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Greece → Ireland → Portugal → Spain → Italy → UK → ? Europe's Financial Domino Effect

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It is now common knowledge that there is a potential domino effect of European sovereign debt contagion in roughly the following order:

Greece → Ireland → Portugal → Spain → Italy → UK

While some people have been writing about this for well over a year, many others have joined the party late (there are now over 600,000 hits from a Google search discussing this topic.)

It is also now common knowledge that while Greece and Ireland have relatively small economies, there will be real trouble if the Spanish domino falls.

Iceland has the world's 112th biggest economy, Ireland the 38th, and Portugal the 36th. In contrast, Spain has the world's 9th biggest economy, Italy the 7th and the UK the 6th. A failure by one of the latter 3 would be devastating for the world economy.

As Nouriel Roubini wrote in February:

> But the real nightmare domino is Spain. Roubini refers to the Spanish debt problems as "the elephant in the room".
>
> "You can try to ring fence Spain. And you can essentially try to provide financing officially to Ireland, Portugal, and Greece for three years. Leave them out of the market. Maybe restructure their debt down the line."
>
> "But if Spain falls off the cliff, there is not enough official money in this envelope of European resources to bail out Spain. Spain is too big to fail on one side—and also too big to be bailed out."
>
> With Spain, the first problem is the size of its public debt: €1 trillion. (Greece, by contrast, has €300 of public debt.) Spain also has €1 trillion in private foreign liabilities.
>
> And for problems of that magnitude, there simply are not enough resources—governmental or super-sovereign—to go around.

And as I've previously pointed out, Germany and France – the world's 4th and 5th largest economies – have the greatest exposure to Portuguese and Spanish debt. For more on the interconnections between Euro economies adding to the risk of contagion, see this.

While it is tempting to assume that the Eurozone bailouts mean that creditor nations which have managed their economies well and saved huge amounts of excess reserves which they lend out, Sean Corrigon points out that the European bailouts are a Ponzi scheme:

> Under the rules of this multi-trillion shell game, the sovereigns guarantee the ECB which funds the banks which buy the government debt which provides for everyone else's guarantees.

(America is no different: Bill Gross, Nouriel Roubini, Laurence Kotlikoff, Steve Keen, Michel Chossudovsky and the Wall Street Journal all say that America is running a giant Ponzi scheme as well. And both America and Europe are trying to cover up the insolvency of their banks by running faux stress tests.)

It didn't have to be like this. The European nations did not have to sacrifice themselves for the sake of their big banks.

As Roubini wrote in February:

> "We have decided to socialize the private losses of the banking system.
>
> ***
>
> Roubini believes that further attempts at intervention have only increased the magnitude of the problems with sovereign debt. He says, "Now you have a bunch of super sovereigns— the IMF, the EU, the eurozone—bailing out these sovereigns."
>
> Essentially, the super-sovereigns underwrite sovereign debt—increasing the scale and concentrating the problems.
>
> Roubini characterizes super-sovereign intervention as merely kicking the can down the road.
>
> He says wryly: "There's not going to be anyone coming from Mars or the moon to bail out the IMF or the Eurozone."
>
> But, despite the paper shuffling of debt at the national level—and at the level of supranational entities—reality ultimately intervenes: "So at some point you need restructuring. At some point you need the creditors of the banks to take a hit —otherwise you put all this debt on the balance sheet of government. And then you break the back of government—and then government is insolvent."

And here's my take from April:

> As I pointed out in December 2008:
>
> > The Bank for International Settlements (BIS) is often called the "central banks' central bank", as it coordinates transactions between central banks.
> >
> > BIS points out in a new report that the bank rescue packages have transferred significant risks onto government balance

> sheets, which is reflected in the corresponding widening of sovereign credit default swaps:
>
> > The scope and magnitude of the bank rescue packages also meant that significant risks had been transferred onto government balance sheets. This was particularly apparent in the market for CDS referencing sovereigns involved either in large individual bank rescues or in broad-based support packages for the financial sector, including the United States. While such CDS were thinly traded prior to the announced rescue packages, spreads widened suddenly on increased demand for credit protection, while corresponding financial sector spreads tightened.
>
> In other words, by assuming huge portions of the risk from banks trading in toxic derivatives, and by spending trillions that they don't have, central banks have put their countries at risk from default.

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But They Had No Choice … Did They?

But nations had no choice but to bail out their banks, did they?

Well, actually, they did.

The leading monetary economist told the Wall Street Journal that this was not a liquidity crisis, but an insolvency crisis. She said that Bernanke is fighting the last war, and is taking the wrong approach (as are other central bankers).

Nobel economist Paul Krugman and leading economist James Galbraith agree. They say that the government's attempts to prop up the price of toxic assets no one wants is not helpful.

BIS slammed the easy credit policy of the Fed and other central banks, the failure to regulate the shadow banking system, "the use of gimmicks and palliatives", and said that anything other than (1) letting asset prices fall to their true market value, (2) increasing savings rates, and (3) forcing companies to write off bad debts "will only make things worse".

Remember, America wasn't the only country with a housing bubble. The world's central bankers let a global housing bubble development. As I noted in December 2008:

> … The bubble was not confined to the U.S. There was a worldwide bubble in real estate.
>
> Indeed, the Economist magazine wrote in 2005 that the worldwide boom in residential real estate prices in this decade was "the biggest bubble in history". The Economist noted that – at that time – the total value of residential property in developed countries rose by more than $30 trillion, to $70 trillion, over the past five years – an increase equal to the combined GDPs of those nations.

> Housing bubbles are now bursting in China, France, Spain, Ireland, the United Kingdom, Eastern Europe, and many other regions.
>
> And the bubble in commercial real estate is also bursting world-wide. See this.
>
> ***

> BIS also cautioned that bailouts could harm the economy (as did the former head of the Fed's open market operations). Indeed, the bailouts create a climate of moral hazard which encourages more risky behavior. Nobel prize winning economist George Akerlof predicted in 1993 that credit default swaps would lead to a major crash, and that future crashes were guaranteed unless the government stopped letting big financial players loot by placing bets they could never pay off when things started to go wrong, and by continuing to bail out the gamblers.
>
> These truths are as applicable in Europe as in America. The central bankers have done the wrong things. They haven't fixed anything, but simply transferred the cancerous toxic derivatives and other financial bombs from the giant banks to the nations themselves.

Caveat: Even though Italy's debt/GDP ratio looks high, it has a high household savings rate and virtually all of its government debt is owned internally, by households. So it may not be vulnerable as one might think.

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