



Who's on first?

The political wags who commented that Barack Obama wanted America to be gentler, more like Europe, got it wrong. The Europeans (at least those in the EU, or more precisely, those who run its ambiguous institutions) want to be more like us. If you doubt that consider how strongly Trichet denounced the thought that the ECB should be the Lender of Last Resort for the sovereign debt of its more self indulgent southern members. When the chips were down, the ECB 'fessed up' and said it would take those dodgy sovereigns onto its balance sheet. Banks throughout Europe uttered a sigh of relief and the markets soared...at least on Monday. "Save the Euro," turned out to be a more potent force than the righteous indignation of the Germans who resent the inadequate saving of their southernmost confreres. Given the likely breakup of the EMU and perhaps the EU itself, if nothing had been done, this was not as surprising as it may seem.

Churchill, whose fondness for America was mixed with a proper dose of skepticism, is often quoted as saying **"The Americans will always do the right thing... after they've exhausted all the alternatives. ..."** The Euromeisters finally concluded that they would prefer to be less candid to the taxpayers of last resort than to let the sovereign debt of their poorer cousins drag down the institutions they have spent some 50 odd years building. The "right thing" might, of course, be that these institutions are inappropriate after all, as so many monetary economists have told them for years. But, honoring their post war history dictated that they did what had to be done to keep Eurodom afloat. And, they had exhausted 'all the alternatives.'

Skeptical Europeans might observe that the richer cousins didn't take on all the obligations. Some got parked in the IMF which means that we too get to participate as well. In addition, perhaps as a *quid pro quo* for allowing the US to get on with its recovery and not be derailed with troubles from Europe, the Fed's currency swap lines were re-instituted. Dollar funding, such as is needed, will be easily available to banks in Europe through the ECB. It is not quite 'déjà vu all over again,' but it does have the quality of history repeating itself **"occurring first as tragedy, the second time as farce,"** as Marx once wrote.

Was this the "right thing" to do? It depends what you take as given. If the maintenance of the EMU is essential to preserving the notion of "Europe" as now constituted, the ECB had little choice. The risks were a massive run on its own banks who had bought up these sovereigns thinking that small divergences in rates were not a sign of risk only a misperception by other buyers of debt. Usually, markets that show divergence in a debt instruments that are supposed to be 'equivalent' from a risk point of view, are telling us something. A Bund is not equivalent to an obligation issued by the Greek Treasury---unless of course the ECB is ready, willing and able to take you out when you wish to get out. That is all past now! There is a bit of irony in this monetary drama. The post-mortem on America's sub-prime crisis is that our banks provided trillions in loans to buyers of homes who could not afford the houses. It would seem that the strong members of the EU have recognized that they are obliged to make good on loans to their weaker cousins who know how to spend but not how to save. The PIGS's debt is the EU's 'sub-prime crisis.' The unequal distribution of income of wealth---the recurring cry of the anti-capitalists around the world---is now confronted with the unequal distribution of effort exhibited by members of the EU. Making a common state out of divergent culture is no easy task.

Where do we all come out on this 'farce?' Europe looks more like America after all. In both arenas, the taxpayers of the future will bear the brunt of the excessive spending of their forebears. In the U.S, taxpayers are financing the overindulgent renters who wished to become home owners. In Europe, the taxpayers (in the North) will finance the early pensions, and other welfare spending of their less energetic cousins to the South. This is not a stable equilibrium on either side of the Atlantic.



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The debt that is being absorbed by the respective monetary authorities won't just go away. Either the U.S. will be forced to save more and spend less at the Government level (which entails reducing current consumption in the private sector) or that debt will be eroded by a deliberate policy of 'a little bit of inflation.' And, in Europe, the devotion of their monetary authority to the 'first pillar' has been fatally undermined. The richer European cousins are now hostage to the political will of their poorer cousins. But where is the incentive for a long run restructuring of budgets in the south of Europe? True, some magnificent pledges of fealty to a more sober course of government spending have been made in the south. Will those pledges be kept? Will they be kept when the Demos decides to 'throw the rascals out' who cut their pensions and force them to pay taxes? Democratic states continue to founder on the demographics of voting. One man, one vote has to mean that there is plenty of inertial resistance to a sober course of government spending and taxation. Why do we think that will change even if the ECB makes good the obligations of the poor cousins? We don't! Economics is all about incentives and it is hard to see what incentives apply to politicians in the South to tell their constituents that they are to get less than what they were getting. In the long run, we are not dead...there is always another election, and if your banker friends up North are willing to refinance your debt, you can go on forever. Right? Kind of reminds one of what we heard during the housing boom. With rising prices, you can always refinance your mortgage and take on an even bigger house.

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