The never-ending Eurofiasco

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Imagine if the local fire chief, in the spirit of conservation, decided he'd use no more than 1,000 gallons of water to put out any given house fire. Do you think the citizens would support that policy if their town was burned to the ground? And, yet, this is the same approach that euro zone leaders are using to address the debt crisis.

The central bank (ECB) has virtually limitless resources (think printing press) to defend the debt of the individual states and to act as lender of last resort, but the eurocrats won't hear of it. They refuse to use the ECB as every other central bank in the world is used. They'd rather reinvent the wheel by creating a funky, improvised emergency fund (European Financial Stabilisation Facility or EFSF) that's massively leveraged and which only provides a 20 percent "first-loss" guarantee on sovereign bonds. So, for example, if Italy goes belly-up in the next year or so and can't repay its debts, then Mr bondholder gets a whopping 20 cents in the dollar. Such a deal!

Can you see how ridiculous this is?

Look; US Treasuries are backed by the "full faith and credit" of the United States of America. What are Italian bonds backed by? Or Portuguese bonds? Or Irish bonds?

Under this new regime, they'll be "partially" backed by a dodgy, undercapitalised insurance fund. That ought to shore-up investor confidence.

Is this any way to run a multi-trillion confederation of states?

And the EFSF is only part of this latest Eurofiasco. There is also a special purpose investment vehicle (SPIV) that will be used to attract foreign investment (re: China). EU leaders assume that the Chinese are so yield-crazy that they'll scarf up hundreds of billions of these (toxic?) EU bonds to stack atop their cache of USTs.

Dream on. Apparently, Nicholas Sarkozy has already been on the horn to leaders in China inquiring about future investments. But, so far, no takers. The truth is, investors are exiting Europe as fast as their two feet will carry them, not lining up to get back in.

As soon as Wall Street got a whiff of Europe's "breakthrough agreement", the Dow went through the roof, over 300 points on the day. Less than 24 hours later, however, the mood was notably more sombre. The details on all the critical points – (haircuts on Greek debt, bank recapitalisation, EFSF etc) – remain sketchy.

"The devil is in the details," Don Wordell, a fund manager for Atlanta-based RidgeWorth Capital Management, which oversees about $47 billion, said in a telephone interview. "Europe is trying to do anything to solve its problems. Still, there are lots of questions on how the plan is going to work and how they are going to fix their debt issues."

Ah, yes, "the details". One of the details that has been clarified is the fact that the credit markets are not "on board", in fact, credit spreads have shrugged off the happy talk and continue to widen. This is from Reuters:

"Italy's borrowing costs jumped to record levels on Friday, underlining its vulnerability at the heart of the euro zone debt crisis and scepticism about whether the struggling government of Prime Minister Silvio Berlusconi can deliver vital reforms."

Okay. So the credit gauges are blinking again and yesterday's announcement provided no relief at all. Banks are still reluctant to lend and credit conditions continue to tighten. And now that EU banks will be forced to increase their capital cushion, you can bet there will be another debilitating credit crunch. Take a look at this from Bloomberg:

"European banks say they have to cut assets to help satisfy a government push to boost capital faster than planned to insulate them against the sovereign debt crisis. That may trigger a credit crunch for companies and consumers throughout the 17-nation euro zone, helping to push its economy into recession, say Citigroup Inc and Deutsche Bank AG analysts."

Banks across Europe have announced they will trim more than 775 billion euros from their balance sheets in the next two years to reduce short-term funding needs and achieve the nine percent in regulatory capital required by the Basel Committee on Banking Supervision ahead of schedule.

"The banks need to deleverage, but if they choose to deleverage by cutting assets not by raising equity then it will have negative consequences for the economy," Simon Maughan, head of sales at MF Global Holdings Ltd in London." ("European Banks Warn of Credit Drought", Bloomberg)

So, euro zone leaders – after having already triggered a mini-Depression in the PIIGS (Portugal, Italy, Ireland, Greece, Spain) with no end in sight – are on course to intensify the downturn by forcing the banks to dump hundreds of billions of dollars of assets onto the market thus pushing down prices and increasing financial market distress. Sounds like a plan. The alternative to this would be that the individual governments recapitalise the banks at their own expense which would mean higher taxes, diverting revenue from public services, and (here's the corker) a steep downgrade by the ratings agencies. So, it's a lose-lose-lose situation.

And what about those "overnight deposits" that banks have been squirreling away at the ECB because they're afraid to leave their money in other banks? That must have improved now that a "comprehensive" deal has been worked out, right?

"The European Central Bank said banks increased overnight deposits to the most in more than two weeks. Euro-area banks parked 218.1 billion euros (US$308.8 billion) with the ECB overnight, up from 204.4 billion euros the previous day and the most since October 10. They borrowed 2.7 billion euros in emergency overnight funds at the marginal rate of 2.25

percent, up from 1.8 billion euros a day earlier." (Bloomberg)

Everything is worse. The Eurozone is imploding, and it's imploding because the policies they're implementing are, well, stupid, which is to say, they won't work. And investors know they won't work which is why they keep fleeing Europe en masse.

Can you blame them?

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