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By John Mauldin
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"*All political thinking for years past has been vitiated in the same way. People can foresee the future only when it coincides with their own wishes, and the most grossly obvious facts can be ignored when they are unwelcome.*"
– George Orwell

" Hindsight is not only clearer than perception-in-the-moment but also unfair to those who actually lived through the moment."
– Edwin S. Shneidman, *Autopsy Of A Suicidal Mind*

Brinkmanship is defined as the practice of pushing dangerous events to the verge of disaster in order to achieve the most advantageous outcome. It occurs in international politics, foreign policy, labor relations, and (in contemporary settings) military strategy involving the threatened use of nuclear weapons.

This maneuver of pushing a situation with the opponent to the brink succeeds by forcing the opponent to back down and make concessions. This might be achieved through diplomatic maneuvers by creating the impression that one is willing to use extreme methods rather than concede. During the Cold War, the threat of nuclear force was often used as such an escalating measure. Adolf Hitler also utilized brinkmanship conspicuously during his rise to power. (More on ignoring events and Hitler later on.)

In the last 48 hours, so much news has come out of Europe that has me frankly shaking my head. It is a strange game of brinksmanship they are playing, and it is one we should be paying attention to (as if the brinkmanship played by US politicians over the debt ceiling is not enough). This week we look at what seems to be European leaders taking random walks through the minefield at the very heart of the European Experiment. As Paul Simon wrote, "A man sees what he wants to see and disregards the rest." But first…

Would You Like to Read Over My Shoulder?

As you know, I read scores (if not hundreds) of reports and analyses each week to put together my letters. Wouldn't you like it if I could filter for you what is important? The few

things that you should read? What would it be worth to you to have someone with my years of experience and breadth of resources available to you as your own personal reader/filter?

I can be just that. I've now launched a new service called Over My Shoulder to bring you the very best 5-10 pieces I read each week.

I'll call your attention to some of the most fascinating analysts out there, **people with non-intuitive perspectives** on some of the most pressing issues facing us as individual investors. Concerned about inflation/deflation? Wondering about the future for US markets and sovereign debt? Europe? It's all here.

If you need **cogent analysis and clear reasoning**, this is the service for you. And if you want to see the **data, charts, and graphics** that back it all up, you'll get them. Would that be worth just $39 every three months? What is just one piece worth to you that helps you make that critical decision?

My job is to find you the best of the best, making sure your radar is pointed at the critical issues and weeding out all the noise. If your time matters as much as your investments, click here to learn more: http://www.johnmauldin.com/overmyshoulder/recent/

And let me hasten to note, this weekly letter will not change. It will still be free, coming to you each weekend. And now on to this week's letter.

Dysfunctional, Thy Name Is Europe

This week one member of the European Central Bank after another repeated the warning that if Greece defaults or restructures its debt, then Greek debt would not be eligible for use as collateral at the ECB, nor would Greek bank debt. They are continually warning of "contagion risks" and the end of the euro as we know it, and all in stentorian tones that would make any doomsday prophet of Armageddon jealous.

But this ignores reality. Greece simply cannot bear the burden of the debt. Some sort of restructuring or "reprofiling" is clearly going to be needed, if not outright default. There are those in the EU who are recognizing this.

Even a Greek EU commissioner (of fishing) noted the problem openly:

"ATHENS, Greece – A Greek EU Commissioner warned that the country's participation in the euro was under threat, though the prime minister insisted Wednesday his government would see through new austerity measures and keep Greece in the joint currency. The EU's Fisheries Commissioner, Greece's Maria Damanaki, warned that:

" 'The scenario of removing Greece from the euro is now on the table. I am obliged to speak openly. We have a historical responsibility to see the dilemma clearly: either we agree with our borrowers on a program of tough sacrifices with results ... or we return to the drachma,'

she said in a statement on her personal website. Damanaki does not represent the Greek government, but she is part of the ruling Socialist party." (Yahoo)

Of course, there were quick denials by the government and the prime minister that there were even any discussions of leaving the eurozone, which I find rather odd. I mean, if you are not having discussions about all the options (behind closed doors) then you are being derelict in your duties. We shall learn soon enough that there have in fact been such discussions. The Greels may in fact reject the idea of leaving the euro, but to think they did not have such a discussion rather strains credulity.

