Open Letter to the Next President, Part 2

By John Mauldin | March 21, 2016

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> "Europe was created by history. America was created by philosophy."
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> – Margaret Thatcher
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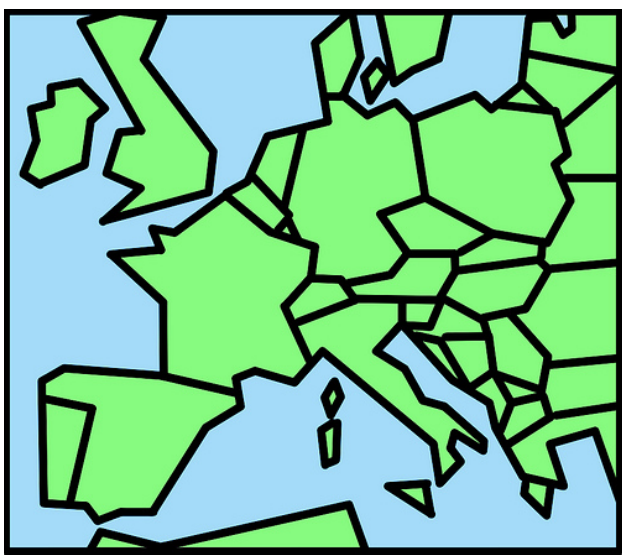
> "Nobody in Europe will be abandoned. Nobody in Europe will be excluded. Europe only succeeds if we work together."
>
> – Angela Merkel



Today we'll continue our world tour with more advice for the next president. Speaking of whom, lLast week's primaries narrowed the race a bit. Marco Rubio is out of the GOP running, and Bernie Sanders is lagging further in the Democratic delegate count. The next few weeks will be interesting. An open Republican convention in Cleveland is very possible, a possibility I wrote about in a recent letter from the point of view of someone who has been deeply involved in very large, raucous, and open political conventions. I was trying to give you some insight into the mechanics of such an event. While an open convention might be fun from an entertainment perspective, I think I would prefer a clean win prior to the convention. I find it really fascinating to think that the race might actually come down to California, the last state primary and one with a potentially decisive number of delegates.

One thing is sure: *somebody* will take the ball from Barack Obama next January 20. Whoever it is will face a world full of challenges, economic and otherwise. Last week we flew west and reviewed Japan and China. Today we'll continue the trip.
By the way, please don't take offense if I skip over your country or region. It likely means your problems are relatively minor on the global scale of things. You may not want whatever "help" our new president offers, anyway. Now, on with the letter.

An Open Letter to the Next President (continued)

Dear Presidential Candidates:

One of you may move into the White House next January, and you're going to have your hands full. Last week I gave you my thoughts on Japan and China. Today we'll take Air Force One further around the challenging world you hope to lead. I hope you're ready.

We'll start with a dip Down Under. Australia is an important American ally. It was also, until recently, a big resource supplier to China. Its huge, high-quality iron ore reserves and convenient location ensured Australia an important role in China's massive infrastructure binge.

With that binge now winding down, Australia's economy and currency are struggling. The country spent several years gearing up to accommodate Chinese demand that is now gone, or at least greatly reduced. On the plus side, wealthy Chinese citizens are finding Australia a convenient place to buy real estate, propping up what to the rest of the world looks like a housing bubble. This trend could persist for some time if China maintains its capital controls. But as you enter office, Australia will be economically fragile.

Your challenge, Mr. or Mrs. President, will be to help Australia economically so that they can afford to continue their cooperative stance as our allies in various endeavors around the world. The same goes for New Zealand, for whom China is now an important agricultural customer. The Aussies and Kiwis I know typically want strong ties with the US, and I believe those ties will remain close. These two countries have been willing partners of the US, but their budgets are being strained, and domestic priorities are coming to the forefront.

