

# Is the European Union the Next Lehman Brothers?

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**“If passion drives you, let reason hold the reins.” - Benjamin Franklin**

The current financial status of the eurozone is cause for concern amongst investors. In July 2011, the European Council met to propose an end to the Greek crisis by utilizing lower interest rates and a combination of rescheduling/restructuring in the private sector. Many in the European Union (EU) perceived this as special treatment for Greece. The country would have all of their financing needs arranged for the next decade and be assured of paying less than 4 percent on the new debt it is incurring. Ireland and Portugal will have similarly low interest rates and long-term loans, but they are still expected to face the test of the markets in a few years.

While Greece, Portugal and Ireland received financial packages, Spain and Italy have experienced a surge in their borrowing costs. These countries cannot afford to provide billions of Euros in credit to the bail-out plans of other countries. The eurozone's rescue fund, The European Financial Stability Fund (EFSF), simply does not have enough resources to stabilize the market. The EFSF was initially sized to primarily support financing to Greece, Ireland, and Portugal. The number of members that can afford to continue providing for the fund is dwindling. In addition, the debt burden on several countries, such as England, France, and Germany, is growing to dangerous levels. The perceived threat in this situation is the possibility of a domino effect. The financial markets are realizing this threat and are consequently driving up borrowing costs for countries, such as France.

Recent rumors touted that France's credit rating was in danger of being downgraded from AAA, in the much the same manner as the U.S. The French President, Nicolas Sarkozy, returned early from his Riviera holiday to chair an emergency meeting in Paris with his inner cabinet and the central bank chief, Christian Noyer. Promises of new radical austerity measures resulted from the meeting, but the rumors had already triggered a collapse of French bank shares. The shares of one French bank, the Societe Generale, fell 21 percent. The bank was plagued by fears that it might be heavily exposed to the dropping global stock markets because of its role in the equity derivatives market. French banks have 410 billion Euro of exposure to Italy alone.

Financial markets do not wait for a country to be downgraded. Investors look to the possible conclusion being the unraveling of the entire EFSF structure. Other banks who witness the falling bank share prices and widening credit-default spreads, react by refusing to provide the vulnerable banks with interbank liquidity. The ultimate danger would be an immediate recession, much like the one experienced after the Lehman bankruptcy showed.

Difficulties can be traced back to 1999, when the euro was created as a stable currency with low inflation and interest rates. However, there existed no way to counter legislatures in their member countries from spending too much. As small countries joined, they could suddenly borrow as cheaply as industrial giants, such as Germany. Some countries, such as Greece, employed their windfalls to create bigger governments and new jobs. Wages and prices rose, and

their economies became less efficient. Now larger countries fear the compromise of their own finances, by putting more and more money into the EFSF.

Unfortunately, there is no quick solution, and the possibility of countries defaulting increase with each passing day. There have been suggestions of Eurobonds, stronger deficit rules, and the creation of a eurozone finance ministry that could veto government spending. In the meantime, global markets are responding with wildly volatile results. There are very few large companies on the stock exchange that do not have worldwide business ventures. As a result, the concerns in Europe become just as big of a concern in the U.S. equities markets. This is evidenced by the behavior of the markets over the past 3 weeks. The memories of the Lehman Brothers collapse are still fresh in investors' minds. We are hopeful that the EU will be able to resolve their debt crisis and prevent a similar outcome. A single powerful state needs to stand behind their currency in order to achieve a workable solution. Please contact us if you have any questions or comments.