The European Debt Crisis: Will the "Weaker" Member States Leave the Euro Zone?

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It wasn't all that long ago that industry estimates were that the issuance of credit default swaps in Europe, CDS, were about $18 billion. At the same time on the street it was estimated that the exposure was $75 billion. We estimate $150 billion – this represented insurance on the holders of bonds issued by Greece, Portugal, Ireland, Spain and Italy. The Bank for International Settlements says that figure is now $518 billion. As we have noted before the big problem is counterparty risk. When CDS, credit default swaps, are triggered to default will the counterparties pay up? Even if writers are buying from one another someone has to get caught holding the bag and loose money. That is where the risk comes in.

We are seeing a change in tactics by Europe's politicians as they head toward allowing euro zone members to leave the arrangement. The realization is that no matter what, the five weak nations cannot compete with the stronger euro zone countries. They want legislation for their exit and to allow them to remain in the European Union. They obviously know that if they all or in part leave the euro they'll probably default as well, in whole or in part. The derivative writers contend if the owners of bonds agree to take a 50% loss on bonds then the insurance doesn't take effect. Fitch, the rating service says yes it is a payable default. We will see who is correct. We agree with Fitch.

At least for the moment bond yields in Europe seem to be finding balance and the euro seems to want to do the same. Pressure is still being applied and yields will probably move up over the next six weeks and we could see the euro at $1.30. the French and Germans are exposing a smaller euro zone finally facing reality, although the euro was all they cared about in the first place. Excepting Germany, most bonds were lower.

At the beginning every sovereign was going to be bailed out if necessary. Germany believed 2 years ago it would cost $1 trillion, we said $4 trillion. When Germany admitted to $3.5 trillion two months ago they knew then they and the other solvent countries couldn't carry the burden without going under themselves. That was very short sighted of Germany. If they had made these decisions earlier they wouldn't have had to make them now in a crisis where the problems are spiraling out of control. What poor preparation and planning. This should have been over last summer, but no they had to have their summer vacations. These people live in la la land.

The future of the euro zone is sealed. There will be six less participants a year from now. The European economy will have 1% negative growth next year and lower growth the following year. In Europe several more members will be forced to phase out the euro and return to their own currencies. We see this as the best option Europe's one-worlders can hope for. What we are seeing is not a liquidity issue. These five countries are broke and all the saviors can do is throw good money after bad.

We hear morbid stories of the terrible results of changing currencies, some of which are true. You know what the problems are. You just avoid them. Everything has to be done ahead of time. You simply trade in each euro for ½ drachma or lira and seven days later there are no more exchanges. There is a 50% devaluation and a total default on debt. The government in question has to either bail out the banks or lets them go under. Either way a new banking system has to be put in place. In order to prepare for such events you simple exchange euros for gold and silver coins and bullion. Only keep enough euros to survive.

The troubles in Europe are not going to go away anytime soon. Expect two years or less before the euro is history. This will cause a rising dollar temporarily, but do not be deceived, it won't last long.

Just to show you how rapid the deterioration has become, Italian banks borrowed $152 billion at the end of October, up from $144 billion in September. Italy's $2 trillion plus in liabilities exceeds the four other countries in trouble. The banks holding these bonds as collateral are seeing their value erode, which means they cannot lend as much money as they would like to lend. In addition, banks have also purchased these bonds and as they fall in value it reduces their capital base. They cannot lend as much and may have to raise additional capital. That is in addition to raising funds to meet the BIS requirement of 9% reserves.

Italy's PM Silvio Berlusconi as of this writing has not stepped down and as a result the yield on the Italian 10-year notes rose. These are killer rates, because Italy has to sell $204.2 billion in notes in 2011 and $231.9 billion in 2012. Italy, like all the other sovereigns that are in austerity programs, has already slipped into recession in addition to a natural slow down in the European Union. That will make all these nations have a difficult time increasing revenues.

Italy is now the key not Greece, and the very fact that France's Sarkozy and Germany's Merkel are pushing for legislation to allow sovereigns to exit the euro zone but stay in the EU is very telling. European and US stock markets sold off on the news, but the US's Working Group on Financial Markets brought the markets right back up. In case you hadn't noticed there are no longer free markets. Most everyone in the investment community knows the markets are being manipulated but no one says anything. That is because all they have to do is watch what the US is doing and follow suit. These actions, of course, make it much more difficult for the nations to sell their bonds and notes and the yields they must pay go higher. There is now no question the euro zone will change. The weak six countries will soon leave and eventually we see an end to this unnatural union. The healthy nations will concentrate on bailing out their banks, which will cost taxpayers a fortune. The bankrupt nations will have to nationalize banks. Depositors will lose 50% to 90% of their deposits. Those subscribers in Europe get out of those banks now. Take those funds and buy gold and silver shares, coins and bullion. In the healthier countries do the same thing, because we do not know how big the losses will be? No one knows how bad this will get.

We wonder if the $518 billion allocated will ever be used under the circumstances. The lenders know if these bankrupts are going to default what is the sense in giving them more money. They should just cut them loose. We see little chance of leveraged loans being used if they are ever made at all. Even those in favor are talking about 3 to 4 to one. Besides the first EFSF offering was under scribed and cancelled. At this time the negative pressure is greater than ever. The new governments in Greece and Italy will not change anything. Their conditions are what they are. The only question in our minds is how far can the new governments go with austerity before revolution begins?

Economies worldwide are slowing down, so Europe's escalating debt crisis will cancel any possible recovery and the world could end up in hyperinflation and deflationary depression. Whatever, these fundamentals are terrible. Over the next 10 days a Greek default and a run on Italian banks has a 65% chance of taking place. What is astounding to us is the professionals, politicians and the public does not understand the gravity of the situation. If this happens will others come to the rescue. Overall we do not think so. They have too many problems of their own. We could have Portugal and Ireland collapse as well. Banks will be bailed out or nationalized. We are dead against that happening, because all it does is put the same corrupt system back into action. It also avoids a purging of the system, which has to take place in order to put a better system in place.

During this time frame French debt could also be downgraded and there is a strong chance of that happening. That would short circuit lending in a big way.

Riots could soon be the order of the day in all the countries implementing more austerity. Insolvency would bring the same results and perhaps revolution.

Then running the show we have the same old elitist retreads. The latest pair being Lucas Papademos in Greece. There are so many Bilderbergs involved we'd need several pages to list them.

Germany and France know they are facing recession with millions more unemployed. This is why they are making contingency plans. They have given up trying to rescue anyone. At the same time they audaciously try to create a new smaller euro zone and include taking over the fiscal reins of all member governments. All decisions would be made by a centralized bureaucracy. 19

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