WILL A EURO CRISIS SET OFF A U.S. RECESSION?

History Says No.

Joe Calhoun has graciously agreed to let me pen a monthly article here in the Alhambra Investment Report. By way of introduction, I'm an economist with a deep respect for the "Austrian" school of economics, and my day-job is teaching at a business school in Asia. I ran money through our two most recent boom-bust cycles (the dot-com drama and the Financial Crisis), and am the editor of the Austrian Investment Monthly. I blog at Profits of Chaos.

In these dog days of June, Europe's financial drama is in the news again. In a re-run we've been watching for going on a decade now, the Greeks are once again playing chicken with the hapless Germans.

Greece, naturally, would like the Germans to give them more money. And Germans, naturally, would like the Greeks to learn how to pay a bill.

The worst-case scenario for near-term financial markets ends with Greece getting kicked out of the Euro for being a deadbeat -- a "Grexit" (Europeans, inexplicably, like putting "xit" on the end of their country names when they leave monetary unions).

Of course, Grexit's just the beginning: Even if things turn out well for Greece, it might not end there since there are lots of other deadbeats in the Eurozone -- Spain, Italy, Portugal, possibly France. Spexit, Frexit, you get the picture.

For those of us outside Europe, the important question is whether an Exit might topple Europe's financial sector. And whether a European financial crisis sets off a recession in the US and, by extension, the rest of the world.

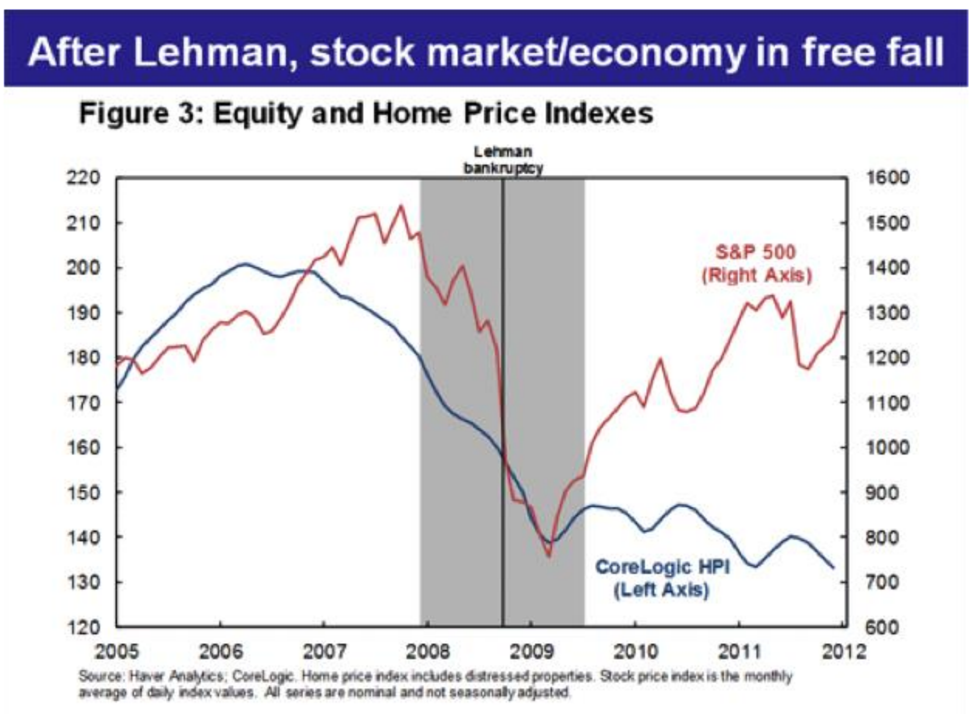
That makes it a great time to talk about the relationship between financial crises and recessions.

The first thing is that a recession and a financial crisis are completely separate phenomena. They often occur together, for the simple reason that both are set off by rising capital costs. But one does not cause the other.

Why does that matter? Because a financial crisis all on its own will not set off a recession. And a recession will not, on its own, set off a financial crisis.

So that’s the first thing to get out of the way: crises and recessions share a father -- rising capital costs -- but they do not cause each other.