This observation brings me to an important point. You will find as president that your power is not absolute. Circumstances are going to dictate what you can and can't do. You won't be able to fix everything, but you *will* be able to make every situation worse. Resist the urge to "do something" simply because you can.

Subcontinental Opportunity

When your predecessor, Barack Obama, promised a "pivot to Asia," he was talking mostly about China. India is equally important, but many Americans forget about Asia's other mega-state. You need to pay attention to it.

India and China may look like neighbors on a map, but they are worlds apart. George Friedman explained recently how the Himalayas make a China-India military conflict all but impossible. Neither country has ever been able to invade the other or even conduct very much cross-border trade across the world's largest mountain range, so the two nations have grown to their present gargantuan size independently. India has been regularly growing at 7%-plus GDP per year.

Your Indian counterpart, Narendra Modi, is now almost two years into a much-needed economic reform plan. India does not have China's vast export industries. Services comprise almost a third of India's exports, mainly call centers serving the English-speaking West. Modi is wrestling with an entrenched bureaucracy, crumbling infrastructure, and a fast-growing labor force. But he is making progress. Roadbuilding has accelerated to more than ten miles a day from barely one mile a day just a few years ago. Modi is beginning to put a damper on the rampant corruption in the bureaucracy and is actually making the bureaucracy accountable. His has been a very tough job.

In an experiment to watch, India is assigning a biometric digital identity to every citizen so that the government can pay subsidies directly into citizens' bank accounts and thus prevent the money from falling prey to a corrupt and incompetent bureaucracy. India is also putting money into its banking system, which has needed a boost. Indian banks are under pressure (a story that is being repeated all across the world, highlighting the fragility of our global financial system).

Geopolitically, India bridges South Asia with the Middle East. Its uneasy relations with Pakistan give India an interest in promoting Middle East stability and trade, but given everything else that is happening in the Middle East now, achieving that end won't be easy.

Middle East Maelstrom

American presidents since Nixon have tried to bring peace to the Middle East. Some came closer than others. You will have to try your hand, too, but the odds are against you. The entire region remains a powder keg, and the situation you inherit will have added complexity and instability.

Saudi Arabia's oil wealth once let it enforce relative calm on its neighbors. That era is now over, as George Friedman and I explained in our recent report. Oil prices stuck at $40–$50 per barrel are forcing a massive Saudi budget shift and draining enormous amounts from their sovereign wealth fund. By some estimates, if the country maintains its current budget, it will run out of cash by 2021. Which of course means it can't maintain its current budget. The Saudi royal family is trying to build a cushion for the inevitable hard landing. Their success, or lack of it, will be outside your control, but the outcome will dictate your options.

Saudi Arabia has been offering major financial support to Egypt and other Middle East countries. How long the Saudis will be able to continue to do so is a question that you will need to answer in order to be prepared for whatever exigencies arise.

Across the Gulf from Saudi Arabia is Iran, where implementation of the Obama nuclear deal is proceeding at an unsteady pace. Here you have an opportunity to make something happen. There are two schools of thought. One posits that the single best way to keep Iran from threatening its neighbors, including Israel, is to reintegrate the country into the global economy, since countries that trade with each rarely resort to war. A big barrier to that process is decades-old US economic sanctions on Iran that Congress refuses to lift. The other school of thought asserts that renewed sanctions and further financial repression are required to force Iran to give up its nuclear ambitions. While most people focus on the political implications of the US–Iran deal, the economic implications might have even more far-reaching consequences. Formulate your Iran policy wisely.

The Middle East is, of course, complicated by the presence of ISIS. Fighting ISIS requires money, and the nations that have been working with us are going to be financially constrained. For the moment, fear of ISIS is spurring many in the Muslim world to flee toward Europe, a continent with its own problems. Dealing with the refugees in cooperation with the Europeans may be one of your greatest challenges as president.