Here's the reality in Europe. Greece and Portugal are effectively shut out of the debt market without EU and ECB loans. Ireland will not be able to (nor should it!) handle the debt it has taken from the ECB to bail out its banks. If they acknowledge that debt, lenders will recognize they cannot service any new debt, and they will be shut out of the debt markets without ECB and EU guarantees.

The IMF warned this week it may not continue funding Greek debt in the very near term. Greece might be denied the next tranche of financial aid if an audit of its budget accounting shows that the country cannot guarantee financing for the next 12 months, Eurogroup President Jean-Claude Juncker said Thursday. "I'm not the spokesman of the International Monetary Fund, but the rules say they can only disburse if there is a financing guarantee for the 12-month period," Juncker told reporters at a conference in Luxembourg. Juncker is very discreet and savvy. Clearly he had discussions with IMF leaders before making such a statement.

"If that happens, he said, the IMF's rules could stop the fund from contributing its share of the next slug of bailout money, due to be paid out to Greece on June 29. The review, from the so-called troika of officials from the European Commission, European Central Bank and IMF, is due to be presented next week. 'I don't think that the troika will come to the conclusion that this'—12 months of funding commitments for Greece—'is certain,' said Mr. Juncker, speaking at a conference in Luxembourg.

"In that case, the IMF would expect other euro-zone governments to step in and cover the funds. Drumming up that financing would be hard in countries such as Germany and Finland, he said. IMF spokeswoman Caroline Atkinson said Thursday in Washington that the fund generally doesn't lend if there are gaps in financing, and that it was seeking reassurance from the euro-zone countries who are also lending to Greece. The IMF is providing €30 billion of the €110 billion facility, with the balance provided by euro-zone countries." *(Wall Street Journal)*

This is all brinksmanship. The ECB says Greece will get nothing if they default. The EU says that to get money the Greeks must make even deeper cuts, while a soon-to-be-completed audit will show they are in worse shape rather than improving. The Greeks have an obscure minister who is not part of the government say they might leave the euro. The IMF says they may not fund without further commitments from the euro members, which are going to be tough to get from Germany and Finland, at the least.

The German government has been proposing to fill Greece's finance gap without providing more loans, by asking holders of Greek bonds maturing in the next couple of years to agree to postpone their repayments. Yeah, like that's going to happen. Let's depend on the kindness of strangers.

Again, from the *Journal:*

"Analysts and officials say a political fudge will likely be worked out that won't leave the euro zone hanging on a precipice on June 29. Since the IMF is providing only around a quarter of the funding, the euro zone's existing commitments alone would tide Greece over for a few months as European leaders debate additional financing.

"However, short-term fixes won't resolve the fundamental tensions around Greece's debt that are putting the ECB, IMF and creditor governments at odds, analysts say. Many believe if something gives, it will be the ECB. 'One of the sides will have to give way. I believe that the ECB's threat of leaving Greek bonds out … is not something it will actually carry through. I don't think it's a credible threat because it's a nuclear option,' Mr. Kapoor said."

Brinkmanship indeed. Let's look at a few graphs from a scathingly critical post in *Der Spiegel* about the central banks of the various countries in Europe and the ECB itself, which show us why the ECB is so worried about a default. As it turns out, the ECB would be in worse shape than Lehman was in September 2008! You can read the article at http://www.spiegel.de/international/business/0,1518,764299,00.html. It is not pleasant reading if you pay taxes in Europe. Especially if you are German.

"While Europe is preoccupied with a possible restructuring of Greece's debt, huge risks lurk elsewhere – in the balance sheet of the European Central Bank. The guardian of the single currency has taken on billions of euros worth of risky securities as collateral for loans to shore up the banks of struggling nations.

