Europe: Running on Borrowed Time

By John Mauldin | July 25, 2015

The More Things Change
Don't Bring a Knife to a Gunfight
New York, Maine, and Boston

> "I am sure the euro will oblige us to introduce a new set of economic policy instruments. It is politically impossible to propose that now. But some day there will be a crisis and new instruments will be created."
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> – Romano Prodi, EU Commission president, December 2001

Prodi and the other leaders who forged the euro knew what they were doing. They knew a crisis would develop, as Milton Friedman and many others had predicted. It is not conceivable that these very astute men didn't realize that creating a monetary union without a fiscal union would bring about an existential crisis. They accepted that eventuality as the price of European unity. But now the payment is coming due, and it is far larger than they probably anticipated.

Time, as the old saying goes, is money. There are lots of ways that equation can work out. We had an interesting example last week. Europe and the eurozone pulled back from the brink by once again figuring out how to postpone the inevitable moment when all and sundry will have to recognize that Greece cannot pay the debt that it owes. In essence they have borrowed time by allowing Greece to borrow more money. Money, I should add, that, like all the other Greek debt, will not be repaid.

I've probably got some 40 articles and 100 pages of commentary on Greece and the eurozone from all sides of the political spectrum in my research stack, and it would be very easy to make this a long letter. But it's a pleasant summer weekend, and I'm in the mood to write a shorter letter, for which many of my readers may be grateful. Rather than wander deep into the weeds looking at financial indications, however, we are going to explore what I think is a very significant nonfinancial factor that will impact the future of Europe. If it was just money, then Prodi would be right – they could just create new economic policy instruments, whatever the heck those might be. But what we've been seeing these last few months is symptomatic of a far deeper problem than can be addressed with just a few trillion euros, give or take.

But first, I'm going to reach out and ask for a little help. I have just signed an agreement with my publisher, Wiley, to do a new book called *Investing in an Age of Transformation.* I've been thinking about this book for many years, and it is finally time to write it. As my longtime readers know, I believe we are entering a period of increasingly profound change, much more transformative than we've seen in the past 50 years. And not just technologically but on numerous fronts. There are going to be substantial social implications as well. Imagine the entire 20th century fast-forwarded and packed into 20 years, and you will get some idea of the immensity of what we face.

Now think about investing in this unfolding era of change. Companies will spring up and disappear faster than ever. Corporations will move into and out of indexes at an increasingly rapid rate, making the whole experience of index investing – which constitutes the bulk of investing, not just for individuals but for pensions and large institutions – obsolete.

Just as we wouldn't think of relying on the medical technology of the early 20th century, I'm convinced that we need a significantly new process for investing that doesn't depend on the concept of indexing created deep in the last century. In an age of exponential change, being wrong in your investment style will no longer mean you simply underperform: you will not merely be wrong; you will be exponentially wrong.

Of course, the flipside is that if you get it right, you will be exponentially right. We will be exploring some new investing concepts in *Thoughts from the Frontline* as I write the book, since this letter is actually part of my thinking process. I've been spending a great deal of time lately exploring new ways of thinking about the markets, different ways to manage risk, and strategies to take advantage of overwhelming change.

This project will be significantly more complex than any book I've attempted so far. I'm looking for a few research interns or assistants to help me on various topics. Some topics are technological in nature, and some are investment-oriented. You can be young or old, retired or working in any number of fields; you just have to be passionate about thinking about the future and be able to spend time exploring a topic and going back and forth with me through shared notes and conversations. It's a plus if you write well. If you are interested in exploring a topic or two, drop me a note at transformation@2000wave.com, along with a resume or a note about your background, plus your area of interest. Now let's jump to the letter.

The More Things Change

Almost four years ago, in an article on Bloomberg with the headline "Germany Said to Ready Plan to Help Banks If Greece Defaults," we read this paragraph:

> "Greece is 'on a knife's edge,'" German Finance Minister Wolfgang Schäuble told lawmakers at a closed-door meeting in Berlin on Sept. 7 [2011], a report in parliament's bulletin showed yesterday. If the government can't meet the aid terms, "it's up to Greece to figure out how to get financing without the euro zone's help," he later said in a speech to parliament.

Over the last few weeks he took a similar hard line, offering the possibility that Greece could take a "timeout," whatever in creation that is, and only the gods know how it could work for five years.

