No Solution For Euro Crisis

The latest plan for the Euro, for the European banking system, for Greece, Italy, Portugal and for the union itself, is unlikely to work.

Here’s why.

Some economies require lower interest rates, some higher. Some need a stronger currency, some a weaker one. Some countries will need to run temporary deficits and some, surpluses. These fundamentals have been ignored in favour of a narrow solution to a particular symptom for a small group of countries. The Eurogroup has suggested that the fate of the Euro is directly related to the unity of the region, a broad and unsubstantiated claim.

The EFSF’s modus operandi is as yet unclear. What we do know is that we intend to establish and maintain a large scale cash flow CLO with the EFSF providing credit enhancement. It is hoped that surplus countries will step in to provide senior financing. The implied leverage will have serious consequences for the financial risks assumed by the EFSF. This is the main risk. Compounding this are credit correlation effects within the term structure of a single sovereign’s securities as well as across sovereigns. Such correlation effects could lead to unexpected losses even if average spreads in the underlying pool are unchanged. The risk management of the EFSF needs special attention. This is a technical issue that has escaped even some of the most sophisticated structured credit traders and the EFSF is at risk of overlooking it.

The credit rating of the EFSF must be questioned if it is providing first loss or subordinated debt to a levered structure. Depending on the implied leverage, small variations or haircuts in the underlying securities could decimate the EFSF’s balance sheet. Member countries’ implicit guarantees to the EFSF will be called and tested.

The 50% haircut negotiated with the banks holding Greek debt still require confirmation. Non-bank claim holders may not cooperate. There is no Chapter 11 process applicable to sovereign distress. The reorganization is therefore not analogous to a prepackaged petition and could be contentious. This is just in the cash securities. The situation in the synthetics is opaque since the quantity of side bets in bilateral credit derivatives is not fully quantified. It is not clear whether the proposed exchange is voluntary or not, and thus if it would represent a credit event under ISDA.

The recapitalization plan for the banking system contained a number, 9% and a date, 9 months down the road. The nature of the recapitalizations have not yet been articulated although bank recaps are known processes. Bank balance sheets remain opaque and or poorly understood and thus cannot be relied upon. Recapitalization to provide for current asset quality is hardly encouraging of bank’s propensity for the credit expansion Europe needs to revive economic growth.

For now at least, the measures are insufficient and not well defined. They are therefore far from a comprehensive solution. Expect failure within weeks.

Recommendations for the future:

Dismantle the Euro, or at least amputate the distressed bits. Free up exchange rates and interest rates as policy tools. Allow additional degrees of freedom for price discovery and resource allocation.

Establish an international Chapter 11 process for sovereign issuers. After centuries of sovereign defaults it is time to establish a process for orderly restructurings.

Create richer sovereign capital structures. The assets of the sovereign are not well defined, mainly because cash flow generation derives from taxes based on potentially fluid corporate and personal taxpayers. As a result, it is not easy to define an ordinal priority of claim against assets. It is, however, possible to define an ordinal claim on cash flows. Such cash waterfall structures resemble CLO structures. Such structures can be complex, as mentioned above, and need careful risk management. But by tranching the immediate liabilities of the sovereign rather than tranching the liabilities of an SPV owning the liabilities of a sovereign, some of the risks are mitigated. Or at least transformed to a less volatile (even if for reasons of serial correlation) form.

Cut marginal tax rates. Countries are basically purveyors of domicile. The elasticity of demand for domicile in a pre Globalized world was low. Today it is high. Reducing marginal tax rates will very likely raise tax revenues. Governments are cognizant of the impact of exchange rates on a country’s competitiveness, they have not yet come to the same realization on taxation.

Social security and welfare reform. Defined benefit schemes of healthcare, unemployment insurance, and pensions need to be reformed in favour of defined contribution schemes. It is beyond the scope of this discussion to delve into the details but the overriding concepts are to instill a greater sense of responsibility for one’s own economic fate, and to discourage the culture of entitlement.

The idea that a common currency implies common goals and aspirations, economic unification, strategic alignment and a common fate is not justified. The efforts of the Euro group have, if anything, exposed the deep differences and fissures within Europe. German pragmatism has clashed with French egalitarianism. Even the tenuous French and German bargain sparked irritation among the Italians. British meddling was warded off curtly by the French. Sometimes it is common ground that is most vigorously disputed.