



In this issue:

Where is the ECB Printing Press?

By John Mauldin | November 12, 2011

Where Can I Find 3 Trillion?
When Leverage Comes Back to Haunt You
The German Dilemma
So How Do We Solve the Eurozone Problem?
Where Is the ECB Printing Press?
DC, Cleveland, and New York

Europe remains the focus of markets, and rightly so. But the picture is not as clear as one would like. Different analysts point to different problems if only this one problem could be solved, then all this would go away, they tend to say. Sadly, it is not one problem but three that must be solved, and none of them is easy. In today's letter I try and offer a basic primer on the problems facing Europe. My challenge to myself is to do it in a short piece rather than the book-length tome it could easily become. Thus, in the pursuit of brevity, we will not be as in-depth as usual, but I think it helps us to step back a few feet and look at the larger picture before we focus on minutiae.

Where Can I Find 3 Trillion?

First, for the record, the European issue is not a crisis of confidence, as Merkel and Sarkozy, et al., keep telling us. It is structural. And until the structural issues are dealt with, the problems will not be solved.

The first problem facing Europe is the glaring sore thumb: there is simply too much sovereign debt in Greece, Ireland, Spain, Italy, Portugal, and Belgium. That is not news. What has yet to be absorbed by the markets is that the cost of bailouts, present and potential, is likely to be in the 3 trillion range, talking an average of the estimates I have seen (with the Boston Consulting Group suggesting 6 trillion). 3 trillion is not pocket change. Indeed, it is a number that is inconceivable in scope.

Greece has been told that they can write off 50% of their debt held by private entities, but not that owed to the IMF, ECB, or other public entities. This means something more like a 20-30% haircut on total debt. Sean Egan suggests that eventually Greece will write off closer to 90%. That is a number that cannot be contemplated in polite European circles, as it is plenty enough to cause a serious banking crisis.

And that is before we get to the rest of the problem children. Portugal will need at least a 40% write-off (probably more!). The Irish are going to walk away from the bank debt they assumed in the banking crisis. While on paper Spain looks like it may survive, in reality it has significant problems in its banking sector. If they move to insure the solvency of their banks, their debts become unmanageable, not to mention that their debt grows each and every month from the rather large



deficits they run and seem totally unwilling to try to reduce. The Spanish government deficit is likely to be at least 7% next year, well above their target of 6%. The semi-autonomous regions are in deep trouble, and their citizens are leveraged due to excessive real estate exuberance. Unemployment across Spain is 21%, and for the young it is over 40%.

The Spanish government has adopted the rather novel idea that if it doesn't pay its bills then its deficit will not be as large and therefore they can get closer to meeting their targets. Yields on Spanish debt are about 1% lower than on Italian debt, but give them time.

And then there is Italy. Italy is simply too big to save. Yes, it looks like Berlusconi is leaving, but he is not the real problem. The problem is a 10-year bond yield at 7%, when your debt is 120% of GDP and growing. Italy is likely to be in recession soon, which will only make the problem worse. A drop in GDP while deficits rise means that debt-to-GDP rises faster. That means interest-rate costs are rising faster than (the lack of) growth in the economy. The deficit is a reported 4.6%. By contrast, Germany's is 4.3%. But the difference is the debt. The market realizes that if you grow debt by 5% a year, it will not be but a few years until Italy is at 150%. There is no retreat without default from such a number, and the markets are saying, We've seen this movie before and the ending is not a happy one. We think we'll leave at intermission.

The ONLY reason that Italian yields have dropped below 7% is that the European Central Bank has been buying Italian debt in size. Any retreat by the ECB from buying Italian debt and Italian yields shoot to the moon. Italy will need to raise close to 350 this year, including new debt and rollover debt. The higher rates will put even more pressure on the deficit.

Debt, whether it is with an individual, a family, a city, or a country, always has a limit. Debt cannot grow beyond the ability to service the debt. That is the clear lesson of Rogoff and Reinhart's epic work, *This Time Is Different*. When that limit is reached, the debt must be restructured in some way, either with better terms or through some sort of default.

Mediterranean Europe simply borrowed more than it could pay, given the cash flows of the various countries. And now we are at the Endgame. How can one deal with the debt?

