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What's Europe's Biggest Loser? Germany

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DURHAM, N.C. ([TheStreet](#)) -- The debt crisis in Europe is a known unknown. It is obvious there is a crisis, but no one knows how bad it will get. An unanswered question is whether the aftershocks will be strong enough to derail the U.S.'s fragile economy.

There are four facts that are important to understand:

1. Most European banks are insolvent.
2. The European Central Bank is massively monetizing to keep the system operational.
3. Germany is doing a backdoor bailout of peripheral countries by racking up huge IOUs issued by the ECB.
4. The eurozone is now an official "Transfer Union."

Let's go through these one by one.

1. Zombie Banks

We all know that the so-called stress tests aren't really testing a stressed scenario. The latest round of European stress tests showed a short-fall of 115 billion euros. [[Details](#)] It is safe to assume that there is a much larger deficit.

It is instructive to look at the indirect evidence.

- European banks don't want to do business with one another because they don't trust one another's solvency.
- The ECB has had to take extraordinary measures, which include three-year loans at very cheap rates [[Details](#)].
- The ECB has had to allow European banks to pledge lower-quality collateral (because the higher-quality collateral is running out -- or has run out) [[Details](#)].
- Investors are wary of these banks and are shifting business to non-eurozone banks they perceive to be safer.
- Policy makers have imposed and extended short-sale bans on eurozone banks [[Details](#)].

2. Euros, Euros Everywhere

The difference between spin and reality is stark. There has been so much talk about the ECB being stubborn and not willing to turn on the spigot. The reality is quite different.

The ECB balance sheet has exploded to 2.7 trillion euros, which is approaching one-quarter of the eurozone's GDP. This is a bigger expansion than the Federal Reserve undertook in the depth of the U.S. financial crisis. [[Details](#)]

The ECB is also effectively monetizing by making subsidized, three-year, 1% loans to eurozone banks. This is called Long-Term Refinancing Operations, or LTRO. It is simple for the banks to take these loans and then invest in many other assets that are yielding 4% or more. The spread is a direct subsidy to these banks. However, many banks are not doing this. They are taking the loan and depositing the proceeds at the ECB (at a rate of 25 bps) to "reduce" their risk.

As mentioned earlier, accepting lower-quality collateral is another way of monetizing.

The Federal Reserve is involved by making it easier for European banks to get access to dollar funding. [[Details \(subscription may be required\)](#)]

3. Backdoor German-Sponsored Bailout

A number of months ago I highlighted a story in Frankfurter Allgemeine about the TARGET2 system. (It's like the Fedwire system in the U.S.; TARGET stands for Trans-European Automated Real-time Gross settlement Express Transfer.) [Here is a good introduction to TARGET2](#). See pp. 35-40.

It is a fact that the credit risk of the Bundesbank has dramatically increased. Let's just look at one channel -- Germany's trade surplus. It used to be that given the surplus with peripheral countries, Germany could just buy peripheral assets. They are not doing that anymore. Instead, they are taking credits with the ECB in the form of TARGET2 balances.

A massive amount of private savings in Germany is effectively "invested" in the ECB. We all know that the ECB's risk has mushroomed. The balance sheet has expanded to 22% of eurozone GDP; they have increased duration; they have lowered the quality of collateral; and they hold, by my estimates, three-quarters of a trillion euros of peripheral exposure. It is close to 1 trillion euros if we include the near-peripheral countries.

The simple point is that these balances reflect risk that is not fully understood. Germany gets an ECB credit, not a credit from the individual peripheral countries. Presumably, the credit could be fulfilled by printing euros. However, this all assumes that the eurozone carries on.

The Bundesbank has racked up a massive amount of ECB credits. Consider the Deutsche Bundesbank Monthly Report, Section XI External Sector, Table 9 External Position of the Bundesbank in the European Monetary Union, column 7 Claims within the Eurosystem. (I am being specific here because the English version is published two months after the German version.)

- 2007: 84 billion euros
- 2008: 129 billion euros
- 2009: 190 billion euros
- 2010: 338 billion euros
- 2011: 508 billion euros (November 2011 data in [December 2011 bulletin](#) in German)

Note 1. Germany's commitment to the European Financial Stability Facility (EFSF) is only 119 billion euros.

Note 2. The country's commitment to the new 500 billion euro European Stability Mechanism (ESM) is 190 billion euros.

The TARGET2 balance alone is the size of the entire 500 billion euro ESM -- and it is all from one country. It is a massive backdoor bailout.

