An Irish Haircut

Two Insights from Ireland
The Irish Chamber of Commerce
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New York, South Africa, Back to Ireland … and Pushups

By John Mauldin | Oct. 7, 2011

Just as only four short years ago it was All Subprime, All the Time, and then it was the Credit Crisis, now it is Europe. (When) will Greece default and which banks will implode as a result? Is there another banking crisis in our future? I just came back from a whirlwind four-country visit to Europe, and I will try to offer a few insights. This week we start with Ireland, move to the problem of Europe at large and, if we're not out of space (and your patience!), we'll visit some last-minute data points. There is a lot to cover, so let's jump right in.

Two Insights from Ireland

This was my first visit to Ireland, but it won't be my last. In an odd way, I felt more at home than I do in some US cities. And the views! I was charmed enough to agree to go back next month to speak at one of the most unusual economic "festivals" I have ever been to, when the last thing I want to do is get on another plane. More on that at the end.

First off, even though we think of Ireland as a country, it is in reality a nice-sized city. Ireland is a little under 4.5 million in population (with another 1.8 million in Northern Ireland). I was lucky, in that I have a number of readers in Ireland who offered to introduce me to people. Remember the old game of six degrees of separation (from Kevin Bacon, the actor)? In Ireland it is more like two degrees. It turns out they all had cousins or mates who knew someone I should see. No one was less than a few introductions away.

I spent a great deal of time going from one meeting to the next, gathering impressions and data. Literally dozens of meetings. I met with officials of government pension funds, the new chairman of the Anglo Irish Bank, former prime ministers, politicians of all types (both front and back benchers), established economists and rogue economists, businessmen at all levels, regular people in pubs, investors, and the fabled Irish ne'er-do-wells. And only got to a fraction of the potential meetings. With such a potpourri of people, you might think it would be hard to draw any conclusions, but I came away with two main impressions (and lots of smaller ones), which I think offer us insight into the world and European situations at large.

But before we get to those, let's review a little history. Ireland is noted throughout the world for its troubles and the Diaspora. Famines, rebellions, and tales of woes. The Irish have emigrated almost everywhere. The Irish pub was created as a way for people to gather when it was against the laws to assemble in public. And they exported their pubs around the world. What city can you go to and not find an Irish pub? (Well, some in Asia, perhaps, though my editor tells me there's a great one in Kyoto.) And in all of them they'll sing about some kid that was killed in the war, which was of course in 1618, or whenever.

I have always loved Celtic music, so I was delighted when I went to some local pubs and, sure enough, heard the music I was so familiar with, complete with the lilting Irish voices. The Irish are nothing if not a social people, wherever they gather. And the local pub is still the center of local communication (more on that later).

The first night I was there, I had the fortune to be invited by David McWilliams to attend the opening night of a classic and much-loved Irish play by Sean O'Casey, at the Abbey Theatre, first staged at the same theatre for its premier in 1924. The play is set in the working-class tenements of Dublin during the Irish Civil War of the early 1920s. It is a comic tragedy on so many levels, and was an interesting introduction to Ireland.

It is those centuries of woes that set the stage for the recent economic crisis in Ireland. For a number of reasons, Ireland began a "miracle" growth period in the 1980s and soon became "the Celtic Tiger." The mood of the country changed from downtrodden to optimistic. And that translated into a construction boom. They ended up believing that "this time is different" and went crazy buying and building homes. Which are now down some 65%.

Ireland is an interesting contrast to Greece. Greece used its access to low rates that came along with the euro to borrow and increase the wages of government workers, until the Greek train system, for instance, had €100 million in revenue and €400 million in salaries, with another €300 million in expenses. A government-sponsored retirement plan for some 600 different "hazardous" jobs (like hairdressing and radio work) was available at 50 years of age.

Greek banks are going to go bankrupt not because they lent money to finance too many homes but because they lent money to the Greek government. That is the opposite of Irish banks, which, while they bought modest amounts of Irish government debt, facilitated a construction boom of epic proportions – a bubble that imploded.

I have written about Irish housing woes. They built 300,000 too many homes, which would correspond to about 15 million too many homes in the US (we "merely" overbuilt by 2.5 million). The resulting crash in building has been a monstrous drag on the Irish economy. And the same happened in commercial construction – a taxi driver took some delight, once he knew I was a financial writer, in pointing out buildings that were empty. "But they are probably a good buy now!"