The best solution is to figure out how to grow your economy faster than the growth of debt. Over time, debt service becomes a smaller part of the economy. But Southern Europe does not seemingly have that option. Certainly not Greece, Portugal, or Spain; and this week we learned that Italian production was off 4.8%. Europe, even Germany, is slipping into recession.

Germany is in the position of wanting the problem countries to cut their deficits through something called austerity. And living within your means is hardly a novel idea. It makes a great deal of sense. But when you are a country in recession and have to cut back, it only makes the recession worse for a period of time. Asking Greece to cut its deficit by 4% a year for 4 years to get to something closer to balance means that the Greek economy will shrink by at least 10%, if not more. Tax revenues, never on solid footing, will shrink, making the deficit worse. How do you ask people to willingly enter into a depression for a rather long time in order to pay back the banks, even if the debts were freely taken on by the government and the money spent on the populace, and even if the haircuts are 50%?



Yes, if Greece leaves the euro that means they will also have a depression. No one will lend them money for at least three years. Their banks will be insolvent, their pension funds destroyed. Their ability to buy needed materials (like oil, medicines, etc.) will be limited to the amount of goods they can produce and sell. Government employees will be forced to leave jobs, as there will be no money to pay them. Those on government pensions will get a fraction of what they were promised. Going back to the drachma will be painful in the extreme. Just as staying in the euro will be painful. Greece has no good choices.

There are those who suggest that Europe is demonstrating the failure of the socialist welfare state. And there is some reason to say that. But I don't think the socialist welfare state is the cause of the debt crisis. One can have a welfare state without debt, if you are willing to run a sensible budget. Think of the Scandinavian countries.

And you can have countries without much social welfare get into debt problems. There are plenty of examples in history. Amassing large amounts of debt is a national problem that has as much to do with character as anything else. That is true for families or for countries. It is wanting to spend for goods and services today and pay for them in the future.

Debt has its uses. Properly used, it can be of great benefit to societies and families. People can buy homes and tools that can be used for the production of goods, build roads and other infrastructure, etc. But debt cannot be allowed to become the master of the budget or the source for current spending, again whether for families or countries. And Greece and its fellow countries have used debt to fund current spending and now have run up against the inability to borrow more at sustainable levels.

The easy answer is to cut spending. But when you cut back spending, even borrowed spending, it is going to affect GDP. It is something that may have to be done, but it is not without consequence. Ireland, a small country of 4.2 million people, just paid close to 1 billion to service debt that it owes for taking on the debts of its banks that went bankrupt. That is hugely unpopular in Ireland, and it will not be long before the Irish government simply says no. If the current one does not, then there will be a new one that does. Unless the Irish renegotiate their debt, they will be paying on it for decades. Debt that was private debt and paid to European banks (who lent to Irish banks) is now public debt. And it is a punitive and crushing debt.

We can go to each problem country and home in on its own particular situation, and the answer almost always seems to be that the debt must be dealt with in some manner that either directly or indirectly amounts to default. (Even if the Eurozone leaders say that a 50% haircut by a bank is voluntary. Yeah, right. European leaders have a different understanding of *voluntary* than I learned in school.)

But that is the problem. The European Commission is trying to figure out how to find 1 trillion to use to bail out southern Europe and Ireland. They so far cannot, and the market recognizes that fact and that the needs are actually much higher. European leaders cannot (at least publicly) fathom how to find 3 trillion. But whether or not they can find another few trillion, that debt will have to be restructured or defaulted. Once you go down that path, as they have with Greece, it is just a matter of time before you have to do the same for Portugal and Ireland; and are Spain and Italy close on



their heels?

When Leverage Comes Back to Haunt You

European regulators allowed their banks to leverage up to 450 to 1 on their capital, on the theory that sovereign nations in an enlightened Europe could not default, and therefore no reserves need to be kept for investing in government debt. And with those rules, banks borrowed massively and invested it in government debt, making the spread. It was an awesome free profit machine. Until Greece became a road bump. Now it is a nightmare. Even if you only invested 4% of your banks assets in Greek debt, if that is more than your capital then you are bankrupt.