"… Since the beginning of the financial crisis, banks in countries like Ireland, Portugal, Spain and Greece have unloaded risks amounting to several hundred billion euros with central banks. The central banks have distributed large sums to their countries' financial institutions to prevent them from collapsing. They have accepted securities as collateral, many of which are – to put it mildly – not particularly valuable.

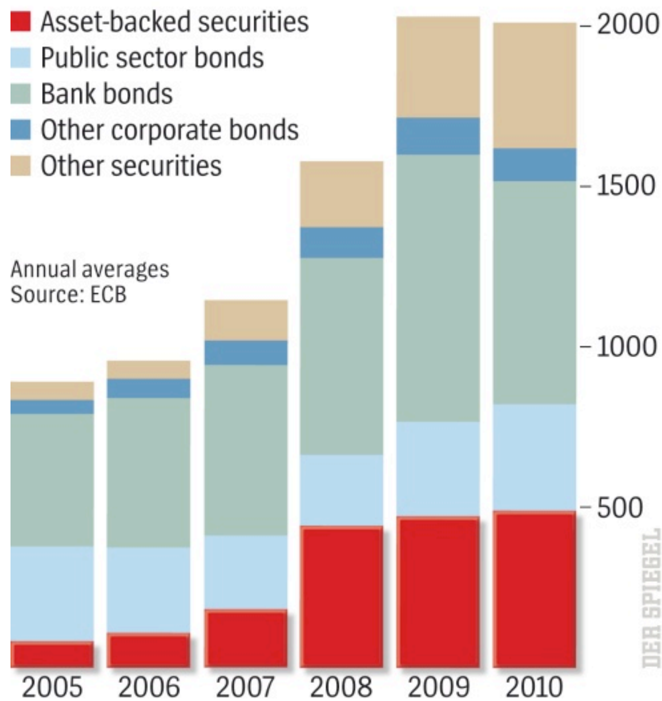
"Risks Transferred to ECB

"These risks are now on the ECB's books because the central banks of the euro countries are not autonomous but, rather, part of the ECB system. When banks in Ireland go bankrupt and their securities aren't worth enough, the euro countries must collectively account for the loss. Germany's central bank, the Bundesbank, provides 27 percent of the ECB's capital, which means that it would have to pay for more than a quarter of all losses.

"For 2010 and the two ensuing years, the Bundesbank has already decided to establish reserves for a total of €4.9 billion ($7 billion) to cover possible risks. The failure of a country

like Greece, which would almost inevitably lead to the bankruptcy of a few Greek banks, would increase the bill dramatically, because the ECB is believed to have purchased Greek government bonds for €47 billion. Besides, by the end of April, the ECB had spent about €90 billion on refinancing Greek banks." *(Der Spiegel)*

Two graphs from the article say a lot:



What Happens if the Greeks Default?

Andrew Lilico, writing in the *London Telegraph,* gives us the answer to that question with a series of short bullet points. I might not agree with all of them, but he is looking in the right direction. (quoting from http://blogs.telegraph.co.uk/finance/andrewlilico/100010332/what-happens-when-greece-defaults/)

"It is *when*, not *if*. Financial markets merely aren't sure whether it'll be tomorrow, a month's time, a year's time, or two years' time (it won't be longer than that). Given that the ECB has played the "final card" it employed to force a bailout upon the Irish – threatening to bankrupt the country's banking sector – presumably we will now see either another Greek bailout or default within days.