The Russian Dilemma

Russia is another commodity exporter that is under tremendous economic pressure. The Russians are running through their dollar reserves at a rapid rate; the country is in recession; and a turnaround doesn't appear imminent. They are reportedly cutting their budgets by 10%, including education and social welfare. Just think about how hard it would be to get through the US Congress a bill that would halt increases in spending for a few years—never mind cutting spending by 10%. Theoretically, Russia's military budget will actually grow a bit, but the realities on the ground mean that the country's projected 1% growth won't go very far. Inflation in Russia is now down to just under 10% but has averaged much higher than that over the past year. Everyone is feeling the squeeze.

The fact that Russia is economically challenged does not make the country any less challenging to US interests. Ukraine is clearly in Russia's backyard, and Russia is obviously opposed to Ukraine's becoming a NATO member. Thus, Ukraine is now a divided country in a semi-anarchic state.

Let me offer an economic solution to Ukraine. Instead of supporting the various oligarchs who are squabbling over Ukrainian spoils, why not get Ukraine to open up its agricultural industry to outside investment? If Ukraine became productive along the lines of US farms, it could be the breadbasket of all of Eurasia. There has been enormous resistance to outside private capital, but Ukraine could become prosperous in less than 10 years if the country were opened up. This initiative would also create significant new employment and whole new industries supporting agricultural growth in Ukraine, stabilizing the country. And this objective is something that could be achieved without a shot's being fired. It would mean that entrenched interests would have to be negotiated with, but continuing to pursue the present policy just isn't working. Just a thought…

European Unity Crumbling

Europe is in economic and political crisis. The last European financial crisis exposed a façade of unity that was never sustainable. The façade will almost certainly collapse before you finish your first term in office. The Eurozone's breakup has the potential to be the biggest economic crisis you will face. How you handle it will make or break the entire global economy. The problem is that there is nothing you can do to prevent the coming crisis. All you can do is help steer Europe on a course that will result in the least damage to the US economy in particular and the global economy in general.

The European Union was a noble dream, but as happens with most dreams, reality eventually sets in. It is simply not possible to maintain economic unity and a single monetary policy among a collection of states each of which sets its own fiscal policies. The EU subset that shares the euro currency already sees this. The rest of the members will follow soon enough.

Europe's sovereign debt crisis was the first sign that something was structurally wrong. Germany spent years loaning euros to poorer Eurozone countries so they could buy German-made goods. Other exporting nations within the EU did the same. The resulting trade imbalance had to show itself somewhere. It did, in the government debts of countries like Greece, Italy, Spain, Portugal, and Ireland.

To this point, the attempted solution for outsized debt has been to impose "austerity" measures on those countries while they supposedly restore fiscal discipline. The European Central Bank has bought struggling nations time by depressing interest rates to artificially low levels, but that policy carries its own unintended consequences. The results have been mixed at best. Spain and Ireland are recovering somewhat; Greece, Portugal, and Italy are not.

Italy will probably be your main headache. Its banking system is already breaking down as nonperforming loans proliferate. Nonperforming loans make up almost 20% of Italian banking system assets. Not surprisingly, as you go from north to south in Italy, the percentage of bad loans increases. Some southern banks hold nearly 40% nonperforming loans. (By contrast, you should be thankful that nonperforming loans of US banks are down to a somewhat manageable 1%. During the worst of our banking crisis, US nonperforming loans never rose above 3½%. Italy's level is almost six times greater, and there is not an economic crisis yet.)

A collapse of the Italian banking system is a systemic risk for all of Europe, which means that it is also a systemic risk for the global economy. Italy is the eighth-largest economy in the world, only slightly smaller than India. But, whereas the world could probably tolerate a major setback in India, Italy is extremely critical because of its economic impact on Europe and thus on the global economy.

Italian government debt is already 132% of GDP and rising. The Italian economy is roughly the same size it was in 2000. Economists have been projecting growth for Italy for nearly all the intervening time, but that elusive growth just keeping slipping farther into the hypothetical future. Italian nonperforming loans represent just under 20% of GDP, yet Italian banks are literally too big to save. Further, another 10% of GDP and more would likely go up in smoke in a banking crisis, in the form of Italian bank bonds that have been sold to the general public as safe-yield vehicles.

