

S&P Downgrades Europe; Morphine and Major Surgery

So S&P has downgraded a gaggle of European countries' sovereign debt ratings. What a surprise. Ratings agencies are not always the last to know, but they are always and everywhere a tad slow.

Fundamentally, Europe is in big trouble. A good number of the countries are cash flow insolvent. Their banks are insolvent. These countries are now expected to operate austerity measures in order to regain their solvency, a task diametrically opposed to their task of regaining cash flow solvency. Tax revenue is correlated with economic activity and austerity is a drag on growth and hence tax revenue.

Basically the situation is as follows. A chap is being told by his bank to cut his debt. 'But I need credit lines to run my business', he says. 'But you're cash flow insolvent', says the bank. 'But I can't do that at the rates of interest you're charging me', he says. 'But we can only lower interest rates if you reduce your debt', says the bank. 'But I can only reduce it if you lower your interest rates', he says. And round and round it goes.

The conversation the bank should be having with the customer is as follows. 'How do you propose to repay us given that you are cash flow insolvent?' The borrower gives some lame excuse. The bank then lays upon the borrower a plan of reorganization that involves selling some assets, cutting costs, laying off some staff, potentially hiring more relevant ones... Ideally, the borrower comes up with their own plan as a counterbid to the creditors' plan involving pay cuts, asset sales, rationalizations, process improvements etc etc.

Fundamentally, it is futile to reorganize the debt of a business that doesn't make

sense. You cannot lever something into viability.

Europe needs to be more competitive. But if the Italians, Greeks and Spaniards were more competitive, then the Germans might be less so. It is not a point the debtor nations want to make to the creditor nations.

The approach taken by the French and German governments towards the debt crisis in peripheral Europe is to prescribe austerity as a means to solvency as a condition for financing at reasonable rates. So far the efforts have been lacking in detail and have thus not commanded the confidence of the bond markets.

Austerity is but one solution to restoring cash flow and balance sheet solvency. In the short run, austerity exacerbates the cash flow problem.

In the short term therefore, a non-economic lender of last resort is required. The ECB's LTRO is designed specifically to this end but requires the (not necessarily guaranteed) participation of the commercial banks. (They do appear to be falling in line.)

Austerity absent the LTRO is not viable. Tax revenues would fall, so would profits, and eventually the insolvency of the peripheral economies would be crystallized.

Austerity requires time. It is hoped that the ECB has purchased sufficient time. Whether the market believes that it has or not will determine the path of bond prices going forward.

The debt and debt service reduction is but an intermediate goal to reduce borrowing costs in the future and thus improve debt reduction. With a common currency, localized domestic prices need to be more flexible, which would be evidenced by less stable prices, i.e. more volatile inflation. This is a consequence the ECB may struggle to reconcile with its price stability mandate.

Price stability could only result from a convergence, not necessarily an

improvement, in respective national productivity, in each factor market. This seems to imply not merely a harmonization of fiscal policy but also of tax and welfare systems, a first extension from harmonization of macro policy to harmonization of micro policy, for example in labour and employment law and policy. The true scope of integration necessary to maintain the Euro, while implementing a viable plan of reorganization begins to dawn.

This is what Merkel and Sarkozy are on about. It is, however, a long term goal, and as we all know, in the long run we're all dead anyway.

The trouble is that there are no short term solutions except pharmaceutical morphine, which the ECB has already shot in the arm. And that kind of medicine has ugly side effects such as inflation and risk of loss of confidence leading to all sorts of nasty things like hyperinflation and acutely high interest rates. Also it is a case of doubling down, requiring insolvent banks to purchase the very assets that caused their insolvency in the first place in the hope of holding up their value so as to stave off insolvency. Its all very precarious.

On Dec 21, 2011, the ECB printed 489 billion EUR. On Feb 28, 2012, one expects it to print even more. That's a lot of morphine.

In the meantime, the surgeons scrubbing down don't look too sure of themselves.