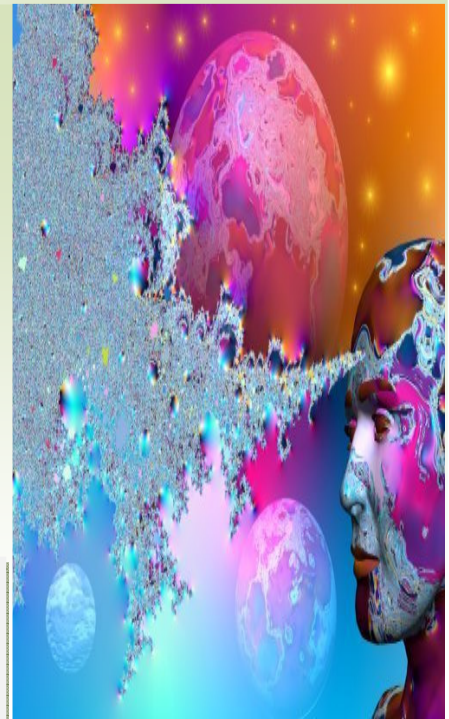




## Collection of Thoughts

Are the Firemen Ready?  
A European Crises.....



European banks are at significant risk. Eastern Europe has borrowed an estimated \$1.7 trillion, primarily from Western European banks. And much of Eastern Europe is already in a deep recession bordering on depression. A great deal of that \$1.7 trillion is at risk, especially the portion that is in Swiss francs.

*It is a story that could easily be as big as the US subprime problem.*

In Poland, as an example, 60% of mortgages are in Swiss francs. When times are good and currencies are stable, it is nice to have a low-interest Swiss mortgage. And as a requirement for joining the euro currency union, Poland has been required to keep its currency stable against the euro. This gave borrowers comfort that they could borrow at low interest in francs or euros, rather than at much higher local rates.

Can you sense an echo of teaser-rate subprimes here?? Along with the synchronized global recession and large Polish current-account trade deficits, which were three times those of the US in terms of GDP, just to give us some perspective? Of course, if you are not a reserve currency this is going to bring some pressure to bear. And it did. The Polish zloty has basically dropped in half compared to the Swiss franc.

*That means for a mortgage holder, the house payment just doubled. That same story is repeated all over the Baltics and Eastern Europe.*

Austrian banks have lent \$289 billion (230 billion euros) to Eastern Europe. That is 70% of Austrian GDP. Much of it is in Swiss francs they borrowed from Swiss banks. Even a 10% impairment (highly optimistic) would bankrupt the Austrian financial system, says the Austrian finance minister, Joseph Proll.

In Europe there are many banks that are simply too big to save. The size of the banks in terms of the GDP of the country in which they are domiciled is all out of proportion. In essence, there are small countries which have very large banks (relatively speaking) that have gone outside their own borders to make loans and have done so at levels of leverage which are far in excess of the most leveraged US banks.

***Ability of the "host" countries to nationalize their banks is simply not there.***

They are going to have to have help from larger countries. Western European banks have been very aggressive in lending to emerging market countries worldwide. Almost 75% of an estimated \$4.9 trillion of loans outstanding are to countries that are in deep recessions. Plus, according to the IMF, they are 50% more leveraged than US banks.

It is East Europe that is blowing up right now. Erik Berglof, EBRD's chief economist, writes that the region may need €400bn in help to cover loans and prop up the credit system. Europe's governments are making matters worse. Some are pressuring their banks to pull back, undercutting subsidiaries in East Europe. Athens has ordered Greek banks to pull out of the Balkans.

"The sums needed are beyond the limits of the IMF, which has already bailed out Hungary, Ukraine, Latvia, Belarus, Iceland, and Pakistan -- and Turkey next -- and is fast exhausting its own \$200bn (€155bn) reserve. We are nearing the point where the IMF may have to print money for the world, using arcane powers to issue Special Drawing Rights.

"The implications are obvious. Berlin is not going to rescue Ireland, Spain, Greece and Portugal as the collapse of their credit bubbles leads to rising defaults, or rescue Italy by accepting plans for EU "union bonds" should the debt markets take fright at the rocketing trajectory of Italy's public debt (hitting 112pc of GDP next year, just revised up from 101pc -- big change), or rescue Austria from its Habsburg adventurism. So we watch and wait as the lethal brush fires move closer. If one spark jumps across the eurozone line, we will have global systemic crisis within days.

**Are the firemen ready?"**

This has the potential to be a real crisis, far worse than in the US. Without concerted action on the part of the ECB and the European countries that are relatively strong, much of Europe could fall further into what would feel like a depression. There is a problem, though. Imagine being a politician in Germany, for instance. Your GDP is down by 8% last quarter. Unemployment is rising. Budgets are under pressure, as tax collections are down. And you are going to be asked to vote in favor of bailing out (pick a small country)? What will the voters who put you into office think?

We are going to find out this year whether the European Union is like the Three Musketeers. Are they "all for one and one for all?" or is it every country for itself?. Dissolution at this point would be devastating for all concerned, and for the world economy at large, without a healthy Europe, much of our world trade would vanish.

However, getting all the parties to agree on what to do will take some serious leadership, which does not seem to be in evidence at this point. The US almost waited too long to respond to our crisis, but they had the "luxury" of only needing to get a few people to agree as to the nature of the problems (whether they were wrong or right is beside the point). And they have a central bank that could act decisively.

In Europe, this situation does not exist in Europe. For the ECB to print money as the US and the UK (and much of the non-EU developed world) will do, takes agreement from all the member countries, and right now it appears the German and Dutch governments are resisting such an idea.

It is not clear how it will all play out. But there is real risk of Europe dragging the world into a longer, darker night. Their banks not only have exposure to US foibles, much of which has already been written off, but now many banks will have to contend with massive losses from emerging-market loans, which could be even larger than the losses stemming from US problems. Plus, they are more leveraged.

### ***Could this bring Euro in Parity with US \$***

The current problems is likely to put enormous pressure on euro to be at parity with \$ While that will be nice if you want to vacation in Europe, it will have serious side effects on international trade. It clearly makes European exporters more competitive with the rest of the world, and especially the US. It also means that goods coming from Asia will cost more in Europe, unless Asian countries decide to devalue their currencies to maintain an ability to sell into Europe, which of course will bring howls from the US about currency manipulation. It is going to put pressure on governments to enact some form of trade protectionism, which would be devastating to the world economy.