"What happens when Greece defaults. Here are a few things:

- Every bank in Greece will instantly go insolvent.
- The Greek government will nationalize every bank in Greece.
- The Greek government will forbid withdrawals from Greek banks.
- To prevent Greek depositors from rioting on the streets, Argentina-2002-style (when the Argentinian president had to flee by helicopter from the roof of the presidential palace to evade a mob of such depositors), the Greek government will declare a curfew, perhaps even general martial law.
- Greece will redenominate all its debts into "New Drachmas" or whatever it calls the new currency (this is a classic ploy of countries defaulting)
- The New Drachma will devalue by some 30-70 per cent (probably around 50 per cent, though perhaps more), effectively defaulting 0n 50 per cent or more of all Greek euro-denominated debts.
- The Irish will, within a few days, walk away from the debts of its banking system.
- The Portuguese government will wait to see whether there is chaos in Greece before deciding whether to default in turn.
- A number of French and German banks will make sufficient losses that they no longer meet regulatory capital adequacy requirements.
- The European Central Bank will become insolvent, given its very high exposure to Greek government debt, and to Greek banking sector and Irish banking sector debt.
- The French and German governments will meet to decide whether (a) to recapitalise the ECB, or (b) to allow the ECB to print money to restore its solvency. (Because the ECB has relatively little foreign currency-denominated exposure, it could in principle print its way out, but this is forbidden by its founding charter. On the other hand, the EU Treaty explicitly, and in terms, forbids the form of bailouts used for Greece, Portugal and Ireland, but a little thing like their being blatantly illegal hasn't prevented that from happening, so it's not intrinsically obvious that its being illegal for the ECB to print its way out will prove much of a hurdle.)
- They will recapitalise, and recapitalise their own banks, but declare an end to all bailouts.
- There will be carnage in the market for Spanish banking sector bonds, as bondholders anticipate imposed debt-equity swaps.

- This assumption will prove justified, as the Spaniards choose to over-ride the structure of current bond contracts in the Spanish banking sector, recapitalising a number of banks via debt-equity swaps.
- Bondholders will take the Spanish Banking Sector to the European Court of Human Rights (and probably other courts, also), claiming violations of property rights. These cases won't be heard for years. By the time they are finally heard, no one will care.
- Attention will turn to the British banks. Then we shall see…"

Or the EU can kick the can down the road yet another time, as many mainstream candidates expect. The ECB will blink. Some way will be found to find money yet again, and politicians everywhere will pray that something happens that saves the system – like the Greeks suddenly start to pay taxes and Greek and Irish GDP jumps up to 5%. Nouriel Roubini has outlined a very clear plan for restructuring. It is not without pain, but there are ways, if they can join what Greg Weldon calls a twelve-step plan for European bankers to deal with reality.

Sidebar: for the record, there are reportedly massive bank runs in Greece, especially on large uninsured deposits.

It is hard to understand how people can ignore what I think are clear warning signs, but the following analysis shows us the process. My good friend and early mentor Dr. Gary North wrote a poignant piece in his *Reality Check* letter today about ignoring the signs of pending problems. I insert it here as the launching point for the close of the letter. (I learned about Austrian economics, and a great deal of what I know about writing, economic history, and more during my early years [in the '80s] as Gary's business associate.)

"Trigger Points and Evasive Action

"When would a wise Jew have begun making plans to leave Germany? 1933? 1934? 1938? 1939?

"In retrospect, most people would say 1933, the year Hitler was appointed (not elected) Chancellor by President von Hindenburg. On 30 January, Hitler became Chancellor. He asked Hindenburg to dissolve the government and schedule new elections for March 5, which Hindenburg did.

"Should a Jew have begun packing his bags? Maybe not. Maybe after the next election, the Nazis would have been defeated.

"On 27 February, the Reichstag building burned down. One man did it, who admitted he had done it. Hitler immediately identified him as a Communist, although even today, it is not clear that he did anything but act alone.

"Hitler used this as a propaganda tool. On March 5, the Nazis got 44% of the popular vote, up from 33%. With an allied party, they had 52% of the vote in the Reichstag.

“Was it time to pack the bags? Maybe not. The Nazis did not have a majority. They had only a coalition majority.

“On March 23, the government passed the Enabling Act. It took a two-thirds vote to do this. Hitler now possessed dictatorial powers. He had attained these by means of support by rival political parties. http://en.wikipedia.org/wiki/Reichstag_fire

“Was it time to pack the bags? Maybe not. Those powers might not be used.