Irish banks were foolish and invested in Irish real estate that was in a bubble. They went bankrupt. Spanish banks were even more heavily leveraged to real estate, but have yet to write down their debt. They assume that houses will only lose about 15%, rather than the 50% that the real world is suggesting. And you can get away with that for a time if you own the agencies that rate the real estate debt, as the Spanish banks do. But most of the rest of European banks are going to go bankrupt the old-fashioned, tried-and-true, proven-over-the-centuries way: by buying government debt. Somehow they want to be seen as rational in leveraging up government debt.

As I told the Irish crowd last week, don't worry about your bank debt; all you have to do is wait a little while. When French and Italian banks (and most of the other banks in Europe) are publicly insolvent and have to go to their respective countries and the ECB for capital, the relatively small amount (by comparison) of Irish bank debt will not even be noticed when you default. I was trying for a little humor, but there is a core of truth in that glib remark.

France cannot afford to bail out its banks. As we have seen this week, they are already in danger of losing their AAA rating, as a false (premature?) press release from S&P suggested. (Someone is in trouble for that one! Seriously, you think S&P is not ready for this? There is reason to believe, I hear, that this was a draft for use later. Well see.) France will want the Eurozone to bail out their banks, and that means the ECB. If France gets such a deal, Ireland will certainly demand and get one, too.

The German Dilemma

And that brings us to the third problem, which has two parts: (1) the massive trade imbalances in Europe, where Germany and a few others export and the rest of Europe buys, And (2) the fact that German labour is far cheaper on a relative basis than Greek or Portugal labour (or that of most of the rest of the Eurozone). German workers have seen very little rise in their incomes, while Southern Europe labour costs have risen to over 30% higher.

I won't go into the details (I have written about this before), but there is a basic rule in economics. You can reduce private debt and you can reduce public debt and you can run a trade deficit. But you can only do two of the three at the same time. The total of the three must balance.

Greece runs a massive trade deficit. They are also attempting to reduce their government debt, and private debt (that borrowed by business and consumers) is being forcibly reduced, as the banks are in full retreat.



Greece must therefore endure a large reduction in its labour costs if it wants to reduce its government deficit. Sell that one to the unions. (By the way, Irish public unions took a large reduction, as did pensioners. Different political climate and country.) Germany seemingly wants the rest of Europe to behave like Germans, except that they also want them to continue to buy German products and run trade deficits, while Germany exports its way to prosperity.

In the old days of a decade ago, a European country could simply devalue its currency and adjust the relative value of labour that way. But with a fixed currency there is no adjustment mechanism other than reduced pay or large unemployment numbers, which eventually translates into lower wages.

Essentially, the southern part of Europe is on an odd sort of gold standard, with the euro being the fixed standard. And the adjustments are painful. There are no easy answers if you stay with the euro. And leaving is its own nightmare.

So How Do We Solve the Eurozone Problem?

Lets quickly look at options for solving this.

1. The Germans (and the Dutch and Finns, et al.) can simply take their export surplus and taxes and savings and pay for the deficits in the southern zone until such time as they can be brought under control. Or they can bail out all the banks. Not just their own but throughout Europe, as a customer without a banking system cannot buy your products. That seems to be a political non-starter.
2. The problem countries can make the extremely painful adjustments, cut their deficits, and enter into a lengthy depression. That also seems to be a political non-starter.
3. The Eurozone can forgive enough debt to get the various countries back to a place where they can function, nationalizing the banks that hold the debt, which would lead to a Europe-wide deep recession. Possible if the Eurozone leaders can sell it, but it is a tough sell.
4. A few countries (2? 3? 4?) can leave the Eurozone. If this is not done in an orderly fashion, the chaos will reverberate around the world.

All of the above paths (or some combination of them) mean a banking crisis and chaos and long-term recessions. These are not pretty paths. But the above options assume that the ECB remains true to its Bundesbank core. Which brings us to the next solution.

Where Is the ECB Printing Press?

It is hard for us in the US to understand, but the commitment of European leaders to a united Europe is amazingly strong. They will do whatever they think they must do (and/or can sell to the voters) to maintain the European Union.