In my opinion, the Bundesbank's [press release](#) in February 2011 is not helpful:

The size and distribution of the TARGET2 balances across the Eurosystem central banks are, however, irrelevant to their risk exposure from the provision of funds by the Eurosystem: TARGET2 balances do not pose specific risks to individual central banks.

To decode, a country's TARGET2 credit is an ECB liability -- not an individual central bank's liability. The Bundesbank has a credit from the ECB -- not the Bank of Greece. There is no risk -- if the euro survives. But that is a big "if." The explosion in the TARGET2 balance is due to the large German trade surplus, German banks' unwillingness to lend to certain eurozone banks and a flight to quality -- or run, whereby people from all over the eurozone want to get their savings into banks in Germany.

4. Central Bank Arcania

It is very difficult to navigate all of the "central bank arcania," and that is part of the problem. There is a remarkable lack of transparency. This opacity feeds the uncertainty and makes things worse.

A great example was the EBA's July 15, 2011, stress tests (not the most recent one of Dec. 7, 2011), where almost all banks got passing grades. [See report](#). No one believed that at the time -- and now few believe -- that 115 billion is the true shortfall today.

It is also remarkably difficult to figure out what is going on with TARGET2. Yet TARGET2 is now a major risk factor.

It would also be instructive to know where the LTRO money is going. It would be useful to know to what extent banks are engaging in a negative carry trade. (Borrow at 1% and then deposit at the ECB at 0.25%.)

Finally, it would be great to know if there were any solvent banks in the eurozone. Doesn't the public deserve to know? Hiding the bad news never works.

5. The Transfer Union Has Already Happened

Many in Germany fear that the eurozone will turn into a dreaded "Transfer Union." I have news: The Transfer Union is not just a concept -- it has already occurred. The TARGET2 balances are direct evidence of this.

Let's put the question to the German public: "Are you comfortable investing your savings in the ECB credits knowing that the ECB has been degrading the quality of the collateral that it accepts?"

It's just a matter of time. Collateral quality will get lower and lower. It's unsustainable. Just wait for that Greek default to rattle the ECB's balance sheet (directly through the bonds they hold and, indirectly, given the havoc it will cause among eurozone banks.

I think it is ironic that Germany is considered the "winner."

It is true that Germany appears to have done well with the euro. They are the strongest economy in Europe. Their export sector has hugely benefited from a cheap euro. Their trade surplus is 5.7% of GDP, which is even bigger than China's 5.2%.

However, we know there are no free lunches. Now is the time to pay the price.

Germany is in an awful lose-lose-lose situation.

They are a loser if they have to single-handedly continue to bail out peripheral countries. Frankly, who else can afford to do it? The next three biggest countries in Europe -- France, Italy and Spain -- certainly cannot contribute in a big way. The latter two are recipients! The U.K. is on the sidelines. But Germany does not have unlimited resources. Remember they are offside already on the debt-to-GDP measure.

They are a loser if the ECB continues to monetize. This likely means future inflation which is simply a tax that especially hurts Germany -- not just because it is wealth, but because of their history and the country's extreme aversion to inflation.

They are a loser if the eurozone breaks up. A new deutsche Mark or new euro based on subset of strong countries would soar in value. This would be devastating for the export sector (which is 46% of German GDP). I previously speculated that Germany could lose half of its exports on a revaluation. While export revenue might remain the same (if the value of the currency doubled), it would be devastating for certain industries -- and lead to severe unemployment -- another thing that Germany has a strong aversion to.

6. Link to the U.S. Experience

To really answer the question of whether Germany is better off under the euro, let's explore a recent parallel example -- the U.S.

The Federal Reserve maintained a policy of very low interest rates -- on a real basis, negative interest rates, for an extended period under former Chairman Alan Greenspan. The result of this policy was an economic boom largely driven by construction and housing. Consumers were refinancing their mortgages at lower rates and doing "mortgage equity withdrawals" (increasing their mortgages and using the extra money to spend). The U.S. is now paying the price for this structural dislocation. The U.S. is facing a "lost decade." Is the U.S. better today off as a result of the cheap interest rate policy? No.

Now to Europe. Countries like Greece, Italy and others were faced with the ability to borrow at very low (German) interest rates. They exploited this cheap financing -- just like the U.S. construction industry did. Germany was booming with exports and running a massive trade surplus given the cheap exchange rate.

Now they realize there is a price to pay. It is not the question of are they better off right now. You need to factor in the future costs.

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