Farewell to the EU Superstate

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Wednesday's press conference with ECB President Jean-Claude Trichet turned out to be a real jaw-dropper. While Trichet didn't commit himself to massive bond purchases (Quantitative Easing) as many had hoped, he did impress the gathering with his magical skills. The Financial Times recounts Trichet's what happened like this:

"…as Trichet started to speak, his ECB troops stepp ed into the market to buy as many peripheral bonds as they could, particularly Portugal and Ireland. Started evidently in bidding for 10 -25 mln € clips and then moved onto 100 mln € clips … which is very rare indeed."

Nice trick, eh? So while Trichet was somberly reading from the ECB's cue cards, his central bank elves were beating down bond yields to convince investors that the contagion had been contained. Not bad for a 70-something bankster with no background in the paranormal. And it seems to have worked, too, at least for the time being. But, unlike the Fed, Trichet can't simply print money. He's required to "sterilize" the bond purchases, which means he'll have to mop up the extra liquidity created by the program. And, that's the hard part. If he pushes down yields in Ireland and Portugal, he has to tighten up somewhere else.

Trichet's critics, like Bundesbank President Axel Weber, think he's gone too far by buying up the bonds of struggling PIGS. (Portugal, Ireland, Greece and Spain) But these countries borrowing costs have skyrocketed and they're quickly losing access to the markets. The more it costs to borrow, the quicker the slide to default, which is trouble for the EU, because it means a wider meltdown across the continent. So what better time for Trichet to stretch the rules?

Maybe Weber hasn't noticed, but the EU is disintegrating, and if Irish voters reject the budget in the December 7 elections or if Spain starts to teeter, the dominoes could start tumbling and bring down the entire EU project. That's why Portugal, Spain and the rest are counting on the ECB to lend a hand despite Berlin's relentless fingerwagging. Here's an excerpt from the Telegraph which gives a good summary of what's going on:

"Spain's former leader Felipe Gonzalez warned that unless the European Central Bank steps into the market with mass bond purchases, the EMU system will lurch from one emergency to the next until it blows up….

Arturo de Frias, from Evolution Securities, said the eurozone will have to move rapidly to some sort of fiscal union to prevent an EMU-break up and massive losses on €1.2 trillion of debt lent by northern banks to the southern states….

The market will keep selling until the yields of Spanish and Italian bonds (and perhaps Belgian and French also) reach sufficiently horrendous levels. ("Mounting calls for 'nuclear response' to save monetary union", Telegraph)

The Irish bailout solved nothing. Brushfires are breaking out everywhere. Bondholders have figured out that Ireland and Portugal are broke and their debt will have to be restructured. Its just a matter of time before the haircuts. That's why bond buyers have gone into hibernation. It's not really a panic; it just shows that investors know how to read the financial tea leaves and make rational choices. Here's more analysis from Michael Pettis who points out the inherent contradictions of the one-size-fits-all currency (euro) and the urgency of settling on a remedy:

"If Europe is going to "resolve" the current crisis in an orderly way, it is going to have to move very quickly – not just for the obvious financial reasons, but for much narrower political reasons. I am pretty sure that the evolution of European politics over the next few years will make an orderly solution progressively more difficult.

For ten years I have used mainly an economic argument to explain why I believed the euro would have great difficulty surviving more than a decade or two. It seemed to me that the lack or fiscal centrality and full labor mobility (and even some frictional limits on capital mobility) would create distortions among countries that could not be resolved except by unacceptably high levels of debt and unemployment or by abandoning the euro. My skepticism was strengthened by the historical argument – no fiscally fragmented currency union had ever survived a real global liquidity contraction……The eurozone is maneuvering itself into a position where it confronts the choice between two alternatives considered "unimaginable": fiscal union or break-up." ("The rough politics of European adjustment", Michael Pettis, China Financial Markets)

The real problem is political not economic, which is why Trichet's "liquidity injection" snakeoil won't do anything. The euro just isn't going to work unless it is backed by a centralized fiscal authority and perhaps an EU-wide bond market. But that means that every nation will have to sacrifice some of their own sovereignty, and no one wants to do that. So, the 16-state union keeps inching closer and closer to the chopping block and the inevitable day of reckoning.

Meanwhile, Trichet continues to do exactly what he has done from the beginning; extend more cheap loans to sinking banks, more low rates, and more propping up of collapsing bond markets. The only difference now, is that investors see the political roadblock ahead and are getting nervous. EU leaders will have to agree to a "quasi" fiscal union or the current slow-motion bank run will turn into a full-blown stampede.

From the Wall Street Journal: "The market was hoping the ECB would get ahead of the curve. They've disappointed us," said Marc Chandler, an analyst at Brown Brothers Harriman. Merely declining to unwind liquidity measures will do little to combat the risk of contagion on distressed assets in Spain and Portugal, he said, describing Trichet's comments as "toothpaste coming out of the tube."

Ireland's problems are just the tip of the iceberg, but its a good place to start. The easiest way to explain what's going on, is by using an example:

Imagine you owe the bank $100, but you can only pay $10 per year. The bank agrees to the

payment-schedule but only if you accept a rate of 15% per annum.

“Okay”, you say. “I accept your terms.”

