Armchair Economics

Perspectives from an everyman for the everyman

The Butterfly Effect

February 2010

The Butterfly Effect is used to describe the sensitive dependence disparate things seem to share. The concept comes out of Chaos Theory, not something most of us spend time considering, but the basic idea is pretty simple…for every action there is a reaction. In our world these last few years it seems for every action there has been an unintended consequence, almost all of which lately have had a negative effect on our economic circumstances.

The phrase refers to the idea that a butterfly's wings might create tiny changes that ultimately alter the path of something in a seemingly different area altogether. The flapping wing represents a small change in the initial condition of systems, which causes a chain of events leading to large-scale alterations of events. Had the butterfly not flapped its wings, the trajectory of a system might have been vastly different.

Within the myriad of 2010 predictions in January's Armchair was that " sovereign default risk will become the top global economic concern". It sure didn't take long for that prediction to reach the top of global economic awareness. Will Greece default? Let's get some quick perspective…

I'm still trying to find further confirmation of these numbers, but recently read that Greece is projected to have a \$50B budget deficit this year, that California is projected to have a \$40B deficit this year and that Greece's GDP is 20% of California's. Whoa buddy! Who would want to own any Greek debt?

These numbers might be inflated for sensational value but odds are good the relevant relationship exists…Greece is way way out of control. And given all the PIGS talk, (Portugal, Italy, Greece, Spain), one would expect these countries have similar economic challenge. Spain's "official" unemployment is reported at 20%. Can you imagine that in the US? Some are suggesting France is not in the best of shape itself, moving focus beyond the PIGS to the "Olive Belt" of southern Europe.

Will the EU come in and save the Olive Belt? At this stage who is left in the EU that can come to the rescue? Belgium? Slovakia? Finland? Estonia? It is obvious why all eyes are focused on Germany.

Will the German's save the EU? If German financial institutions hold a mountain of Greek debt the odds are good they will try to save the EU, to save themselves…at least for the near term. But one must be very careful trying to save a drowning man….and what of several drowning men? It takes excellent economic lifeguard skills to not get pulled under in the struggle to stay alive. There's not much room for lifeguard error and drowning victims are not always so cooperative.

Any form of bailout will come with severe austerity measures for Greece and their Olive Belt neighbors. Wages and benefits will have to be cut. Government budgets will have to contract. Government workers will have to be laid off. Taxes will have to be raised. Many years of economic misery will set in.

Will unions, pensioners and voters of these countries make personal sacrifices for the sake of their sovereign debt holders? Do the citizens within the EU care as much about this common economic union as the bureaucrats? It seems we are about to find out.

As a few friends have heard, I believe that once a Black Swan surfaces it is highly likely conditions are good for others to follow. Only after many years of not seeing one can we rest easier that they have migrated far enough away to no longer be feared...which is probably the time we should start doing so. Today that Black Swan gate is likely still wide open.

Our next Black Swan event could be the risk of EU sovereignty. This is a bit difficult to understand since the EU is not a sovereign nation but instead more of an economic union that developed from European insecurity with its economic competitive position. Although an economic union of sort, it is not a true sovereign nation.

Therein lies part of the EU's problem. They are bound together by a common currency but they are not bound together by common culture, which means they are not bound together by common values across its geography. These cultures have been distinctly different much much longer than they have attempted to be economically common.

For those that don't remember, the EU was established by treaty in 1993. That was not twenty years ago. So any thought that the "institution" of the EU has a firm foundation may be quite naïve. Milton Friedman suggested the EU would not survive its first major economic recession and today's conditions seem to suggest his prediction may soon come true.

So today, with Greek butterfly wings flapping, an integral part of the recent global economy may now be at risk. Large amounts of pain and suffering of a post Lehman scale may soon rise again. Either the EU is going to fall apart or fiscally profligate countries are in for many years of economic misery. Actually it appears this misery is unavoidable, as there seem to be only three options here.

An EU break up would surely be chaotic, not something that will inspire worthwhile economic activity. Just imagine the finger pointing, bruised egos and especially the infrastructure collapse and struggle rebuilding country by country.

Default by Greece likely spreads to others in the Olive Belt hammering institutions holding that sovereign debt, most of which are likely European. Here comes another banking crisis and its myriad of probable contagion across the globe. Default would also severely contract access to new outside capital for countries, not helpful to restoring worthwhile economic activity.

The seemingly most palatable choice of bailout though would come with severe economic constraints on those being bailed out…but then given an economy 20% the size of California how can Greece ever pay back more debt than California? The lifeguard risks going under with the victim.

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The EU is boxed in with seemingly no easy way out. Yet there is a small sliver of sliver lining within all these perfect storm clouds.

The Butterfly Effect may provide some near term stimulus to the US. This EU challenge is going to cause capital flows out of Euros and into other currencies and/or assets. And with virtually no other currencies with a large enough float for Euro holders to trade into, the US dollar might soon rise dramatically.

Some flow of funds out of Euros would likely find its way into US Treasuries, helping to keep those interest rates low. This flow could also inspire foreign purchases of US assets, putting money into US pockets that can boost consumption and/or savings or at minimum improve balance sheets. And a rising dollar will likely inspire lower oil prices, another boost to US consumption and savings potential. All this could inspire US job creation, seemingly the most important political re-election issue and likely the most important US economic issue.

But the boost from EU capital flows to the US may only be temporary. If these capital flows make it easier to sell more cheap debt then Washington may lose the political will to tighten our own purse strings. And if capital flows relieve voter economic anxiety then fiscal responsibility focused tea party movements may lose momentum. There's nothing like "prosperity", whether real or perceived, to numb the mind of self-discipline.

In the end the US itself must get its house in order. Fiscal deficits as far as the eye can see are ultimately unsustainable. Eventually the buck has to stop somewhere. It may soon stop in the EU, but any near term relief to the US should be considered a gift rather than a solution.

Should the US not be able to use this opportunity to fix its own infrastructure and systems then not long after the EU collapses capital will flow back there in search of bargain opportunities. Who wouldn't want a house in Tuscany for 50% off?

Even this seemingly positive potential to the US carries its own set of unintended, maybe better said, unwanted consequences. A stronger dollar makes US exports less competitive. And Europe is the US' largest trading partner and export market. A weakened Europe leads to a weaker global economy.

Will the flow of investor capital to the dollar and US assets be a tipping point that moves the US from Washington inspired to organic growth? It is likely prudent not to assume so, but at this stage of economic evolution the US should be happy with any good fortune it can get it's hands on.

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