Unintended Consequences

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Just One Question, Daddy

By John Mauldin | March 3, 2012

"Illusions commend themselves to us because they save us pain and allow us to enjoy pleasure instead. We must therefore accept it without complaint when they sometimes collide with a bit of reality against which they are dashed to pieces."

– Sigmund Freud

Let me introduce Mauldin's Rule of Thumb Concerning Unintended Consequences:

For every government law hurriedly passed in response to a current or recent crisis, there will be two or more unintended consequences, which will have equal or greater negative effects then the problem it was designed to fix. A corollary is that unelected institutions are at least as bad and possibly worse than elected governments. A further corollary is that laws passed to appease a particular group, whether voters or a particular industry, will have at least three unintended consequences, most of which will eventually have the opposite effect than the intended outcomes and transfer costs to innocent bystanders.

This week we wonder about the consequences of the European Central Bank (ECB) issuing over €1 trillion in short-term loans to try and postpone a banking credit crisis and lower sovereign debt costs for certain peripheral countries in Europe. What if, instead of holding the European Monetary Union (EMU or Eurozone) together, that actually makes a breakup more likely? That would certainly fall under the rubric of unintended consequences, and be worth our time to contemplate in this week's letter.

Further, what if the group that oversees credit default swaps declares an actual sovereign debt default not to be a technical default in order to avoid a credit crisis because CDSs would have to be paid? Could that actually undermine the ability of smaller countries to borrow money at lower cost, if they could even borrow it at all? Thus making the eventual outcome even worse? We will explore these perplexing questions and more as we once again turn our attention to Europe.

But first, and quickly, we are now ready to take reservations for the 9th Annual Strategic Investment Conference, May 2-4, which this year will be in Carlsbad, California for the first time, at a venue that will allow us to take a few more attendees but still keep that intimate feeling. I host the conference, along with my partner Jon Sundt and his team at Altegris Investments.

Each year I wonder how we could make the conference any better, but I think we have done it. I must say that I do not think any conference anywhere has the quality speaking line-up that we do. It is the finest collection of top-notch raconteurs posing as economists assembled anywhere. Each speaker is a headliner in his own right, wherever they go. We have nothing but the best each year.

Look at this line-up: Dr. Woody Brock, Mohamed El-Erian, Marc Faber, Niall Ferguson, Jeff Gundlach, David Harding, Dr. Lacy Hunt, Paul McCulley, David McWilliams (from Ireland), David Rosenberg, Jon Sundt, and your humble analyst. Plus the surprise guests. Seriously, where else can you find all that talent under one roof? I design the conference each year to be the one that I would want to attend. And Sundt and team run as smooth and enjoyable a conference as you will find anywhere.

Signing up will also give you access to exclusive papers and webinars. For example, next week I'll be interviewing Winton Capital Management. For regulatory reasons, you will need to speak with Altegris to verify your accredited-investor status, prior to being allowed to attend. You can learn more and register by going to http://meetings.StrategicInvestmentConference.

I should note that the best feature of the conference is the attendees themselves. You will make new friends and meet old ones. And the speakers are very accessible. The price goes up considerably on March 15, so register early. We always sell out, and I get calls asking to get in at the last minute, and have no way to help. Don't procrastinate. Register now. We are way ahead of last year on the pace of registrations. Again, it will sell out. Do it now.

Unintended Consequences

The ECB injected (created? printed?) €529.5 billion for an annual cost of 1%, more than the €489 billion they issued just last December. This was called a long-term refinancing operation, or LTRO. The total now is over €1 trillion euros (around $1.3 trillion), which can only make Ben Bernanke jealous. That money was technically issued to the various national central banks, who in turn lent it to their various commercial banks for almost any collateral that still had a pulse. Which banks in turn used it to shore up their balance sheets, and any spare change was used to buy more sovereign debt of their countries, thus financing their own government's deficits. And making a nice juicy spread for the next three years, which can help repair that balance sheet.

I can't find a chart I have permission to use and don't feel like spending three hours to make one just to show that the ECB has simply exploded in the last 6 months, swelling almost four times in that period, on a time-adjusted basis. Just imagine a slowly rising line that viciously turns north beginning July of last year. As in a "J" curve.

Did we see a rise in loans to commercial establishments? Easy money for all? Hardly.

The markets were quite happy that a credit crisis has once again been put off. So were the various governments. Did we see a rise in loans to commercial establishments? Easy money for all? Hardly. So what did the banks buy with their new money? (Besides the chance to deposit it back at the ECB?) They bought short-term government bonds, which more or less matched the terms of the money they had borrowed.