Reports of the final meeting before the agreement with Greece was reached demonstrated that there is little solidarity in the European Union. The *Financial Times* offered an unusually frank report of the meeting:

> After almost nine hours of fruitless discussions on Saturday, a majority of eurozone finance ministers had reached a stark conclusion: Grexit – the exit of Greece from the eurozone – may be the least worst option left.
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> Michel Sapin, the French finance minister, suggested they just "get it all out and tell one another the truth" to blow off steam. Many in the room seized the opportunity with relish.
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> Alexander Stubb, the Finnish finance minister, lashed out at the Greeks for being unable to reform for half a century, according to two participants. As recriminations flew, Euclid Tsakalotos, the Greek finance minister, was oddly subdued.
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> The wrangling culminated when Wolfgang Schäuble, the German finance minister who has advocated a temporary Grexit, told off Mario Draghi, European Central Bank chairman. At one point, Mr Schäuble, feeling he was being patronised, fumed at the ECB head that he was "not an idiot". The comment was one too many for eurogroup chairman Jeroen Dijsselbloem, who adjourned the meeting until the following morning.
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> Failing to reach a full accord on Saturday, the eurogroup handed the baton on Sunday to the bloc's heads of state to begin their own an all-night session."

That meeting ended with Angela Merkel and Alexis Tsipras arguing for 14 hours and giving up. Donald Tusk, the president of the European Council (and former Polish Prime Minister), forced them to sit back down, saying, "Sorry, but there is no way you are leaving this room."

Essentially, they were arguing over what form of humiliation Greece would be forced to swallow.

For all intents and purposes, Greece had to surrender its sovereignty and is now a European protectorate. But in the end, a majority of the Greek parliament agreed that was better than holding hands and stepping off the cliff into the abyss. In the wake of all my reading this past week on the topic, and after a lengthy conversation with George Friedman of Stratfor, let me offer some thoughts.

Europe as a free trade zone essentially works. It is not perfect, as no free trade zone is, but it is far better than the alternative. However, the eurozone has been an utter disaster for most of its members. It has been a triumph for Germany.

Germany now exports almost 50% of its GDP, with half of that to its fellow European Union members. Germany has prospered with a far weaker currency, the euro than it would have with its deutschmark. The southern members of the eurozone (including France) have suffered with a far stronger currency than they deserve.

George Friedman argues (quite aggressively) that the Germans were bluffing. The idea that Greece might lead the eurozone panics German leaders, since they know that if other members were also to leave, their export market share would begin to erode.

I agree with George that there is a two-speed Europe that is trying to make a single monetary policy work for dramatically different economies. If you were to split the eurozone into several different currency zones, the zone that contained Germany would soon see its currency appreciate, perhaps dramatically, against the currency of its southern peers.

The vision of a European Union as something more than a trade zone is one for Euro-romanticists. It's a political vision, not an economic one. And during the meetings in mid-July, the political reality crushed economic reality. No one really thinks that Greece can repay the debt it has incurred. Greece was once again forced to agree to a deal that will let it to borrow more money that it can't pay in return for hobbling its economy even further.

Why would Greece do this? Especially after the people voted overwhelmingly not to take a deal that was somewhat better? Because if they simply walked away from the debt and returned to the drachma, then every Greek pension would have to be paid in drachmas. Grexit would almost immediately cut the lifestyle of every person on a pension in half. And whatever we may think about the situation in Greece, Greek pensions are not all that generous.

Greece has to import nearly all of its pharmaceuticals and medical supplies, all of its energy, and most of the bits and pieces needed to run its machinery and businesses. By contrast with Germany's, Greece's exports are less than 15% of its economy. Greece is already at the critical point in the medical arena, with most drug and medical companies already dealing with Greek hospitals on a pay-as-you-go basis. Hospitals are short of the basics such as sutures and bandages, not to mention life-saving drugs.

If Greece left the euro, Greek banks would immediately be completely destroyed. Business would grind to a halt, as there would be no way to roll out a new drachma overnight. There is no mechanism in place to do so. Things would eventually sort themselves out, but for the several months that the transition would would require there would be a real humanitarian crisis in a developed country, a phenomenon unprecedented in post-World War II Europe.

Tsipras, with the political naïveté that only a new politician could muster, came into office thinking the Germans would blink because the threat of the eurozone breaking up would terrify them. He overplayed his hand. Now he is a dead politician walking. Relatively soon there will be a new Greek election. There is no way the Greek economy gets any better over the next few months, and voters will be looking for another option.

Though I have little sympathy for radical socialists like Tsipras, I will admit to feeling sorry for him. He was in a no-win situation. Greek voters do not want to leave the euro, but they don't want to have to deal with the realities of austerity that is European- (read German-) imposed.

If Tsipras and Syriza actually took Greece out of the euro, there would be a massive voter backlash, because the economic reality on the ground for the year after exit would be quite ugly. No politician who wants to get reelected wants to inflict that kind of pain.