And the construction boom helped finance a huge boost in government revenues. In 2004, the Irish Home Builders Association calculated that 40% of the price of a house went straight to the government in taxes. You can find details on their calculations in this newspaper article. The government of that time protested that the figure was only 28%!

And the Irish willingly took on the debt of banks that went bankrupt. If Anglo Irish Bank were a US institution, the equivalent debt would have been about $3.5-4 trillion (depending on the exchange rate). Can you imagine trying to get a bailout for ONE bank for that much? And in Ireland there were three of them (!), though the other two were somewhat smaller. The Irish government guaranteed the bank debt for ECB loans, which money then went to European banks that had loaned the Irish banks the money in the first place.

Michael Lewis, in his just published book *Boomerang!* (I saw several people reading it on the plane coming back – soon to be downloaded to my iPad), noted that he thought it was interesting that the Irish people did not seem all that aware of the rather crushing nature of the debt they had assumed. He also commented on that in an interview with Charlie Rose. More on that bank debt below.

Before we get to my two impressions from Ireland, a few things we should keep in mind. First, I heard time and time again that Ireland is different from Greece and other Mediterranean countries. The Irish willingly undertook an austerity program, without major public protests, and have actually begun reforms. They cut public salaries (around 15%), pensions, and other "untouchables." (Try that in the US! Wisconsin went berserk over cuts that were a fraction of what the Irish did.) Other government budgets were slashed. And they acknowledge the need for even more cuts. That being said, a clear backlash is beginning to brew over cuts to government social programs. (I should note that even though this is about the Irish, I hear this complaint everywhere in Europe and the US.)

This is from the Irish paper *The Independent:*

"A LABOUR senator has questioned the need for massive social welfare payments to many families after revealing yesterday that some are receiving €90,000 a year. Senator Jimmy Harte highlighted the case of one family who are being paid €1,763 per week. The unemployed married couple, who have four children and live in Dublin, claim a range of social welfare benefits.

"Mr. Harte, who received the information from Department of Social Protection officials, said €50,000 is more than enough for a family to survive on. The Donegal-based senator told the Irish Independent yesterday that he believed the figure was far too much to be handed to a family in support payments.

"The family are doing nothing illegal but the system is wrong when a couple are able to receive €90,000 per year for doing nothing. I don't think this sort of payment is acceptable in the good times, never mind the bad times we find ourselves in now…. There are married couples in this country with two good jobs, working very hard and are not receiving anything like this. As well as receiving €90,000, they will not have to pay property tax or water charges. That is just wrong. You would need to be earning close to €140,000 to take that sort of money home after tax.

"This is a Dublin-based family but I know there are families in other counties receiving up to €85,000. They won't take in as much in rent allowance but they are still entitled to all the other payments [said the Senator].

"According to figures obtained by Mr Harte, the following is the weekly breakdown of the social welfare payments received by the family: father on disability allowance, €322;

guardian's pension for child taken in, €286; rent supplement, €276; mother – carer's allowance, €380; child benefit, €288; daughter (17) with special needs, €211. Mr. Harte said he has forwarded all this information on to the Minister for Social Protection Joan Burton and wants a cap put on welfare payments."

And from my understanding, this is on top of health care. Which is another thing that I was told needs reformed. Which of course you hear in the US and all over the developed world, so the Irish have no corner on politicians who like to hand out a lot of benefits when times are good. But now the bills are coming due.

Sidebar: The one thing the Irish have plenty of is politicians. The Dail (pronounced "doil") is their parliament. It has 150 members. And their upper house has 60 members. That's about one member of parliament for every 30,000 voters. Peter Mathews, a new member of parliament, was kind enough to show me through the parliament building, opening up the chambers in the evening. Now *that* is something you don't see US Congressmen do.

So, Ireland is not without its issues that must be dealt with. But I did come away with some positive views.

The Irish Chamber of Commerce

As I noted, I met with people of all different stripes and political bents, from avowed socialists to libertarians. When they would ask me who else I was going to see (or had seen), they would almost invariably wince and say, "Don't let them put you off Ireland" or "They don't understand the real problems," or some variation.

They are not shy about voicing opinions. David McWilliams is seen as something of a rogue in polite political circles. When McWilliams began to suggest that the Irish housing market was a bubble that would wreak havoc when it broke, the prime minister said that people like him should just commit suicide. (Seriously!)