Which collapsed shorter-term bond yields. In November, Spanish one-year bonds paid about 5% over similar German bonds. Today it is less than 1% more. Still a nice total spread over 1%. Three-year bonds have dropped from around a 5% spread over the corresponding German bonds to slightly under 3%. Italian debt has dropped from a spread (over German yields) of 6% to 1% for one-year bonds and from over 7% to under 4% for three-year bonds. Nine and ten-year bonds are roughly the same for both countries as three months ago.

Sufficient Unto the Day

So what does a country with deficits and growing debt do? It sells lower-current-cost short-term bonds to help its current deficit (more on that later), rather than take on longer-term debt. It can also buy back more expensive longer-term debt sold last year for much lower short-term rates today.

But that means there is more roll-over risk in the very near future, as you have to borrow to replace those bonds when they mature; but why worry about that today? As my Dad was wont to say when he wanted to ignore the problems cropping up in his future, "Sufficient unto the day is the evil thereof."

I saw a table created by those clever people at Bridgewater. They analyzed the nature of the capital of the banks of various European countries. Not much has changed in the last few years, except that foreign capital is still fleeing and that capital is being replaced (almost euro for euro) by ECB debt. Let us make no mistake, without ECB largesse, European banks would either have to sell equity at fire-sale prices or their governments would have to nationalize them. Otherwise they would be insolvent. And that would in all likelihood mean a credit crisis worse than 2008, as hard as that is to imagine.

And while many applaud Mario Draghi's actions, as they feel he has averted a crisis with his initiation of the LTRO, there are others who are not pleased. This note from yesterday's *Financial Times:*

"The head of Germany's Bundesbank has launched a powerful attack on Mario Draghi, president of the European Central Bank, in a sign of mounting concern in Europe's biggest economy at measures being taken to try to contain the eurozone financial crisis.

"Jens Weidmann's warning of increasing risk stemming from some ECB policies highlights fears of potential costs for Germany from its role as the eurozone's biggest creditor nation and may spark fresh doubts about the eurozone's ability to deal with the long-running banking and sovereign debt crisis.

"Mr Weidmann, who has an influential voice on the ECB's governing council, said the central bank risked endangering its reputation and called for a quick return to stricter rules on the collateral that the ECB accepts from banks in return for central bank funds. The criticism in a letter to Mr Draghi was revealed on Wednesday by Germany's *Frankfurter Allgemeine Zeitung."*

Peter Sands, the head of Standard Chartered (a British commercial bank), warns that the new money runs the risk of "laying the seeds for the next crisis." He wonders what happens in three years' time when all that debt needs to be refinanced. That seems a reasonable question, as finding a spare €1 trillion will not be a lot easier in three years.

Former ECB board member (and fellow Italian) Lorenzo Bini Smaghi added to Mr. Sand's concerns. He said that banks may become "addicted to easy financing," creating a disincentive for them to "stand on their own feet once the crisis is over." (the FT)

The concern is that the ECB is now committed to more than just €1 trillion. As noted above, ECB financing, which amounts to almost 8% of peripheral countries' bank financing, has offset foreign (to the home country) debt that is leaving. Since that exodus is accelerating, the word *fleeing* may be more appropriate. And foreign investors (mostly banks, as I understand it) have another 14% of funding in peripheral banks.

The concern is that the ECB may have to come up with even larger sums to offset the losses as foreign assets flee. (Foreign in the sense that they are not from in-country sources. As an example, Italian banks have about 6.5% of ECB funding and 12% of foreign – non-Italian – funding.)

There is really no way to know how much will be needed to forestall a further crisis. The ECB has so far signaled it is willing to step up, and the markets seem to see no reason it won't continue to do so.

But therein lies the unintended consequence. In an effort to keep the eurozone from breaking up in the midst of a credit crisis, they may have made it easier for it to break up in the future. To understand why, let's revisit Greece a few years ago.

Was it only three years ago that the market was willing to lend Greece all the money it wanted at rates not far above those of Germany? And then it seemed like, all of a sudden, in the blink of an eye, Greece could no longer sell debt at interest rates that allowed it to credibly have a hope of repaying the debt.

And Europe had to step in and bail them out. But let's be certain of one thing. As I was writing back then, the ONLY reason that Germany, France, et al., were willing to continue to lend Greece money was that their banks had bought so much Greek debt that if they had to write it off all at once it would cost the various governments hundreds of billions. The financing package of €130 million that Greece will get? €100 billion goes right back to private bondholders, mostly banks and institutions (like insurance and pension funds). Just to create the fig leaf that there is no default. So Greek debt actually goes up, even though there is a haircut on current debt. (More on that below.)