There are negotiations underway to create a "bad bank" in Italy and somehow sell its paper to the public. That bad-bank debt would of course come with government guarantees, but these would cover only a portion of the nonperforming loans. There is still no agreement for a total solution. Germany is especially wary of committing to cover bad-bank loans of another country, because to do so would set a precedent that could be staggeringly expensive.

Italy is not the only European country with problematic nonperforming bank loans; it is just the biggest such country with the largest pile of debts. There is a laundry list of countries in Europe whose economic problems may not be as big as Italy's but whose woes are certainly significant and will become much worse if another financial crisis hits Europe. Crises have a way of cascading beyond national boundaries.

Compared to Italy, Greece will seem quite manageable. Obama was able to watch from afar as Merkel and the EU dealt with Athens. You will not have that luxury when Italy craters. It is much bigger than Greece and far more important to the world economy.

Greece remains important for another reason, though. It is the main gate through which fleeing Syrians, Iraqis, and others try to enter Europe. The wealthier states need Greece's cooperation to keep the flow of refugees manageable.

I know some of you presidential candidates are not fans of the *New York Times*, but let's look at a recent *Times* report concerning Greece and the refugee crisis anyway. A feature story last week explained how Greece is the eye of two different storms:

> Greece is now ground zero for the two greatest challenges to afflict Europe in recent years: the debt crisis and Germany's insistence on austerity as the only cure, and the backlash against the wave of human migration from war-torn and impoverished countries….

> Greek officials warn that refugees might be stranded in the country for two years. So many are stranded at the port of Piraeus, near Athens, that the passenger terminals – usually where vacationers wait for ferries to the islands – are crammed with sleeping Syrians and others. On Saturday morning, a group of bewildered Korean tourists wandered into a terminal transformed into a Little Syria.

The migrant crisis is already a humanitarian disaster, and the situation is getting worse. The European Union is all but paralyzed, as I wrote last September in "Merkel Opens the Gates." In that letter I quoted a column from *The Economist* that nicely illustrates the problem:

> Policymakers are fizzing with ideas, from the use of development aid to bring recalcitrant transit countries into line to the strengthening of a Europe-wide border guard. Once the principle of shared responsibility for migrants is established, says another official, the numbers of relocated migrants can be scaled up, and new programmes established, without too much wrangling.

I responded with this:

> What arrogance. Brussels will bring those "recalcitrant transit countries" back in line. The "wrangling" will be over once they establish the "principle of shared responsibility."
>
> **"Shared responsibility" is exactly the principle the EU never manages to establish, regarding immigrants or anything else.** Yet nameless officials still tell everyone not to expect "too much wrangling."
>
> Nothing is ever done in Europe without a great deal of wrangling.

That was more than six months ago. Is Europe any closer to a solution now? Hardly. If anything, the crisis is intensifying. The Paris terror attacks in November resulted in the reimposition of border controls through most of the previously open "Schengen" area. The attacks also convinced many Europeans that migrating Muslims are a security threat. An initial welcome turned into fear. One of the key leaders in Europe, Angelina Merkel of Germany, finds herself under intense political pressure because of an anti-immigrant backlash from voters.

Desperate for any solution, the EU is now seriously entertaining a deal to accept Turkey as a member in exchange for Turkey's holding most of the migrants within its borders. That nascent deal is already running into the EU's dysfunctional structure that demands unanimous approval by member nations for everything.

Stop right here. Those who originally designed the EU had visions of a "United States of Europe." Yet the USA they wish to copy does not require every state to agree on everything. Can you imagine if we had to do so? Would Texas and Vermont ever find common ground? Florida and Montana? Hawaii and Mississippi? Of course not. The idea is absurd. Our government would have collapsed long ago if unanimity were the requirement.