“On April 1, a one-day boycott of Jewish businesses was staged by the S.A., which were technically private storm troops. Was it time to pack those bags? Maybe not. This was not government-directed. It was only symbolic.

“What about 1935's Nuremberg Laws on Citizenship and Race? They made it illegal for Jews to be citizens. But that was only politics. How many votes did Jews have, anyway? They were only 1% to 2% of the population. Politics isn't everything.

“And so on, right down to Crystal Night in November 1938, when rioters broke the plate glass windows of 7,500 Jewish-owned businesses and burned or damaged 200 synagogues, meaning most synagogues in Germany.

“After that, over 100,000 Jews packed their bags and departed. Between 1933 and 1939, about half the Jews in Germany emigrated: 250,000. But half did not.

“There were a series of trigger points, 1933 to 1939. Most Jews sat tight until very late.

“Yet in Austria, Ludwig von Mises saw the handwriting on the wall in 1934. He looked at the map. He concluded that the Nazis would wind up running Austria. Hitler was an Austrian, and he would want to control Austria. He packed his bags and took his first salaried teaching position, a job in Geneva, Switzerland. He warned Jewish friends to get out. Economist Gottfried Haberler did, in 1936. Economist Fritz Machlup already had. He fled in 1933. Well, not quite. He was in the United States in 1933, and he decided not to return to Austria. Both men found safe havens in the United States. So did Mises in 1940, when he left Switzerland, barely escaping German troops in France as he and his wife road a bus toward Spain, and from there to Portugal and the United States.

“One might have thought that a careful reading of ‘Mein Kampf’ (1926) would have been a sufficient trigger point in the Summer of 1933. The gun was loaded. Then the hammer was cocked in March: the Enabling Act.

“Laws enacted by the Reich government shall be issued by the Chancellor and announced in the Reich Gazette. They shall take effect on the day following the announcement, unless they prescribe a different date. Articles 68 to 77 of the Constitution do not apply to laws enacted by the Reich government.

"Articles 68 to 77 stipulated the procedures for enacting legislation in the Reichstag. 'So what?' This seems to have been a mere technicality. The language was so procedural. But there was substance to it. As we read on Wiki, 'The Enabling Act allowed the cabinet to enact legislation, including laws deviating from or altering the constitution, without the consent of the Reichstag.'

"It was time to move out and move on . . . and not just if you were Jewish.

"Some people see the signs. Others do not. Some decide to get out while the getting is good. Others do not.

"Incident by incident, trigger point by trigger point, people see signs. Most people ignore them. 'It can't happen here.' Most times it doesn't. Sometimes it does."

A Random Walk Through the Minefield

According to Dealogic, European banks have to refinance about €1.3tn of maturing debt by the end of 2012. This is the sort of pressure point capable of triggering a liquidity panic unless Euroland policymakers become much more proactive in the interim. But, as noted, it may take more market stress now to force precisely this sort of policy response. That implies a much greater correction for the euro against the US dollar than what has been seen thus far, and a further correlated sell-off in risk assets, including commodities (Chris Wood, writing in *Greed and Fear).*

There are just so many risks in Europe that it is hard to make a list long enough. I think the risk to the world markets is higher than the subprime risk, at least from what I can see today. I know that the leaders of Europe think they can "contain" the risk. So did Bernanke in the summer of 2007. You cannot contain this until you actually admit the problem.

Our credit institutions are so intertwined that a repeat of the 2008 credit crisis is entirely possible. Who plays the role of Lehman? Let me count the candidates. Greece. Ireland. Portugal. Spain. The ECB. Any number of large European banks with massive Irish exposure. Greece alone could be dealt with. That is why ECB leaders are right to talk passionately about contagion risks. But ignoring the political realities is not the way to deal with it.

The simple fact is that at some point, whether this year or the next or the next, depending on how long they can kick the can down the road and how long German voters are prepared to bite 27% of the cost (NOT a given), Greece is going to default. Maybe the plan of the ECB is to keep financing Greek debt until it is off enough bank balance sheets and onto the back of the euro through the ECB balance sheet, before they pull the plug.