If the only banks that held Greek debt had been Greek banks, then Europe would simply have let Greece go under, with its banks. Maybe some token help, but nothing like the amounts that have been funded. Greece would have had no choice but to leave the eurozone and return to the drachma.

I wrote at the time that we would know when German banks had essentially sold their Greek debt, written it down, or were otherwise able to handle a default, because Merkel would no longer be willing to fund Greece. That point was essentially reached a few months ago. Now Europe keeps demanding ever more austerity from Greece, and every time Greece agrees they move the line and ask for more. Greece is now going to have to demonstrate it is willing to cut spending and raise taxes, no matter what.

Greece's economy will experience deflation this year as GDP falls 4.4%, the nation's fifth straight year of recession, according to the European Commission. Greece's economy contracted 6.8% last year and 3.5% in 2010.

As recently as November, the commission forecast the Greek economy would contract just 2.8% this year. But just two weeks ago that estimate was blown away. Fourth-quarter data showed Greece had contracted by almost 7% in 2011. But they had just agreed to massive austerity cuts for the next ten years, totaling as much as their current annual GDP. In an economy where government spending is 40% of GDP. Such cuts will make it even more unlikely they can meet their targets.

Europe will then demand even more cuts when the targets are not reached (or increases in taxes on what's left of the private sector). Everyone realizes the party is over, but no one wants to be the first to leave. It simply will not do for the eurozone to expel a member. The precedent is dangerous. So they make staying in the eurozone so onerous that leaving eventually becomes the best choice (more on that later). "*We* didn't tell force you to leave; it was your own choice."

So what is happening now is that European banks are slowly shedding their foreign sovereign debt and buying the sovereign debt of their own countries. More Italian debt is coming home to Italy, Spanish debt to Spain, and so on. Given ECB funding, this process will go on for several years.

And at some point, if Spain or Italy decided to partially default, then European banks will be able to absorb the losses. If one of the peripheral countries does not get its budget in order, then it too will have to face the music of austerity and rolling recessions, just as Greece is, in order to get funding from Europe.

If, as an example, Europe decides to no longer fund Spanish debt (at the cost of German and other taxpayers) without draconian austerities, what then? Since Spanish debt will mostly be in the Spanish system (banks, insurance, pensions, etc.), if Spain decides to leave the eurozone it will be much easier on the larger European system.

I think the very fact of allowing (encouraging?) the various countries to bring the debt home to internal banks and institutions is in fact increasing the likelihood of exit from the eurozone, when a future crisis occurs . It's all well and good to talk solidarity, but continuing to fund the peripheral nations at the cost of other taxpayers, with the accompanying damage to the euro, will soon wear thin on voters in those other countries.

Far-fetched? Aren't Spain and Italy getting their act together? Kiron Sarkar makes the following points, with which I agree, so let's jump to him (courtesy of The Big Picture):

"Spain unilaterally set its 2012 budget deficit at 5.8% of GDP, much higher than the 4.4% previously agreed with the EU. The budget deficit came in at 8.5% last year, once again higher than the target of 6.0%. A 'discussion' between Spain and the EU is inevitable, especially as (to date) the EU has insisted that Spain sticks [sic] its prior commitment. Quite an interesting development, particularly as it has come on the same day that 25 out of 27 EU countries (excluding the UK and the Czech Republic) signed up to the 'fiscal compact' which, once approved by each country's national Parliament (Ireland will need a referendum), will introduce the German inspired 'debt brake' into their constitutions – basically commits the 25 EU countries to reduce borrowings and, indeed, balance their budget deficits.

"Spanish unemployment rose by a massive +2.4% MoM in February, with youth (under 25) unemployment over 50%, yep that's 50%.

"The EU has a tough task. If it offers concessions to Spain, expect Portugal, Ireland, etc., etc. to submit their own 'requests.' However, I just can't see how Spain can meet its prior commitment. Officially, GDP is forecast to be -1.0% to -1.7% this year, though in reality the actual outcome will be closer to (indeed may exceed) the more pessimistic forecasts.

"Whilst Spain is facing increasing pressures, Italy announced today that its 2011 budget deficit fell to -3.9% (-4.6% in 2010), better than the -4.0% forecast. 2011 GDP came is a marginally higher at +0.4%, (+0.3% expected). Whilst Italy entered into recession in the last Q of 2011 and its economy is expected to contract this year, Italy has pledged to balance its budget deficit by 2013.

"As I keep banging on, Italy is in far better shape than Spain, in spite of its higher headline debt to GDP. Spanish and Italian bond spreads continue to converge – I remain of the view that Italian bond yields will decline below equivalent Spanish bonds."

With that in mind, let's change the focus a bit.