Merkel and team knew Tsipras would have to cave at the end of the day. It is not that Angela Merkel is mean-spirited or wants to make the Greeks suffer. She has her own political realities to contend with. The odd thing is, the majority of German voters think they are the victims. They were innocents who goodheartedly lent Greece money, and now Greece doesn't want to pay them back.

There was a fascinating op-ed in the New York Times last week by Jacob Soll, a professor of history and accounting at the University of Southern California and the author of *The Reckoning: Financial Accountability and the Rise and Fall of Nations.* He talks about speaking at a conference in Germany where they were debating the Greek situation. I'm going to quote a little bit more than I usually do from someone else's essay, because he conveys a serious point really well. He has spent much of the day listening to German economists before he rises to speak and debate on a panel.

> …but to hear it from these economists, Germany played no real part in the Greek tragedy. They handed over their money and watched as the Greeks destroyed themselves over the past four years. Now the Greeks deserved what was coming to them.
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> When I pointed out that the Germans had played a major role in this situation, helping at the very least by insisting on austerity and unsustainable debt over the last three years, doing little to improve accounting standards, and now effectively imposing devastating capital controls, Mr. Enderlein and Mr. Fuest scoffed. When I mentioned that many saw austerity as a new version of the 1919 Versailles Treaty that would bring in a future "chaotic and unreliable" government in Greece – the very kind that Mr. Enderlein warned about in an essay in *The Guardian* – they countered that they were furious about being compared to Nazis and terrorists.
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> When I noted that no matter how badly the Greeks had handled their economy, German demands and the possible chaos of a Grexit risked political populism, unrest and social misery, they were unmoved. Debtors who default, they explained, would simply have to suffer, no matter how rough and even unfair the terms of the loans. There were those who handled their economies well, and took their suffering silently, like Finland and Latvia, they said. In contrast, a country like Greece, where many people don't pay their taxes, did not seem to merit empathy. It reminded me that in German, debt, "schuld," also means moral fault or blame.

> When the panel split up, German attendees circled me to explain how the Greeks were robbing the Germans. They did not want to be victims anymore. While I certainly accepted their economic points and, indeed, the point that European Union member countries owe Germany so much money that more defaults could sink Germany, it was hard, in Munich at least, to see the Germans as true victims.
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> Here lies a major cultural disconnect, and also a risk for the Germans. For it seems that their sense of victimization has made them lose their cool, both in negotiations and in their economic assessments. If the Germans are going to lead Europe, they can't do it as victims.

Admittedly, conferences tend to attract a focused group of attendees and are generally not representative of a population at large; however, the reaction he got is in line with the opinion polls I see coming out of Germany and other northern-tier European countries.

Merkel will not remain popular if she is seen to be caving in to the Greeks. And so she dug in her heels. But at the end of the day she finally had to agree to lend the Greeks more money in order to maintain the appearance of a united Europe.

But the agreement with Greece undermined, if not destroyed, the concept of European unity. Germany clearly dictated what were essentially unconditional surrender terms to Greece. One can be sympathetic to the German position that the Greeks have been profligate, don't pay their taxes, need significant reforms, and on and on. But that doesn't take away from the fact that the Germans who lent the money have benefitted from the system. The reality is that the Greeks owe something approaching one-half trillion euros to the rest of Europe. The Germans are going have to pick up about €200 billion of that, give or take.

If Merkel had to deal with a €200 billion loss, her popularity would plunge. And there would be the risk that other countries would decide – perhaps on an emotional basis but decide nonetheless – that they would walk away from their debts owed to Germany as well. Germany is on the hook for multiple trillions of euros, just as I wrote some five years ago. The longer they keep lending money, not just to Greece but to the rest of Europe, the bigger the debt grows. What money are they lending, you ask? They are lending as part of their commitment to the European Central Bank and eurozone banking system and various European financial mechanisms. All that money is one day going to have to be accounted for, or the ECB is simply going to have to print a vast amount of money or guarantee an even larger pool to absorb all the debt.

A fiscal union in Europe will require that nation-states will have to give up their fiscal sovereignty. Try sliding that past voters. You might get a significant number of smaller countries to do that, but can you really imagine France doing it? Seriously? Marine Le Pen is getting 40%-plus of the prospective vote today. Try getting the French to agree to give up to Brussels their ability to control their own budget and see how large her poll numbers get.

My friend Eddy Markus and the rest of his team at ECR Research offered a good summation of where this leaves Europe. (I always make a point of getting Eddy to take me to lunch or dinner when I'm in Amsterdam. He has a way of getting the best tables with the most scenic views in really good restaurants – an excellent talent for an economist to have.) The bold print is from me.

