Whatever It Takes

By John Mauldin | February 20, 2013

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> Lord Melchett: "Farewell, Blackadder [hands him a parchment]. The foremost cartographers of the land have prepared this for you; it's a map of the area that you'll be traversing. [Blackadder opens it up and sees it is blank] They'll be very grateful if you could just fill it in as you go along. Bye-bye."

– From the English comedy series *Blackadder* (Part 2, Episode 3)

Was it only a few years ago I visited the Emerald Isle of Ireland? So recently had this fair land come to such a sad state. The collapse of its largest banks foreshadowed the demise of many other European banks that had borrowed money from British, German, and other European banks to lend against homes and property. The Irish government had to guarantee deposits and bond holders in order to prevent a bank run. I think I am correct when I state that the Central Bank of Ireland was the first central bank to avail itself of large-scale use of the Emergency Liquidity Assistance (ELA) provision of the European Central Bank. This was before we became so familiar with the process in Greece.

The Irish banks had lost a combined €100 billion, borrowed largely from other European banks, which would also have incurred great losses had the Irish government not stepped in. You have to remember that this was before Greece and Spain needed assistance, although as Ireland stepped up to the table, the acronym "PIIGS" was coming into vogue; and some of us were writing about the debt problems that plagued Greece and other peripheral countries. The European Union compelled the Irish government to bail out its banks, and so the Central Bank of Ireland took on the debt (via the ELA) of the six main Irish banks that had failed because of the property bubble.

In the "bailout," Ireland received €67.5 billion (and in addition borrowed another €17.5 billion from its pension and cash accounts), which it pledged with a promissory note to pay back. The public was quite upset, and the government was then overwhelmingly rejected at the polls, in a clear show of sentiment demonstrating that the Irish people did not view that bank debt as something that should be on the public balance sheet.

Government workers had to take large pay and pension cuts and government services were cut, as one of the conditions for getting the money was significant austerity. This was before "austerity" became a bad word in Europe. Meanwhile, unemployment rose from 4% to 14%.

I visited Ireland after the new government took over. I met with some two dozen business leaders, politicians of all persuasions, journalists, and economists. I remarked at the time that the only thing they agreed upon was that Ireland would never pay that bailout money back. A former prime minister told me that they would not have to openly repudiate the debt, but rather were expecting, after Greece and other countries were allowed to default, to be invited not to pay it.

A leading Irish economist who was at the negotiating table told me point-blank that the IMF negotiator told them they would not have to pay it back. But you have to remember that at the time there was true panic and no road map for dealing with such a crisis. Something had to be done. That something was the issuance of bailout funds (which conveniently minimized losses at said German, French, and British banks), which came with a private assurance to Irish leaders that whatever was done for other countries would be available to them as well. "But please, just work with us right now?"

So the Irish, as we say in Texas, took one for the European team. The blow left a rather ugly scar, as the national debt ballooned into impossible-to-manage territory, crippling the national government.

But there was one group in Ireland that was aghast – horrified – at the idea of not paying back that debt: those were the people I met at the Central Bank of Ireland. And they did have a point. The document that created the European Central Bank did not allow a national central bank to not pay its debts. Governments could default (as we learned with Greece), but not national central banks. Those were the rules that everyone who adopted the euro played by.

At the time, I wrote that the Irish would not pay that debt. I had listened to the 99% of the people who told me so. Silly me. Yet, the last two weeks have seen the Irish convert their promissory note into government debt and agree to sell bonds. So it looks like the Irish will pay after all. Except that when you read the details, the Irish (after a great deal of controversy ensues) will end up either not actually paying or not paying anything close to the value of what they borrowed. So how can they both pay and not pay? That is the topic for this week's letter; and an instructive reading it is, not for what it tells us about Ireland but for what it tells us about the EU, the eurozone, and the future of the euro.

Who's Got the Map?

Fans of British comedy will recall fondly the early-'80s series *Blackadder*, originally about a self-serving courtier of Queen Elizabeth (played by Rowan Atkinson, who later became known in the US for his role as Mr. Bean). At one point, Blackadder is compelled to sail around the Cape of Good Hope in order to remain in the Queen's good graces. The voyage seems, of course, like a death sentence, and Blackadder never intends to sail. His nemesis, Lord Melchett, offers him a map and voices the lines quoted at the beginning of this letter. The map is a blank page. "It's a map of the area that you'll be traversing. They'll be very grateful if you could just fill it in as you go along. Bye-bye."