Let’s run though, briefly, what causes the typical recession. Interest rates are suppressed by central banks in order to spark a short-run investment-led boom (some of the money “leaks” into boosted consumer spending as well). Easy money eventually leads to inflation, which central bankers fear. So at the slightest hint of inflation they yank up rates, which chokes off investment (and “leaks” out of consumer spending now). Essentially, central banks are driving a car by alternately stomping on the gas and the brake. Thus is born the cycle, and the key mechanism was manipulation of interest rates.



Financial crises, on the other hand, are a whole different hustle. The key here is bailouts.

Governments have, for well over 200 years now, allowed the financial sector to discharge their bad debts. In the old days banks got permission to postpone their debts – suspension of "specie redemption" if you've got a free afternoon to browse economic history.

Nowadays it's more brazen -- governments simply assume the debts. These bailouts have gotten more brazen over time: starting with government bailouts of bank deposits (the FDIC), they were gradually extended until they, absurdly, covered hedge fund gambles (LTCM, in the 90's).

The problem is that bailouts create what economists call "moral hazard": the idea that if you tell a gambler you'll cover his debts he'll get more reckless. Bailouts, then, encourage risky behavior. Banks know that risk pays -- leveraging your money 10-fold will earn you great profits. But they wouldn't be so reckless with their own money. It's only when governments (well, taxpayers) cover their losses that banks go wild.

This is why crises are related to recessions: when interest rates are hiked, it sets off a chain reaction of credit distress. This distress is resolved through the recession. But the credit distress will stress the financial system as well, since some debts will go bad. This stress is what can set off a financial crisis, which is basically when a lot of people can't pay each other at the same time. This is precisely what happened in 2008.

So the first question is whether a Grexit (Spexit, Frexit) might set off a financial crisis in Europe. I think it's possible but unlikely. Possible because Euro assets are currently priced on the assumption that countries can't leave. If it becomes possible to kick out countries, then a lot of financial assets get repriced. They get repriced because their risk profiles change.

For example, Greek bonds are today only holding any value at all because of the possibility that Greece's fellow Eurozoners bail them out. If Greece is out, those bonds are probably worthless. Meaning any loans for which they are collateral -- Greek mortgages, perhaps -- are also worth less. The chain continues, ripples from a stone tossed in water.

Eurozone bankers and regulators know this "contagion" risk exists. So the question becomes whether they're fully insulated against it. The optimistic argument is that, with 2008 so recent, Europe has quantified their risks and insulated. The pessimistic argument is that these risks are essentially impossible to quantify so they are not insulated.

Then there's the third possibility, which I think is likely: the risks aren't fully insulated, but we get a benign outcome because the EU stands readier than ever to bail out banks. The idea is that, paradoxically, the crisis of 2008 made for more riskmaking in financial markets, but less catastrophe. Simply because the great question pre-2008 of "Will gamblers be bailed out?" has now been answered with a resounding "Yes!"

Of course, this is terrible if you're a taxpayer, but we're talking investor here. And, for an investor, I think 2008 substantially reduced systemic risk. If only because it established the expectation in financial markets that catastrophic risks will be bailed out. That we're all "too big to fail" now.

How to invest all this? I think there's a small chance of a European financial crisis causing damage world-wide. Eurozone countries in general do not want Exits (monopolistic organizations like to keep their members). A lot of brainpower has gone into insulating.

Moreover, even if we do see Exit and failure-to-insulate, EU governments (and even the US) stand ready with essentially unlimited bailouts. I wouldn't necessarily want to be a French or German banker in the ensuing public backlash, but I don't think the crisis gets to the point that it infects the rest of the world.

So my best guess is that, in the small chance of a Eurozone crisis, we see short-term declines in overseas markets, as risk gets repriced upwards. I don't think it will be lasting, and I think soon enough we turn to the separate question of when we're due for our own recession. Which, as regular readers know, I think is awhile off yet.

Peter St. Onge, Ph.D.
Economist for Alhambra Investment Partners, LLC

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For information on Alhambra Investment Partners' money management services and global portfolio approach to capital preservation, please contact Alhambra at:

786-249-3773
Jyc3@alhambrapartners.com