and the troubled countries hold a lot of sovereign (government) debt from the problem nations. According to the NY Times July 11, 2011article, *Debt Contagion Threatens Italy,* "European banks have total exposure of $998.7 billion to Italy, $774 billion to Spain, $532 billion to Ireland and $162.4 billion to Greece. American banks have $269 billion in exposure to Italy, and $179 billion to Spain."

Banks are being allowed to pretend that these debts are still worth full value, even though Greek bonds really go for as little as 30 cents on the dollar. Even with this pretension, several large banks in Europe are undercapitalized by at least 150 billion Euros according to one source. A default by Greece, especially if it was followed by other weak countries would render those banks insolvent, requiring enormous government bailouts.

You might have heard reported that these banks passed a stress test recently. They did but it was a pure political sham without realistic pricing and not very extreme circumstances. Like the U.S. stress test a while back, it was simply political theater meant to downplay fears lest they multiply out of control.

U.S. banks and money funds have been decreasing their exposure to European banks. The NY Times reported in August that U.S. money funds cut exposure by 20% in June and another 9% in July. European banks increasingly even disdain lending money to each other. Borrowing at higher rates from the European Central Bank is higher than normal. This fear to lend is exactly what brought on the worst of the 2008 crisis. George Soros, one of the biggest names in the hedge fund world is quoted on CNBC today as saying the European debt crisis is worse the 2008 Lehman Brothers crisis.

**Now what?**

The long-term answers are likely polar opposites.

1. Make the ECB much stronger to where it dictates to member nations and is willing to enforce its demands by any means, much as the Civil War and 14th Amendment did in the U.S. Aside from a charismatic dictator whose rise would likely be from real financial hardship like a depression, this option would take a much longer time than is available. However, there are have been calls for much stronger leadership and a charismatic leader to solve this.
2. Partially dissolve the ECB, booting out the weak countries. This has the advantage of letting the countries default, revalue a national currency and work their way back to health again, at which time they could re-enter the ECB

**Investment Implications – Stocks**

Europe will be a drag on stocks and economies worldwide until there is an acceptable resolution. That could take a while, probably several years. One should avoid all European bank stocks. Big U.S. bank stocks should continue to be pariahs for the near future even though their prices have come down a lot. Long term buyers should over time accumulate the strongest banks, especially growing regional banks.

I have never had a lower exposure to overseas stocks in general. Brazil may have bottomed recently and SE Asia, including China may be big winners over the next few years but have not started up yet.

Eventually, European stocks will get to be screaming buys but that will be a while and will come only if there is a disintegration of the current crisis. They are actually relatively cheap now.

U.S. stocks are in an intermediate-term downtrend and we are a little underweighted there at present.

**Bonds**

Treasury bonds and mortgage prices continue to head higher even at historically extreme levels. The 10 year Treasury now pays the lowest rate in 60 years. At these prices it is hard for me to put money there.

Corporate bonds are holding up OK if they are high quality and are falling if they are not. Municipal bonds continue to do well. Emerging market bond prices have come down some and flattened out.

**Gold & Other Commodities**

Gold has had a terrific run. Its near-term future will be dictated by the amount of fear in the markets – the more fear, the better for gold and vice versa. That means gold will continue to move in the opposite direction as stocks.

Oil has come down some but not enough for me to buy it. Grains are benefitting from another year of worldwide weather problems which makes supplies relatively scarce and increases their price.

If trouble increases in Europe the U.S. dollar will do better. The reverse is also true, though on the charts, the dollar seems have found pretty good support just under its current price.

**Outlook**

September is on average the worst month for stocks and October has had some of the biggest one-month drops so many people are wary. There are a few bargains out there and prices in general are pretty reasonable.

Economic numbers are on the whole signaling very slow growth and perhaps another U.S. and European recession. Most economists are in the slow growth camp. Most economists however have a terrible record of predicting turns in economic fortunes. The bears are still bearish and the bulls still bullish.

I am inclined to keep our allocations about where they are, with lower risk bonds, a little lower than usual stock allocation and usually 10% in cash for opportunities. We have roughly 10% in gold and a little in food commodities. I continue to research new opportunities. As mentioned above, international investments are significantly below normal allocations but that can change on short notice.

Dave Hoshour