The document that created the eurozone is right along the same lines. Everyone thought they knew what it meant, or at least the Germans did. The Bundesbank (the German central bank) was quite sure that it prevented monetization of debt. It said so right there in Article 123. But the EU and the ECB (with their faithful companion the IMF) seem to be constantly wandering off into uncharted territory. Banking, credit, and sovereign debt crises seem to require legal maneuvering that was not explicitly detailed in advance. As the rest of Europe looks on, the ECB draws in lines on the map as it goes along.

Article 123, as every good Bundesbank member will tell you, explicitly says there will be no debt monetization. But it turns out that while everyone agrees that monetization of national debts is a bad thing, the definition of monetization is not as clear to much of the rest of Europe as it is to the good German burghers.

Wolfgang M*ü*nchau writes rather merrily about the recent "rescheduling" of Irish debt:

> Everybody seemed to be talking about monetary financing of debt last week – the ultimate taboo in monetary policy. And hidden behind a veil of unbelievable complexity, the eurozone may have done just that.
>
> Various European central bankers rushed to proclaim that the agreed rescheduling of Ireland's so-called promissory notes would not set a precedent for sovereign debt laundering. In legal terms, the agreement is probably watertight. It may be a borderline issue, but who cares? In economic terms, the situation is much clearer. This is monetary financing in all but name – and a jolly good thing it is too. *(The Financial Times)*.

All this can get quite complicated (trust me). But it essentially boils down to this: Anglo-Irish Bank was bankrupt. The Irish government had to come up with some type of collateral that it could hand to what was in essence a bankruptcy trustee in order to be able to borrow at the ELA (Emergency Liquidity Assistance, sometimes referred to as "Lending Assistance"). The government gave the trustee a promissory note that was supposed to be paid off rather quickly (in ten years). It quickly became a large financial burden for Ireland's government – and a very sticky political problem. Only an Irish central banker could love that debt.

But someone in Ireland came up with a very creative solution. They turned that 10-year note into 25- to 40-year bonds. The interest that the government pays on the bonds to the Central Bank of

Ireland goes right back to the government. M*ü*nchau is right: this is monetization in all but name. But there is a small fig leaf that keeps it from being outright monetization: the CBI agreed to sell the bonds into the marketplace over time, as the situation dictates. From the Irish Department of Finance press release:

> The Central Bank of Ireland will sell the bonds but only where such a sale is not disruptive to financial stability. They have however undertaken that minimum of bonds will be sold in accordance with the following schedule: to end 2014 (€0.5bn), 2015-2018 (€0.5bn p.a.), 2019-2023 (€1bn p.a.), 2024 and after (€2bn p.a.).

Let's put that in context. Ireland issued €2.5 billion in 5-year bonds last month, which are now yielding 2.8%, less than Italy's corresponding bonds. That is also less than the 5.9% the Irish paid last summer when they first came back to the market. (Someone made a rather large profit on those bonds!) The bank deal has evidently reduced the cost of Irish bonds for the government. They expect to raise about €10 billion this year. Right now, issuing another €0.5 billion in bonds is rather easy for them. Granted, the government has to pay the interest to what will be private bond holders, but that is far less than they were paying.

By switching to lower-interest-rate bonds and stretching out the burden of repayments over four decades, Ireland will save itself €20 billion ($26.78 billion) over the next decade and free up €1 billion for future budgets. Goodbody Chief Economist Dermot O'Leary was kind enough to send me a private client letter that shows what a large help this move will be to the Irish government. It gives them a much better chance to actually reduce their deficit to a European-standard 3% within the agreed-upon 2015 time frame. O'Leary thinks they will do even better.

The Irish ran their plan by the ECB staff before they announced this. I was told that initially they did not offer a specific schedule for selling the bonds, but the ECB (the Germans?) required at least a token schedule.

So, the Irish will pay those bonds back. Kind of. Perhaps. I say "kind of" for several reasons:

1. Think back 40 years to the US in 1973. Want a 1973 dollar? It's worth about 19 cents today. How about an Irish punt? An Italian lira? 25-40 years is a long time. And given that the ECB is going to have to print massive amounts of euros to hold the eurozone together, the betting is that when the Irish do pay that debt, it will be in a euro (or successor currency) that costs far less in terms of nominal GDP or buying power.
2. There is a reasonable chance that at some point the European Union, or at least the eurozone, will move to something close to the mutualization of debt and fiscal union. Debt that grew out of the crisis would seem to be a likely prospect for debt mutualization. This would reduce that burden of that debt. Of course, it would bring in other debt, but that's what the long term and central banks are for – or so the logic will go. I most definitely do not agree with that world view, but I will not likely be asked my opinion. In any case, the Irish debt will be so small relative to Spanish and Italian and French(!) debt that it will be considered a rounding error.
3. In the short and the long terms, this is a good deal for Ireland. Those who say the debt should be repudiated altogether would seemingly vote to withdraw from the euro. The time to reject the debt was at the beginning, and they should have. If German, French, and British banks lent

money to Irish banks to invest in Irish property, then they deserve the fruits of their investment prowess (or lack thereof), not a taxpayer bailout.