What Should Greece Do?

This is a hard question. If Greece borrowed money from me, I would want them to pay. But if I am Greek the situation looks different. Let me take a cold-blooded look at what will offer the best long-term economic outcome for Greece, laying aside all the moral arguments about paying one's debts, etc.

The simple arithmetic is that Greece cannot afford to pay its debts. They are getting ready to give debtors close to a 70% haircut, if you figure in the time cost of money. There is no way in Hades, to borrow a Greek term, that they can get back to 120% of debt-to-GDP by 2020, given the massive austerity they have agreed to and which is just the beginning. (Is 120% now the new sustainable level because that is where Italy and Belgium are?)

Forcing debtors to take such a loss is not going to entice future lenders. Greece is effectively shut out of the bond market for a very long time. Their only source of borrowed money is the EU, and that debt is now costing the future of the country for at least a generation.

Most Greeks who are able send their children abroad to study. Given that the unemployment rate for people under age 25 in Greece is nearly 50 percent, it appears few young people are returning from abroad. In September 2011, organizers of a government-sponsored program on emigration to Australia, a program that reportedly attracted only 42 people in 2010, were overwhelmed when more than 12,000 people signed up to attend. (Source: Stratfor)

What is the point of paying back part of the bonds if you don't get access to future bonds? The current program offers no hope, and the people of Greece know that.

Greece should declare an "emergency," along with a bank holiday, and leave the eurozone and return to the drachma. Keep as much hard currency and reserves as you can, so you can buy needed medical supplies and energy until things turn around.

Don't pay one dime of debt to anyone for at least a few months, if not years. Default on every penny. Let the market set a value on the future currency, and only then offer to give two drachmas of debt repayment for the value of one drachma in hard euros in new debt. If you get no euros, then give no drachmas. But be very frugal about making that offer. Run up as little debt as possible in the beginning.

Play the political game, of course. Maybe even promise participation in a better future, when that happens.

Meanwhile, get your budget house in order. Figure out how to eventually run small surpluses, which will be easier if you don't have to pay for that old debt. Fix future growth of government spending to some percentage of GDP growth. Amazingly, you will soon – in just a few years – be seen as a worthy credit and be allowed back into the bond market. Ask Iceland or even Argentina (if ever there was a country that should be shut out of the world bond market, it is Argentina. They have made a national sport of defaulting on debt. Go figure.)

Right now tourism is 15% of your GDP. Make it 25%. Divert resources to make it happen. Make your country the best vacation value in Europe. Get your people, who are naturally hospitable, to get behind the drive for more tourism. Greet each traveler like someone bringing you gold, because that is what they are doing. That hard currency is what will buy you the resources you need (like food, energy, and medicine).

Note: you are not leaving the European Union, just the euro. There are lots of members of the EU that have their own currencies. You will just be another such country.

But since there will be a black market in euros if you try to keep a closed currency, at some point not too long after converting everything in the banking and financial system to drachmas, just go ahead and let people use their euros. Let businesses post two prices, but all government transactions will be in drachmas. Your citizens and businesses must pay their taxes in drachmas. If they take euros, they will need to find the drachmas to pay the VAT or other taxes.

Don't let the central bank go crazy printing money. That will just cause inflation and drop the value of the drachma further, postponing a recovery.

If a business wants to open a factory, then make it happen. Encourage all the foreign direct investment you can. Give them a tax holiday. Look at Ireland and match their tax rates. No government red tape to open a business, just bring your money and jobs. If some of your citizens "magically" find some euros that were in offshore bank accounts and want to bring them back to invest, let them. Declare a tax holiday on all money that shows up. Let them bring their euros back for the market price of the drachma until things stabilize.

Drop your tax rates to the lowest in Europe and then enforce them. The lower you make them, the more money you will raise in taxes. Look at some of the old Warsaw Pact countries. Selectively sell your government-owned businesses to get the currency you need for infrastructure (roads and such) and to remove the annual losses they have from your books. Or simply give most (and in some cases all) of the assets to the employees and unions, for businesses like your railroads.

There are local contingencies and characteristics I am not close to being aware of, I am sure. But structure everything that you can for the future, which will arrive faster than you think. There is a huge Greek diaspora. If they see opportunity, they will invest, if not come back. Make sure they see it.

It will be tough for the first year or two. But then you can grow your way out of the crisis, at first slowly and then more rapidly. There are myriad examples of countries that have done similar things without your natural advantages.

But staying in the euro and trying to pay that debt will just put chains on your children and elderly. You have been in recession for close to five years. Staying in the euro will mean at least another ten. Facing such a bleak future, the young and entrepreneurial will leave, which is what you cannot afford. They are your most precious asset. Without them there is no growth and no future.

