Cruising Toward European Debt Resolution
By Craig Phillips, CFP

Saturday, August 27, 2011

Two weeks ago, the markets were rocked by the Standard & Poors ratings downgrade of longer-term U.S. Treasury securities. This past week, it was problems with European debt.

It's not immediately obvious, even for financial professionals, why U.S. stocks should suffer because Greece or Italy have trouble paying their debt obligations. But in a recent posting, PIMCO, the world's largest bond management company, made an interesting analogy that helps to make the situation a bit clearer.

Their analogy suggests that we think of the European Central Bank as a Coast Guard cutter in the Mediterranean, and it gets a warning that a relatively small cruise ship called Greece is in trouble. The ship passed through a significant storm called 2008, and now, through poor planning, has run out of food and fuel and is in danger of sinking. True to its mission, the Coast Guard cutter sets out to tow the battered ship back to shore.

But then the rescue ship receives another message. A somewhat larger cruise ship is also in trouble, as a result of the same storm. Another call comes in, another ship is foundering. And then one of the larger vessels, called Italy, announces that it is in trouble as well.

What to do? Nobody prepared for the possibility that more than one ship would be in danger at once, much less four or five. The Coast Guard vessel can think of only one thing to do; it radios the two largest cruise ships in the Mediterranean, called Germany and France, and asks them to participate in the rescue operation, by cutting short their trips, sharing the food and fuel that was set aside for their passengers, and basically rescue the cruise ship business before too many future passengers become disenchanted and cancel their tickets.

The captain and the cruise ship lines (the leaders of France and Germany) are willing to help out, but the passengers are extremely restless. Why should their trip be sacrificed? Why should the food they paid for be shared with the passengers of less stable or thrifty cruise lines? The captains of the France and Germany cruise ships are afraid their passengers will mutiny if they execute a rescue, and afraid of the consequences if there is no rescue and one of the smaller cruise ships goes down with passengers and crew.

The world, of course, is watching. The overwhelming hope is that the larger ships will come and save the day. The fear is that they may not. Meanwhile, the crew of the struggling rescue vessel is struggling with a once-unthinkable decision: should they throw somebody overboard to lighten the vessel and save the rest of the passengers?

This is the European Central Bank's situation today. And if we have learned anything since 2008, it is that in such a highly-connected global economy, if one major entity is allowed to go under the waves (think Lehman Brothers), the entire global system will be negatively affected. Hence, investors sell stocks in fear of another 4th quarter of 2008.

How likely is that? There appear to be three possible endgames to the European Sovereign debt crisis. One is a disorderly breakup of the eurozone, which would mean temporary economic chaos. This could happen if the countries with the most debt problems--Greece, Ireland, Portugal, Iceland, Spain and Italy--fail to address their fiscal balance sheets due to pressure from their voters. To return to the cruise ship analogy, the people aboard the vessel named Greece believed that they paid for an appropriate ticket, and now the captain is telling them that they will have to sacrifice their vacation and pay back the Coast Guard and the other cruise ships. The response, for some, has been rioting.

A second possibility is a tighter fiscal union among the European countries, which basically means that Germany (and, to a lesser extent, France) reaches into its pocket and bails out the debtor nations to the south. In return, Germany gets more control over over the economic governance of the other members of the European Union. The slogan of this approach: never again will we float unsafe vessels.

And the third? Several economists have floated the idea that two or three "peripheral economies" (Greece and Italy) would take a sabbatical from the euro. They would go back to their own currencies, which would allow them to devalue immediately, making their exports more competitive and their debt less costly. Instead of imposing an unpopular new tax on the population, the countries would impose a stealth tax in the firm of higher inflation. Meanwhile, the euro becomes stronger. The motto: fix your own vessels, and then come back to see us when you're finished.

As one of these scenarios plays out, it might become obvious that many American and European stocks are currently being affected more by anxiety and uncertainty than by any direct connection with the Euro's woes. A report recently noted that Apple Computer was worth more than all 32 of Europe's largest banks. If chaos reigns across the Atlantic, there could be a flood of capital looking for a safe, liquid home in the U.S. stock market.

Source: http://www.project-syndicate.org/commentary/elerian8/English

http://www.cultofmac.com/apple-was-worth-more-than-all-the-banks-in-europe-earlier-today/109642