> For the moment, Greece may have been saved from the abyss, but the underlying weaknesses of the Eurozone and the EU remain in place. Still, **we do not think Europe will disintegrate for the foreseeable future.** After all, the EU project is of eminent importance to the European leaders. It has boosted economic growth, there is an extremely low chance of war breaking out between the EU countries, former communist countries are functioning as democracies, and Europe counts for something around the world. This is not forgotten, and the EU leaders will not easily abandon the project.
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> On the other hand, the Eurozone and the EU are no longer a byword for unity, prosperity, democracy, solidarity, and mutual respect. In essence**, the project should be revamped to stop the rot, but this is unlikely to happen**. After all, visionary leaders are lacking, and the sprawling structure of the EU is **incredibly complex** and often rigid. Reforms are years in the making.
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> The most likely outcome is that **the Eurozone and the EU will continue to muddle on**. At the same time, there is a constant threat of disintegration and waning global influence. Europe also needs to **narrow the gap between the economic viewpoints in the North and the South of the continent.** Not to mention the rise of populism and the problems arising from Germany's ascendant dominance. Such a climate does not seem to be conducive to euro strength.
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> A geopolitical analysis of Europe's future underpins our economists' opinion that the euro will have a hard time holding its own against the dollar in the medium to long term.

Don't Bring a Knife to a Gunfight

For the next few years and maybe for the remainder of the decade, Europe will indeed continue to muddle on. The European Central Bank will try to paper over whatever problems they have. Greece will again go critical, if not next year, then the year after. If Schäuble is still around, he will again say that the Greeks have to figure out their own financing; and we will have another endless round of meetings with a lot of shouting and finger-pointing as they try to kick the can down the road one more time. That will continue to happen until one country or another finally reaches the endpoint and says, "We are out of here."

But when it happens, it won't be a last-minute surprise. Greece taught a lesson to all those who might someday want to leave the euro. If you want to exit, then you have to plan for it. Waiting to the last minute is an absolute, utter, complete, total, (insert your own adjectives and expletives) disaster.

If Tsipras had wanted to do more than bluff, he should have started contacting currency printers about printing his new currency. He should have been making real plans to exit. He should have told the voters that he was prepared to walk away from the euro. Of course, he could not have gotten elected if he had done that.

So he walked into a poker game holding a pair of deuces and tried to bluff his way through. I know the rules of poker, and I have a lot of friends who play poker at a serious level, but I would have a snowball's chance in Hades of walking into the World Series of Poker and not being blown out of the room. I might get lucky for a few rounds, but luck is not how you win that tournament. And you certainly don't prevail by trying to bluff your way through. Germany knew that at the end of the day Tsipras was bluffing. And they held all the cards.

Tsipras broke the first rule of politics: don't bring a knife to a gunfight. This time, politics crushed economics. But my long-term bet is that economics wins. At some point some country is going to break from the herd, and we will once again see a multicurrency Europe. Or somehow countries will agree to give up their fiscal sovereignty, which means their own pensions and benefits will be at risk. Either way, it's going to be a tough time to be a European politician.

New York, Maine, and Boston

I am going to close quickly because there is a party down at the pool, and I don't want my hamburger to get cold. I will be home for the rest of the month, and then I'll go to New York for a day or two before heading off to Maine with my youngest son, Trey (who is now 21) for our annual fishing trip with all my economist friends. Then later in the month I will go back to New York for a few days before heading off to Boston. I will have to figure out how to get up to Gloucester to see my friend Woody Brock, who is recovering from a freak medical problem that cropped up while he was in Europe and put him down for the count for the last month or so. The good news, he told me, is that he has lost a lot of weight. Then I will spend some time in Boston with Steve Cucchiaro, who has hopefully gotten his new boat ready for some *mild* sailing (I get seasick too easily for the rough stuff). I'm still working out my September schedule, but I'm going to be all over the place. American Airlines loves me.

Trey came over today asking me if he could get a shirt, as he had an appointment he needed to dress up for, and all of his were wrinkled or dirty. I took him back to my closet, and we found one for him, which fit perfectly. I know he walked away thinking "score," as he now has a nice shirt, but I was thinking of the preteen who went on that first trip to Maine nine years ago. How did he get so big? And so fast? I might give up a shirt or two or three to see if I could get time to slow down.

Have a great week. I hope you're enjoying your summer, at least if you're in the northern hemisphere. I understand from my Aussie friends that they're suffering through a freak polar vortex in Sydney. Who knew?

Your waiting for parity on the euro analyst,

John Mauldin

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