

JVB Financial Group, LLC

CRONIN'S CORNER MONTHLY

A Perspective on the International Economy

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Those who pass a cogitating eye across our monthly scribbles might not be remiss in thinking that the author is obsessed with Europe. A bit extreme perhaps since the voluble and voluminous that dress our financial media continue to point in a similar direction and the drama that envelops the region continues to demand an attentive pen. Thus, as August heralds in the eventual and final susurrations of the summer of 2011 and the shadow of autumn draws closer, the Europeans will be returning from vacation. Many will be hoping that things might have improved in the month or so and that the umbrellas of the Rivas had succeeded in occluding the outside nasties. Many more will know that they have not. Those who have been uninformed, whether by choice or not, or those who remain befuddled by the fiscal farrago choking Europe may gain little solace from the Italian and Spanish yield curves. So the ECB was able to prevent a fire sale of Spanish and Italian sovereigns by going on a buying spree of its own. Many Europeans will probably shrug, gesticulate or light another cigarette. It may ultimately change nothing. It probably won't. The bigger issue, for those who care to look closer, will be the specter now of closer European fiscal unity. This is something that will change everything.

Riding the vacation train a little further, for any of us who have gone to Holland for a trip the choices are usually Rotterdam or Amsterdam. Both doused in cultural and historic splendor, the canals, the painfully clean streets and the clogged tulips all make for a Dutch delight. Mention of a place called Maastricht in southern Holland is unlikely to imbue images of windmills and dams, but it does instead conjure up the historical birthplace of the European Union. It was here back in 1992 when this city hosted the signing of a certain treaty, that would eventually herald to the world the Euro and the Eurozone, that history was made. By 1998 eleven members of the European Union had been able to satisfy criteria established by the treaty that would allow them to create the Eurozone – the Euro had been born.

The entrance fee into the Eurozone required steadfast convergence criteria that had to be adhered to in order to become a member of this new specious club and it was blatant disregard

for two key elements of this criteria that has Europe gasping today for a fiscal salve. One of the covenants stated that the deficit of any country must not exceed three percent of GDP at the end of the previous year and that any divergences would only be tolerated temporarily. Another one was that the debt to GDP ratio must not exceed sixty percent and, if it did, distinct signs of improvement and convergence to the target rate should be observed. Given what has happened in the past two years, these mandates reek of quixotic shortsightedness and bipolar economic analysis. Each member was left to manage its own fiscal future and monetary policy would emanate from the European Central Bank. A single monetary policy that would complement eleven (which has now grown to seventeen) distinctly different fiscal briefs would create a 'United States of Europe' that could finally challenge the 'unctuous' might of America and of course everyone knew, but few admitted, that it would all be based upon German might. We are not trying to use hindsight as a weapon of critique but surely once some of the less powerful countries became members of the Eurozone they no longer had an incentive to adhere to any fiscal handcuffing? Of course, punitive language was bandied about and if any country veered from the fiscal criteria punishment would be severe. The specter of opprobrium (as that was all it amounted to) must have appeared risible and inevitably stimulated chortles of indifference across Europe especially since Germany and France themselves violated the sixty percent rule for the debt to GDP ratio and no sanctions or punitive action was ever taken against them for doing so. Who would dare? Therefore, with Germany not adhering to the rules of play why should Greece? Or Italy? Or Portugal? The fiscal farrago had begun.

The response by the European hierarchy to the whole crisis has been languid, shallow and hitherto ineffective. They have dandled across the realms of reality with patchwork solutions that aim to provide an unguent for a petrified market place without actually addressing the real macro-economic problems. The most recent meeting of the Franco-German duopoly bordered upon the ridiculous. Promising to take definitive steps towards a closer political and

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economic union of the seventeen members of the Eurozone is not enough. Pledging to defend the Euro at all costs is blustering rhetoric. Proposing the need for possible future changes to the European Union treaty as the need arises is a political gimcrack. Surely the need has arisen, continues to arise and will continue to arise? Merkel et al. seem to have removed themselves from any spatial dimensions of time and seem content to propose a gradual template for enhanced economic governance and economic supervision that will evolve over time. Time that Europe does not have. Similar proposals seem to have also been penned into the original Maastricht treaty and how that has evolved continues to leave its unfortunate afterclap. The ECB cannot perpetually continue to buy sovereign debt and the EFSF's (European Financial Stability Fund) new powers have not even been ratified yet for it to absorb the toxics in the secondary market (this was from the July summit wherein Greece received bailout number two and the EFSF's powers were augmented). Essentially and ultimately, we feel, for the Euro and the Eurozone to insure its survival fiscal union will have to occur. The original model for the European Union saw no need for fiscal as well as monetary union and this has always been a source of concern and one of the reasons the Euro could never replace the US Dollar as the world's reserve currency. The markets would obviously like to see fiscal unification immediately but that desideratum is painfully unrealistic. The union that is "Merkozy" would like to postpone any fiscal marriage until they have exhausted all options. A last resort when everything else fails. Really? Once again it seems that European prevarication runs amok. The creation of a EuroBond is no longer a luxury but a necessity if the Eurozone is to continue to exist. Of course it is easier said than done.

German opposition to such a proposal is vehement as the issue is not only an economic caterwaul but also a political one. Understandably perhaps but Germany is the region's most powerful economy and most influential country, thus it is time for the dithering to cease and for her to take responsibility. Of course the issuance of a Eurobond will cost the Germans more to borrow. Currently they have to pay just over two percent for ten years as compared to the Italians and Spanish who are shackled with five percent plus rates and lucky to be that low. It may cost the Germans thirty billion Euros a year more to service their debt

under a EuroBond structure, but wouldn't a perpetual fiscally scourged European economy pose a greater threat to Germany's future? An overly dependent export driven economy, Germany needs the European Union to grow. It's that simple. Startling data this month revealed that last quarter's growth for the union was a mere 0.2% whilst that of Germany was only 0.1%. The wavering European economy will make it more difficult for the peripheries to impose their austerity measures exacerbating their fiscal ructions and extending this crisis ad infinitum. The risk of 'contagion' across the sovereign spectrum has proliferated within itself as we saw the surge in Italian and Spanish yields over six percent before the ECB finally intervened. The risks of contagion though we think run deeper and are not only confined to the Sovereign space but also the whole banking and financial sector in Europe. We have seen European banking stocks melt in the past two weeks and it seems that European banks are becoming increasingly reluctant to lend to their brethren. We know that these banks have peripheral sovereign debt on their books but no-one realistically knows how much except for the individual banks themselves. As long as the fiscal affliction torrents through Europe a fiscal crisis has the potential of degenerating into a banking one also. The success of a Eurobond initiative will, as we have said, require closer fiscal integration. It may even eventually mean that countries cede fiscal control of their economies to one autonomous body like they have with their monetary policy. Political discourse will swirl upon its own calliope of profligate debate but, as is necessary in the US, economics must now take precedent over politics to ensure a future for the Eurozone.

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