Is leaving the euro and returning to the drachma a good choice? No, it will be a disaster. But I think it will be a lesser disaster than staying.

And Then There Is Ireland

What do the Greeks get by staying? My friend the Irish provocateur David McWilliams writes last week about how Ireland should view the Greek deal:

"For Ireland, this [the Greek deal] means that we will get a deal on bank debt most definitely. It might take time because the last thing the ECB wants is a queue of 'me too' demands from Ireland and Portugal. But it is clear that our hand has been strengthened, if we decide to play it.

"But just in case you think this is a victory for the citizen, let's examine in a bit more detail how it works. There will be no default. Greece will be given a €130bn loan. With that loan it will pay out €100bn to bondholders, who will have seen their bonds fall 53pc in value. After the penal interest Greece has paid on these bonds already, we still see an insolvent country paying bondholders 50pc of face value when they should be getting nothing.

"So Greece gets €100bn written off, but borrows €130bn in order to achieve this, so it is still borrowing more making its overall debt not better but worse in absolute terms.

"Now it needs to grow to bring these figures down and that is going to be impossible. So we are going to be back to square one in a few years except for one crucial thing.

"After all this is done, private creditors to Greece will have been paid by European public money stumped up by the taxpayers of other European countries. The banks have been bailed out again. Without help they would have got nothing. They now get 50pc of their worthless holdings and the subsidy comes from the taxpayer."

David is going to be at the Strategic Investment Conference, as I mentioned at the beginning of the letter. I am going to give him the podium and then put him on a panel with Marc Faber (a [Swiss] Austrian economist) and maybe even the Scot Niall Ferguson, and throw some raw meat up on the stage and see what happens. It will be highly instructive and good fun as well.

You can see what McWilliams is calling "Punk Economics" at www.davidmcwilliams.ie. It is a short video clip but fascinating. He represents a growing populist strain in Europe. And he does so with Irish verve and humor. You've got to love it.

New York, Orlando, Sweden, and Paris

I leave for New York for two days tomorrow. I will be on Tom Keene's show on Bloomberg Radio at 9:30 am or so. That is always fun. And meetings and a fun dinner with friends. Then a quick trip to Orlando the next weekend for a speech. And then I leave for Stockholm to give a talk, spend a day or two simply being tourist, write my letter on the way to Paris, and then play tourist some more for the weekend, along with meeting a few managers that my partner Jon Sundt of Altegris Investments will introduce to me. Then on Monday we will both attend the GIC conference at the Banque de France, with our friend Paul McCulley. The title of the conference is Re-Examining Central Bank Orthodoxy for Unorthodox Times:

Inaugural Meeting of The Global Society of Fellows (this is also a link, if you want more information). There are a few spots still left. It will be a most fascinating time to talk about central banking in Europe.

Just One Question, Daddy

I spoke at the Shareholders Service Group conference in San Diego on Thursday, with a lively audience of investment advisors. I made a few comments, something to the effect that "all your models are garbage," and it made the headlines here and there. (http://www.advisorone.com/2012/03/02/fellow-advisors-all-your-models-are-garbage-john-m)

My daughter Melissa was in the audience, as she was in the area attending a writer's seminar and stayed over to listen to Dad, which she has not often been able to do. She had to leave as I was doing Q&A, and I said goodbye from the podium.

She turned around, grabbed the microphone from a gentleman standing there, and said, "Since you mentioned me, is it alright if I ask a question?"

It had been a rather intense speech, even if I did get a few laughs here and there, so I was curious as to what had piqued her interest. Let me say that she does not share Dad's political leanings. (I don't know where I went wrong.) She is also not shy, so I was bracing for a tough question. The audience was on the edge of their seats, waiting to hear what she would ask, as well. And then it came:

"Dad, you said you were going to get a new iPad 3, right?"

"Yes," I said, even as I knew I was being set up. I had mentioned the new iPad in the context of telling them to get one so they could get my book. And I do love my iPad. And I will scramble to get one as soon as the new ones come out. They are way cool.

"Ok then, can I have your old one?"

What can you say? She knows all the brothers and sisters will soon be asking the same question. But you are on stage and she has asked so sweetly. How can you refuse? You just smile and say yes. She has great timing.

(Note to Apple marketing management: You should make sure I can buy one before I leave for Europe. I will show it off everywhere. I am willing to pay for the privilege of advertising your product. I just want one as soon as possible. Please.)

Have a great week. Find a few friends and spend some time with them. It makes it all worthwhile.

Your finding pleasure in the small things analyst,

John Mauldin

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