Whatever the plan is, right now Europe looks like a very dysfunctional family. The potential for a messy divorce is quite real. Can you see Greece or Ireland giving up sovereignty to Brussels? Really? Then you should buy Greek bonds at 24%. They are a steal. At a minimum, Europe is in for years of expensive "therapy." And we have not even gotten to their version of their health-care and pension crisis.

The euro appears to me to be a massive short. (Note: I and my family leave the eurozone [Tuscany] June 16-17. Just saying.) You should limit your exposure to Eurozone sovereign debt and bank debt. If you are invested in US financials that write credit default swaps to European banks or hedge funds, you are not investing, you are gambling.

Gaming the GDP Numbers

I know I should quit, but this one quick note, as this just really annoys me. I get the methodology and rationalization of how GDP is calculated, but it does have the appearance of being "gamed." This from my friends at Consumer Metrics. Link to the full report after.

"The importance of the price deflater used by the BEA cannot be overstated. In calculating the "real" GDP the BEA continued to use an overall 1.9% annualized inflation rate, which is substantially lower than the inflation rates being reported by any of the BEA's sister agencies. The mathematical implications of the deflater are simple: a lower deflater creates a higher 'real' GDP reading. If April's CPI-U (as reported by the Bureau of Labor Statistics) of 3.2% year-over-year inflation is used as the deflater, the reported 1.84% annualized growth rate shrinks to a 0.56% annualized rate, and the 'real final sales of domestic products' is actually contracting at a 0.63% rate. If instead of the year-over-year CPI-U we were to use the annualized CPI-U from just the first quarter (5.7%), the 'real' GDP would be shrinking at a 1.82% annualized rate, and the 'real final sales of domestic products' would be contracting at a recession-like 3.01%." (http://www.consumerindexes.com/)

Tuscany (And I Get the Irony)

I am in Boston (Cambridge) at a Harvard reunion week with friends (I went to Rice – Harvard on the Bayou, as it was called back then – so am not a Harvard alum) and fly to Rome and then take a train to Tuscany on Sunday and Monday. Five of my kids will already be there. After having basically trash-talked Europe for nine pages, I get the irony of going there; but the little village of Trequanda is the first place I have ever gone back to for a vacation. It is heaven, or at least it is for me. I love Italy. For that matter, I love France, Spain, Greece, and the other dozen-plus European countries I have been to. Rarely have I had a bad time.

There is a difference between the people and land of a country and its government. I am truly sad for what I think will be a difficult time for the people of the eurozone, not that we in the US (as I have written many times) don't have our own issues on the near horizon. But there is no reason not to enjoy ourselves on the descent into economic hell.

Finally, although I rarely do this, let me highly recommend you take about 15 minutes and watch the "rap" videos of a sparring match between Keynes and Hayek. The first, which hit the streets a year ago, was sensational and fun; but the second one is the best capture of the economic irony (that word again) of the acceptance of Keynes in the press, when Hayek is being proven right, right in front of our eyes. For those with some understanding of economics it is great fun. It is also a serious teaching tool.

I met Hayek in his late '80s in the mountains in Austria, for a magical 3-hour interview/private lecture. If you have not watched the first rap video, then do so as a set-up to the second, which has amazing production values. Look for the Bernanke, double-nodding in time to Keynes rapping about consumer spending. I guarantee better than TV. You can see them both at http://pipesandtheories.blogspot.com/2011/04/keynes-v-hayek-rap-battle-part-ii.html

It really is time to hit the send button. I had intended to make this a short letter, but these things happen. And for the record, this is the first time in eleven years I have gotten up at 6 AM to write this letter. I am usually a very late-night guy. Go figure.

Have a great week. And thanks for being one of my closest friends. I do appreciate each and every one of you.

Your seeing fabulous Tuscan meals for two weeks in his future analyst,

John Mauldin