At the end of the first year, you make your payment of $10 which reduces the amount you owe to $90. But the interest on the loan turns out to be $15, which means that you now owe $105 –more than you owed at the beginning. Finally, you realize that every year the debt will get bigger and harder to pay.

This is the pickle that Ireland is in. The IMF/EU loans put them in a fiscal straightjacket from which there is no escape. They’d be better off defaulting now and restructuring their debt so they can start over. It’s better to put oneself on a sustainable growth-path than to submit to long-term economic hardship, harsh austerity measures, loss of sovereignty and civil unrest. That’s just a lose-lose situation. For Ireland, leaving the EU is not the just best choice; it is the only choice. Here’s how economist Barry Eichengreen sums it up:

“The Irish “program” solves exactly nothing – it simply kicks the can down the road. A public debt that will now top out at around 130 per cent of GDP has not been reduced by a single cent. The interest payments that the Irish sovereign will have to make have not been reduced by a single cent, given the rate of 5.8% on the international loan. After a couple of years, not just interest but also principal is supposed to begin to be repaid. Ireland will be transferring nearly 10 per cent of its national income as reparations to the bondholders, year after painful year.

This is not politically sustainable, as anyone who remembers Germany’s own experience with World War I reparations should know. A populist backlash is inevitable. The Commission, the ECB and the German Government have set the stage for a situation where Ireland’s new government, once formed early next year, rejects the budget negotiated by its predecessor. Do Mr. Trichet and Mrs. Merkel have a contingency plan for this?” (“Ireland’s Reparations Burden”, Barry Eichengreen, The Irish Economy)

Still Irish Prime Minister Brian Cowen is moving forward with the faux-bailout, perhaps to endear himself to his ruffle-shirt EU overlords. And even though his administration has lost all public support, he’s still pushing through his slash-and-burn budget that will pare 15 billion form public spending–raise taxes on the poor, reduce the minimum wage, slash social welfare programs and fire thousands of government workers. Irish workers will see their standard of living plunge, only to find that at the end of the year they are more in the red than ever. Here’s how Edward Harrison of Credit Writedowns sums it up:

“…given the debt burdens in the periphery, some combination of monetisation and default is the most likely eventual scenario for Europe. Ireland, for example, cannot grow nominal GDP at or above the 5.8% interest rate on offer under the bailout terms. Unless the country sheds its bank debt guarantee as I recommend, default is likely. Therefore, the ECB will have to step in or Europe will risk a meltdown and dissolution.” (“Brynjolfsson bets on spread convergence…”, Edward Harrison, Credit Writedowns)

Ireland is being thrust into a Depression. Its leaders have chosen obsequiousness and expediency over clear-headed resolve to face the challenges ahead. Cowen is condemning his people to years of high unemployment and grinding poverty for nothing. There are alternatives. It will just take a little guts.

The Irish people are being asked to suffer needlessly so that bondholders in Germany, France and England get paid-in-full on their soured investments. It's worse than a bad idea; it won't work. Ireland is just digging itself a deeper hole. But there is a way out, as Wolfgang Münchau points out in a recent op-ed in the Irish Times. Here's what he said:

"What should be done now? My ideal solution – from the perspective of the euro zone – would be a common bond to cover all sovereign debt to be followed by the establishment of a small fiscal union; furthermore, banks should be taken out of the hands of national governments and put under the wings of the European Financial Stability Facility. That would clearly solve the problem.

If this is not going to happen, what can Ireland do unilaterally now?…

First, Ireland should revoke the full guarantee of the banking system, and convert senior and subordinate bondholders into equity holders." ("Will it work? No. What can Ireland do? Remove the bank guarantee and default", Wolfgang Münchau, The Irish Times)

Sure, the experts know what needs to be done, but nothing will come of it. German voters will never support stronger ties with the other EU nations which they have already dismissed as profligate spenders. Nor will the other countries surrender more of their own sovereignty when they see how Ireland and Greece have been treated. That means, the EU is probably headed for the dumpster. And, maybe, that's a good thing. After all, behind all the public relations hoopla, the real goal of the EU was always to create Corporutopia, a place where bankers, business chieftains and other elites lined their pockets while calling the shots. Just look at the Lisbon Treaty fiasco back in 2008, when the EU's corporate Mafia used every trick in the book to push through an agreement that ran roughshod over basic democratic principles and civil rights. Fortunately, the Irish people saw through the ruse and sent the Treaty to defeat. Here's what a spokesperson for the "No Campaign" said at the time:

"The Irish people have spoken. Contrary to the predictions of social and political turmoil, we believe that hundreds of millions of people across Europe will welcome the rejection of the Lisbon Treaty. This vote shows the gulf that exists between the politicians and the elites of Europe, and the opinions of the people. As in France and the Netherlands, the political leaders and the establishment have done everything they could to push this through – and they have failed. The proposals to further reduce democracy, to militarize the EU and to let private business take over public services have been rejected. Lisbon is dead. Along with the EU Constitution from which it came, it should now be buried."

On December 7, Irish MPs will vote on Cowen's austerity budget. If they reject the budget, then the IMF/EU loan package will probably not go through and the eurozone will begin to splinter. Once again, Ireland finds itself with an opportunity to strike a blow against the EU and end the dream of a corporate superstate. All they need to do is vote "No".

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