4. Greece and Spain have also gone to the ELA, as have many European countries and banks. At some point, the eurozone is going to have to create some sort of banking union, as much as the Germans do not want to. There is the potential for these ELA loans to be considered banking-related losses. That is part of the negotiation process. Who knows what will happen, so why not cut your expenses in the short run, because the long run may make the whole thing go away.

Monetization – A Rose by Any Other Name

> "What's in a name? that which we call a rose
> By any other name would smell as sweet…"

There are those who oppose this Irish move. Jens Weidmann, the president of the Bundesbank, has been especially critical. But then, what would you expect? There is a genetic predisposition in Germany against monetizing debt, and has been since at least 1924. And make no mistake, this is monetization, no matter how much legal perfume you slather on it.

Quoting M*ü*nchau again:

> This is monetary financing for all intents and purposes. The whole structure of this agreement is so convoluted that newspapers do not report all the relevant details. As always, convolution has a purpose. It renders legal what would otherwise not be, and it allows for obfuscation.
>
> In this case, the purpose of obfuscation would be to hide what would otherwise be a contradictory message. You cannot admit publicly in the creditor countries that monetary financing is taking place – this is sacrilege. But then this is what it takes to save Ireland from a debt trap. It was then considered the best strategy to put back the debt repayment by a generation or two.
>
> I am marginally encouraged by this, not so much because I believe that monetising is a good thing in principle, which I do not. What encourages me is that I can see this as one of several components of an ultimate solution of the eurozone crisis. Without some form of arbitrage between debtors and creditors, this would be hard to achieve.

I wrote at least three or four years ago that if you are going to keep the eurozone together, there will have to be monetization. It is going to take trillions of euros, whether they are monetized or in the form of extended debt – or however you care to characterize them – to solve this puzzle. And the only entity that has that type of money is a central bank, in this case the European Central Bank.

Super Mario: Whatever It Takes

You have to give Mario Draghi, European Central Bank president, high marks on your central-banker scorecard for style and creativity. Following hard on the heels of the bland Frenchman, Jean Claude Trichet, Super Mario has pushed the ECB to the point where it is, for want of a better word, central to the European enterprise. In July of last year, with the eurozone in crisis, he stood up in London right before the Olympics opened and stated (now famously):

> Within our mandate, the ECB is ready to do whatever it takes to preserve the euro. And believe me, it will be enough.

The *Financial Times* named him Man of the Year for 2012.

While I am told that the Irish came up with the plan to monetize the debt (excuse me, I mean to magically change an Irish government promise into German and French [and other eurozone] money; not exactly the same as monetization if you look at it in the right way, perhaps aided by a pint or three or four of Guinness), Draghi had to have approved it. And rather than saying he appreciated the creativity involved, he simply said that the ECB had unanimously decided to "take note" of the Irish actions, whatever that means. "There isn't any decision [to back the Irish debt swap] today. We simply took note," he said. I guess €28 billion isn't enough to officially mess with; you simply take note of it.

The *Financial Times* reports today that the ECB, rather than giving formal approval, wants to be able to pressure the CBI to actually sell those bonds; and it also gives the ECB some negotiating room with other national central banks, which will want to make similar moves.

The New Policy Implications of the Irish Deal

The ECB is going to need that room. Part of the controversy of the Irish deal is that senior secured creditors of *banks* are potentially going to lose money. This may represent new EU and ECB policy. That part of the map is not yet clear. Sovereign debt holders have lost money in Greece and will lose more in Spain (unless the ECB gets creative again). Predictably, those most critical are the ones losing money.

Some think that Draghi's recent comments mean the Irish deal will be reexamined. I can see where that might make political sense (to pretend to address concerns, *etc*.), but taking back this deal would create a major storm in Ireland. The bank debt is a deep wound, and the salve is a reduction in government costs. Taking away that salve is likely to create all sorts of voter backlash and possibly lead to a Sinn Fein government that would want to repudiate the debt outright.

