Written by Charles Scaliger on November 26, 2011

Financial Endgame in Europe

But, with Italy now propelled into the company of the desperately indebted, the Europeans have all but run out of options. Unlike Greece and Portugal, Italy, with its $2.6-trillion debt, is far, far too large to be bailed out. Italy's political leadership — like America's — has been absolutely unwilling to cut the expense of government, clinging like ivy to cherished government programs that cannot be sustained by any level of taxation. Over the past couple of weeks, markets have finally taken notice, driving interest rates, or "yields," on most Italian government bonds to over seven percent. Today, for example, the Italians managed to auction off $10.6 billion worth of six-month bonds at yields of 6.504 percent. Two-year bonds, meanwhile, were selling for 7.64 percent, and 10-year bonds for 7.26 percent. By comparison, consider that six-month Italian bonds were selling for a mere 3.535 percent only last month, while two-year bonds were just above 4.1 percent in early October and at 2.3 percent in mid-March. Borrowing rates for Italy have more than tripled in a few months.

Elsewhere in the eurozone, events are looking no better. Standard & Poor's lowered Belgium's credit rating to AA from AA-plus today, citing that country's absence of a functioning government for a year and a half. Belgium has been effectively divided in two by irreconcilable divisions between politicians from the Flemish and the French-speaking areas. Belgium's debt situation has also worsened considerably in recent months because of its absorption of the Belgian half of failing French-Belgian bank Dexia, the largest European bank so far to fail in the crisis. Creditors have not been blind to Belgium's woes, pushing rates for Belgium's 10-year bonds up an entire percentage point in less than a week, from 4.817 percent Monday to 5.832 percent today. Two-year rates jumped to 5.1 percent.

Spain, the other mega-economy on the brink, is nearing the point of no return, despite a change in government in Madrid. Spain's new Conservative majority inherits a country about to plunge back into recession, with unemployment rates over 20 percent to boot. Spain's two-year bond closed at 6.10 percent — the first time in the euro era it has exceeded 6 percent. Another week like this one, and Spain will join Italy in the unsustainable 7-percent-plus club. Like Italy, Spain, with the world's seventh largest economy, is much too big to bail out.

International investors are so spooked that even Germany, long considered a rock of financial stability, was unable on Wednesday to sell all the bonds it tried to auction off. While German bond yields are still well within sustainable limits, the perception worldwide is growing that, once Europe's economies start to tumble like proverbial dominoes, even the likes of Germany and France will be hard-pressed to stave off bank runs and avert the failure of megabanks with heavy exposure to southern European debt.

In sum, we now have three European countries on life support (Portugal, Greece, and Ireland), for whom there would be no financial tomorrow without bailout monies. One country too large to bail out (Italy) has already reached unsustainable levels of indebtedness, and another (Spain) is a few tenths of a percentage point away from following suit. Still another (Belgium) has already fallen apart politically, and is not much farther than Spain from the point of no return. Nobody knows how much exposure the large European and American banks have to the debts of puny Greece, let alone Italy and Spain. It seems likely that the string of impending European sovereign defaults will take down a number of money center banks on both sides of the Atlantic, but how many or which ones is impossible to predict.

What is predictable is that the coming months will see an economic crisis more severe than the Panic of 2008 and its aftermath. In the early going (as has been the case already), Europe's calamity will likely be America's windfall, as investors turn from European to American debt as a safe haven. But when Italy and all the rest actually do default, as Argentina did in 2002, the consequences for the United States, both political and economic, will probably be less benign. For one thing, as the world surveys the financial and political ruin of Western Europe, it will dawn on the investment community that, only a couple of years ago, such an outcome seemed unthinkable. And if such a thing could happen to Europe, it could certainly happen to the United States of America.

Moreover, Europe's crisis will engender large-scale civil unrest, as millions of Europeans find themselves without jobs or bank accounts, and prices spiral skyward. The same will happen here as the Federal Reserve frantically prints money in a last-ditch effort to save us from ourselves (or, more accurately, to save our political and financial insiders from themselves). Continued refusal on the part of our elected leaders to cut the size of the federal government will inflame perceptions that our country is politically unable to change course — the same perception that has sunk Italy.

What is going to happen to the eurozone and the European Union? As many European insiders are now admitting, they made a grave strategic error, in their lust to hasten the day of continental union, in seeking political and financial union without fiscal union. Each member of the eurozone has maintained fiscal independence, resulting in widely varying levels of public debt and very different legal structures for handling public expenses. But it's too late to bandage this wound. The eurozone as presently constituted cannot possibly survive the building financial tempest.

The European Union, on the other hand, is politically as viable as ever. European elites have refused to consider dissolving the EU, no matter the future of its common currency. A likely solution to the problem is cutting the eurozone in two, with southern and northern Europe constituting its two halves. This, after all, was the solution of Diocletian when the Roman Empire slipped into bankruptcy on his watch. The resulting Western and Eastern Roman Empires followed very different trajectories thereafter, with the East eventually morphing into the Byzantine Empire that endured another thousand years even as the West went into a death spiral that ushered in the Dark Ages.

As for the United States, as we have repeatedly warned: Europe's present is likely to be our future.