We can amend our Constitution if 75% of the states agree. An amendment to the Maastricht Treaty, which is the organizing document for the EU, requires agreement by all 23 members.

The US has survived because we have a system of majority rule with minority rights. We require supermajorities for certain big decisions such as Constitutional amendments. We do not demand that every state agree to every major decision, because it would never happen. Paralysis would be the result – as Europe is now proving.

Giving Turkey a path to EU membership is problematic to Cyprus, which is a tiny island but an equally powerful EU member state, with technically the same vote and potential veto that Germany and France have. Cyprus can veto the refugee deal that the rest of Europe so desperately needs to make with Turkey.

The solution to this point has been for the large and economically powerful EU/Eurozone members to simply force their will on the smaller states, resolving short-term challenges at the cost of long-term unity. This week they did it to Cyprus. The *Wall Street Journal* reported on Friday that the "EU Agrees on Deal to Send Migrants Back to Turkey." Notice this part of the deal:

> Turkey's EU membership bid will also be accelerated, while steering clear of a conflict with Cyprus that has held up negotiations. Cyprus has an EU-backed veto on starting accession negotiations over a number of new policy areas, because Turkey doesn't recognize its passports or allow ships and airplanes from Cyprus into its ports and airports.
>
> Under the agreement, the EU commits by the end of June to start negotiations on aligning Turkey's legislation on financial and budgetary affairs to EU law – a policy area, or chapter, that wasn't blocked by Cyprus.

Cyprus has legitimate concerns here. The EU solution is to simply ignore those concerns and plow ahead on other fronts. That approach will probably work, too, but each such episode pulls a few more bricks out of the EU superstructure. Bullying your smaller members is not consistent with the idea of an "ever-closer" union.

Let me put this more bluntly: there is a substantial probability that Europe will have a financial crisis that will create significant economic chaos, and if it is combined with an immigration crisis, the results are unknowable but unpleasant to contemplate.

Another looming danger is that the United Kingdom will hold a referendum this summer that may well lead it out of the EU. A member leaving the EU would set a dangerous precedent. For years following, there would be major consequences for world trade and currency flows.

There are two possible outcomes to a European financial crisis stemming from massive sovereign debts and unbalanced budgets. The first is that an entirely new economic structure might evolve in the European Union. If the EU is to stay together, it is going to have to resolve the sovereign debt issues. Because the European elites really do want to see a united Europe when push comes to shove, they are likely to take on the debt of every Eurozone nation according to some odd formula that only a European bureaucrat could love, mutualize that debt, and stick it on the balance sheet of the European Central Bank. They would then require each country to balance its own budget, much as the various states of the United States must do. It would be a difficult thing to do, but it could be done.

However, mutualization would very likely make the euro weaker, possibly much weaker. And of course, Germany would have to go along with the mutualization of debt. Why would they do this? Because 40% of their GDP derives from exports, half of which are sold to their fellow European Union members.

The second possible outcome is that there will be no agreement on how to deal with the debt, and the European Union currency region will sunder and its various countries go back to managing their own currencies. Those new currencies would likely be much weaker against the reinstituted German mark, thus pummeling German exports. As a side effect, a significant portion of the European Union's former member states would then find their currencies 30 to 40% lower against the dollar (and some small countries might see a much more significant drop). While that scenario would be good for American tourists (think cheap Italian and Greek holidays), it would not be good for American exporters of all types, including and especially agriculture.

We will talk next week of what you as president might do to strengthen the exporting capability of US corporations – and there is much that could be done on a bipartisan basis – but continuing deterioration of the European situation could lead to an immensely difficult environment for US exporters and would likely trigger a deep recession in the US.