Greece and Cyprus have to be watching very closely. As I wrote a few weeks ago, the chairman of the Council of Economic Advisors in Greece told me that the money they are being loaned to recapitalize the banks will not be repaid, because Greece does not have the financial ability to do so. Ireland was in the same spot, and with this magic they have changed the equation. Will the same deal be available to Greece in the future, if they keep on jumping through hurdles?

Cyprus will likely have a new pro-bailout government in a few weeks and will have to negotiate a €17 billion bailout from the EU and IMF – that's for a country with a population of 545,000, so about $40,000 per man, woman, and child of mostly new debt, taking their debt-to-GDP ratio up to

145%. A family of four will have to pay $10,000 a year (at 6.5% interest) just to cover the new debt. On top of the old debt. Where can a country get such income and remain competitive?

Will there be another haircut on European government debt? Someone somewhere is going to have to lose some money on this deal. Again, the Irish deal opens the way for a new brand of creative thinking in Europe on old debt.

Currency Skirmishes

I continue to think the euro is going to parity with the dollar over time. The ECB in conjunction with its various national banks is going to have to monetize and print (or we can call it by its polite name, "quantitative easing") to an even greater extent than the US Fed. Along with the money gushing from the Bank of Japan and the Bank of England, there are going to be sums injected into the global system that simply cannot be comprehended. And all this easing will force developing nations to compete at the printing press.

The recent G20 meeting basically said, "It is OK to print as long as you are doing it to stimulate your economy and not to devalue your currency. And for heaven's sake, don't talk about it. Shut up already!"

That's a loose interpretation, I admit. But read Super Mario's statement about the G20 meeting, and you make the call:

> Most of the exchange rate movements that we have seen were not explicitly targeted; they were the result of domestic macro-economic policies meant to boost the economy… [and] In this sense, I find really excessive any language referring to currency wars… [but] What I did say at the G20 in Moscow, I urged all parties to (exercise) very, very strong verbal discipline.

In an article titled "G-20 Moves Toward Common Ground on Currencies," the *Wall Street Journal* reported:

> … there was more agreement on the need for market based exchange rate and [the G-20] pledged Saturday to refrain from targeting their currency policies to gain a competitive trading advantage….
>
> Germany's central bank president, Jens Weidmann, said it was clear at the meeting that G-20 members agreed that "politically driven devaluations can't sustainably improve competitiveness, don't solve structural problems and produce backlash reactions…."
>
> "The understanding in this meeting was clearly that without going to extremes, developed countries will do what it takes to stimulate their economies, and developing countries—again without going to extremes – will do what it takes to protect themselves from hot-money inflows," said a senior official at a developing-country government that is part of the G-20.

We have not yet seen real currency wars. What we see today are mere skirmishes in what is shaping up to be a brutal battle to simply maintain a competitive stance.

I should note – as I almost hit the send button – that Ian Bremmer (who will be speaking at my conference in May) sent me a recent note about currency wars. He argues that Europe and China do not want to get involved in a currency war and that many emerging nations would also rather not. His argument makes sense, as a currency war is kind of like having an old-fashioned gunfight, except with hand grenades – there are no winners.

China will continue to allow its currency to appreciate slowly, for at least a few years. I can see Bremmer's argument with regard to Europe, in that they would really like to focus on inflation and the ECB would like to be a proper central bank; but Draghi's words keeps ringing in my ears: "… whatever it takes to preserve the euro." And what it takes may be money printing and a little inflation. We will get lip service, but the presses will run.

Korea? Taiwan? They have to compete with Japan. And the rest of Asia has to compete with all three. Can Brazil, Australia, and the other commodity-intensive countries allow their currencies to be priced out of the markets, thus weakening their economies? I think self-interest will trump all. This is the problem of the commons writ large.

Toxic Debt Scare

Finally, while researching this letter I came across the following post written by Colm McCarthy. I find it hilarious (by the standards of economics humor), and I hereby pass a few paragraphs along for your enjoyment. (For the young and those for whom English is a second language, a "knacker" is a person engaged in the trade of rendering animals that have died on farms and are unfit for human consumption.)