As a way to think about it, the US fought its most bloody war over the question of whether or not to remain a union. I think you have to call that commitment. While I am not suggesting that Europe is getting ready to start a civil war, I think it is helpful to remember that commitments to an ideal can drive people into situations that others have a hard time understanding.

Lets summarize. There is too much debt in many southern countries; and while I have not yet mentioned it, France is not far from having its own crisis if they do not get back into balance. And if they lose their AAA rating, then any EFSF solution is just so much bad paper.

The banks and banking system are effectively insolvent. There are large trade imbalances that make it almost impossible for the weaker Eurozone countries to grow their way out of the problem.

The path of least resistance, and I use that term guardedly, is for the ECB to find its printing press. Perhaps they can borrow one from Bernanke. Yes, I know they are buying sovereign debt now, but they are sterilizing it, meaning they sell euro paper to offset the monetary base effects (large oversimplification, I know).

But the money to solve the crisis does not exist. The only way to find it is for the ECB to print money and print in size, enough to lower the value of the euro and make exports cheaper (which gives southern Europe a chance to grow out of its problems). Which is of course something the Germans vehemently oppose, as it goes against their core DNA coding.

But the choice is print or let the euro perish. I see no other realistic solution, aside from massive austerity, willingly accepted by Europeans everywhere, along with the nationalization of their banks, etc., as described above. I think there is even less willingness to endure all that.

It is a hard choice, I know. If you held a gun to my head and asked, What do you think they will do? I would have to say, I think the ECB prints. But not without a lot of rancour and solemn pledges and maybe a rewriting of the treaty in order to get Germany to go along.

The choice is between a much lower euro or one that is far different from today's, with a number of countries having left it. There are no good or easy choices.

As a closing aside, a lower euro means lower US and emerging-market exports (Europe is Chinas biggest customer!) to Europe and more competition from Europeans in what the rest of the world sells to each other. It will be the beginning of serious trade issues and when coupled with the collapse of the Japanese yen, circa 2013, will usher in currency wars and protectionism. This will be a decade we will be glad to leave in 2020.

DC, Cleveland, and New York

I leave on Sunday for a few days to go to DC to speak at the UBS national wealth management conference. I hope to see my friend Art Cashin there, as well as finally meet Ken Rogoff, for whom I am an admitted groupie. Next weekend I will take a day trip to Cleveland and the Cleveland Clinic for some medical work. Mike Roizen is going to see what he can do to keep this 62-year-old body going for a few more decades. It is getting stiff! Then Thanksgiving, my favourite holiday, followed



by a very quick trip to NYC with Tiffani for some business, media, and friends.

I had great fun in Atlanta this week. Hedge Funds Care raised over \$100,000 to help abused children, a very worthy cause. Last Monday I was with my daughter Melissa for her 31st birthday dinner. I was sitting across from her, and some of her friends asked where I was going next. Atlanta, I said.

What are you doing there?

I am going to speak at a fundraiser for Hedge Funds Care, was my short answer. They were aghast. There's a charity for hedge funds? That's just wrong!

I couldn't resist. I went with it. Absolutely. Not a lot of people know or care, but a lot of hedge funds went bankrupt in the crisis in 2008. The managers lost their jobs and everything. Think of their kids! They had to leave their private schools, give up their cars and vacations, and lost their credit cards. It has been hard on them. Someone has to help, and we need to take care of our own. I totally sucked them in. It was fun until Melissa burst out laughing And teased them for being gullible.

Trips in the US somehow don't seem all that bad any more. Just a few hours on a plane, reading and writing. It is the long international trips that wear and tear the body, I am thinking. Tomorrow I sleep in, trying to catch up.

By the way, be on the lookout for a very special note from me later next week. I am working on a special offer of some of the best business marketing advice I have ever seen (which has sold for tens of thousands of dollars as seminars, papers, books, etc.), and I have arranged for my readers to get it totally free. My little way of trying to help. And now I will hit the send button and relax for the rest of the night. Have a great week!

Your still having fun analyst,

John Mauldin

**Copyright 2011 John Mauldin.
All Rights Reserved**