Alternatively, the ECB could continue to monetize Eurozone debt and step it up a notch or two in the wake of an Italian crisis, which is likely to weaken the euro. Such a program might kick the European crisis can down the road a few years, but that debt is going to have to be rationalized sometime. The latest ECB move to create a multitrillion-euro "loan book" – essentially paying European banks 40 basis points to borrow money and then turn around and lend it at very low rates, and presumably even buying negative-rate sovereign debt – could potentially kick the can far enough down the road to bounce it into your second term. It is unclear what the consequences of such a radical ECB action will be, but the experience so far suggests that the strategy might not result in the growth that we would like to see in Europe. How long a low-growth or no-growth continent could maintain political stability without a backlash from voters – especially given the immigrant crisis – is a question that looms like a spectre over the whole EU project .

Regardless how the economic crisis turns out, the migrant crisis will remain. The refugees will not stop coming as long as jihadists threaten their homes. The deal with Turkey is unlikely to solve the problem. Refugees will keep crossing the sea; and with 23 countries having to approve Turkish membership in the EU, it is truly up in the air as to whether such a deal on immigration will actually come about. There is much more potential for instability in a region that is the equivalent of the US in economic importance.

I could say much more about Europe, but I will leave it there. We'll wrap up this letter next week when we look at Africa, Latin America, and the US itself.

Newport Beach, New York, and Abu Dhabi

I'll be heading out at the end of month to Rob Arnott's fabulous advisory council meetings, this time at Pelican Hill in Newport Beach. Those of you who know Rob and Research Affiliates know that his conference is a tad more academic than most, but he combines the intellectual heavy lifting with a fabulous food and party experience. It's kind of like Adult Nerd Heaven. Then the following week I'll be in New York, speaking and attending a conference.

For those who want to attend my annual Strategic Investment Conference this May 24–27 in Dallas, I hope you have registered. The conference is sold out, and we are creating a waiting list. We are trying to figure out how to accommodate more people but will not do so if we cannot make sure that the total experience for those already registered will be up to the standards we always strive for.

That said, if you want to attend, I suggest you go to the Strategic Investment Conference **website** and register to have your name put on the waiting list. I can almost guarantee that if we do find a way to accommodate a few more folks, those seats will almost immediately disappear, too. Those who wanted to wait until the last month to register are going to be disappointed. I won't even tease you with the fabulous new speakers that we are adding every week. The lineup just keeps getting better and better. And since I can't take everybody to Austin for the amazing local music scene, we are working on bringing Austin music to Dallas. It's going to be fun! Just a little Texas ambience for y'all.

By the way, I was looking through the list of attendees. There are almost 100 people from outside of the US already registered. I see a lot of familiar names, and we could easily put together a fascinating conference just from the attendees. We are evaluating two different computer apps that will, among other things, significantly enhance attendee networking. One of the things I have heard over the years is that people would like to be able to meet more of the other attendees but are not sure whom they want to meet. Whichever app we choose, it is going to allow you to find and grow a network of people who share your interests.

Just for the record, I can't write about your favorite market every week. But I am paying attention to the possible bottoming of the commodity markets and to what looks like a significant new bull market developing in gold and gold stocks. I continue to be mystified by continually lowering projections of future earnings almost across the board … and a rising stock market. Past performance says that perverse trend should not endure; but then, markets can be perverse longer than you can stay solvent.

As readers know, I am immersing myself not just in the economics of the future but also in the technology of the future as I put together my new book, *The Age of Transformation: What the World Will Look like in 20 Years.* I will leave you with this Ted Talk about some of the latest developments in augmented reality. I suspect that it's not as easy as Meron Gribetz makes it look, but this technology is coming to a home near you (and if you have millennials in your family, it may come to a home near you very soon).

As cyberpunk science-fiction writer William Gibson said back in 1993, "The future is already here. It's just not evenly distributed." I am increasingly drawn to thinking about the implications of an unevenly distributed future. It's not something that we can prevent or should necessarily want to. But it is a transition that is going to force a great deal of uncomfortable change and adaptation on many of us. Oh well, full ahead warp five, Scotty.

Have a great week as the seasons, too, began to change.

Your really worried about Europe analyst,

John Mauldin

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