> Teams of economists have detected traces of bank-debt DNA in samples of Irish sovereign debt in portfolios all over Europe. Genuine Irish sovereign debt is believed safe for humans but bank debt is toxic. The economists believe that as much as 30% of all Irish sovereign debt is not genuine. The source of the contamination appears to be a premises in Frankfurt, Germany. The contamination dates from 2010, when a sovereign debt knackering plant was run from the premises by a Monsieur Trichet, a French national. It is alleged that he gathered up large quantities of toxic bank debt and mixed it up with genuine sovereign debt in the middle of the night, when nobody was looking.
>
> There is no licensing or supervision of sovereign debt knackerers at European level and it is understood that the Frankfurt plant was staffed by people with no previous experience in the trade. Genuine debt from several other European countries was processed through the Frankfurt plant in 2010 and 2011 and may also have been infected. The plant, which claims to be the only sovereign debt processing facility in Europe, is now run by a Signor Draghi, an Italian. Monsieur Trichet has retired from sovereign debt knackering and has commenced a new career in the aviation business.
>
> The Irish Department of Finance has been seeking to return the infected sovereign debt to

> the Frankfurt plant with a view to removing the toxic component. They are afraid that retailers might remove the sovereign debt from their shelves. Signor Draghi has promised to do his best, but one of his assistants, Herr Weidmann, a German, believes that the toxic bank debt is harmless, and that anyway nobody will notice. He is refusing to operate the decontamination equipment.

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My Conference, Palm Springs, and Vagabond Shoes

My tenth annual Strategic Investment Conference (May 1-3 in Carlsbad, California) seems to be filling up nicely. The speaker lineup is exceptional: Kyle Bass; Ian Bremmer; Mohamed El-Erian; Niall Ferguson and his wife, Ayaan Hirsi Ali; Lacy Hunt; Charles and Louis Gave; Jeff Gundlach; Anatole Kaletsky; David Rosenberg; Nouriel Roubini; and Gary Shilling.

Seriously, where else can you find a roster like that? And the attendee list has a "who's who" feel to it, as well. Those who come regularly know that the real value is in meeting the other attendees. David Rosenberg noted last year that this is the top investment conference he has ever addressed. The speakers all seem to bring their "A" game. The attendees agree, and this year we will have more interaction than ever.

The conference always sells out, so I suggest you register at your earliest convenience. Invitations have been sent out to past attendees and those who are members of the Mauldin Circle. Registration is now open. Because of security regulations, we do have to limit attendance to accredited investors and those in the securities/investment business. You can start the process by going to the Strategic Investment Conference page There is a significant early-bird registration discount.

I will be in Palm Springs at the California Resource Investment Conference this weekend, February 23-24. My good friend Grant Williams, who writes the blockbuster *Things That Make You Go Hmmm…* and the Mauldin Economics *Bull's Eye Investor* letter, will be there, as will the best resource investor I know, Rick Rule, along with my favorite data maven, Greg Weldon. There is a full two-day slate of speakers. The event is free to investors and is always fun, and it's a great time of year to be in California (hate the pensions, love the weather). Come see us! You can read all about it and register at the Cambridge House website.

It has been almost four years since I have moved, and I tend to forget (kind of like childbirth, I suspect) how difficult a process it is. The home-buying part of the process seems to be proceeding apace, with the usual caveats. But I have to move out of my current home before I can move into the future one, so I will have to live in a hotel for a while. Oh, wait, hotel rooms are where I spent most of last year, so no big deal. Then it looks like I will move into one-half of the new apartment (in a Dallas high rise) while waiting four months for the other half to vacate, and then move back into a hotel again for 90 days while renovations are being done. And then, sometime in November – if all goes right – I will be in my new digs. So far, the mortgage process has not been painful.

With this move, I really am going to get rid of all that stuff I have been accumulating for decades. Since I intend to live in the new place for at least ten years, I need to be careful what I bring with me. Interestingly, I think we are going to seriously downsize the office space and more or less go virtual. With the new Internet phones we can be anywhere, and the new condo has a nice board room for the rare larger meeting. Video conferencing, email, texting, *etc*. all make a physical office less necessary.

I'll put in a small room for staff, for when we need to get together, but the days of a larger office may be over. I have my office in my home now, but we use over 1,000 square feet. All those old files I feel compelled to keep? Now scanned and stored in the cloud. My "office" (which is now simply a desk where my larger monitors sit) will be even cozier if I design it right... with a better sound system and some floor-to-ceiling windows looking out on the Dallas skyline.

Somewhere in the background I think I hear Old Blue Eyes singing *These Vagabond Shoes*. Have a great weekend.

Your actually trying out buying a home analyst,

John Mauldin

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