I have been involved in political circles for many years, although lately I have more or less "retired" from my political activities. In my experience, nothing is more sharp or divided than local politics. There is far more direct involvement at the local level, and that means more opinions and personalities get involved.

Remember when I said Ireland was a nice-sized city? That is what their politics reminded me of. When everyone knows everyone, and when there are enough politicians that everyone can get to them with their views, it is indeed a small world.

But after they had shared their opinions with me, a strange thing happened in almost every meeting. I pointed it out to a friend, Phil Harkin, who set up so many of the meetings and helped me get where I was going. He began to pick up on it as well, and it became our running bit of humor.

It seemed everyone I met was a member of the Chamber of Commerce. They would tell you why Ireland needed to adopt one policy or other, what their views were, and then at the end they would pull out a figurative brochure and tell me why I needed to "buy Ireland." Bring your business here. Set up shop. Hire the locals, who are flexible and educated and willing to work, etc. They speak English. They are skilled workers.

The Irish seemingly get it. While they all (left, right, and center) want the government to adopt the particular set of policies they prefer, they all recognize that the way to growth and jobs is for businesses to prosper. And they wanted more of that! The virtues of Ireland are manifest to all, if you only look. And they were more than happy to show me where to look.

The Irish may bicker and moan amongst themselves, but when they face the world they lock arms and join the chorus. "Buy Ireland," they sing. It really is rather amazing to listen to all at once.

Ireland has more direct investment from the US than all the BRICs combined. Think about that. More than China, Brazil, Russia, and India. That rather stunned me. There are over 600 US companies in Ireland, employing 100,000 people. Google has 2,700 employees from over 40 countries and is growing, adding office space and people as fast as it can. Technology is everywhere. Biotech, medical devices, all sorts of computer services. The Irish seem to have a knack for research and development. Entrepreneurs are taking over as fast as they can. I heard one amazing story after another of businesses that had blossomed in the Irish soil.

It is not just one-way. Irish companies have a lot of US employees. There are some 82,000 people employed in the US by 227 Irish firms, almost as many as are employed by US firms in Ireland. That is a far cry from the US employees of Chinese firms.

As a result, Ireland is in the enviable position of having a positive trade balance, which is necessary if you want to balance your budget in a country where the banking system is imploding and people are deleveraging. It is why Greece will become a basket case and Ireland has a way to get through its crisis. When Greece defaults, whether or not they leave the euro and go back to the drachma, they are in for a massive deflationary depression. At the end of the day, you either have to have "hard currency" to buy oil and medicine and other essentials, or find someone willing to loan you the money. Greece and Portugal and Spain do not export enough to make it through without some kind of devaluation. Ireland does. That is a critical difference.

And that brings us to my next take-away, which has serious ramifications for Europe.

An Irish Haircut

Michael Lewis noted from his time in Ireland that the Irish seemingly went along with the Irish government taking on the bank debt. The large majority were not aware of the nature of the impending crisis. In the last few years, that has changed.

I have written extensively in the past about how the Irish have figured out they are taking on debt for banks that no government should have touched. It was just too much. It's simple arithmetic: the Irish cannot repay that debt under the current terms (even after the ECB and Europe gave them lower interest rates in July) and ever hope to get out of debt in the next 30 years. They have consigned themselves and their children to decades of toil to pay back English and German and French banks (among others).

And that fact dawned upon them. They voted out the government that allowed the debt to be assumed. It was a clear message, but the government has not yet done anything to rid itself of the debt.

There are those like McWilliams who simply want to repudiate the debt. “It should never have been done, so we will not pay it.” He is not alone; that view is becoming increasingly mainstream now.

When you press politicians and establishment types (and I did) who are against unilaterally disavowing the debt, a strange thing happens. I kept asking, “But the voters seem to want to forego the debt. And the math suggests that Ireland can’t pay back these foreign bankers without great sacrifices.” At first, they would point out that Ireland is doing what needs to be done: cutting spending and payrolls. We are not Greece, they say; there is a need for “respectability.” But when pressed, they would come around to admitting that, “Yes, Ireland will get a haircut.” *Everyone* I met expected it to happen. **The difference was the path to the haircut. But while the politics matter, the destination is the same.**

Some favor doing it outright. Others truly believe they will be offered a haircut when Greece and Portugal get theirs. They fully expect it. In a meeting with an establishment-insider economist (off the record), who was at the table when the first deal was done, he said there was an implicit understanding with the IMF (and ECB) that whatever was offered to Greece, et al. would be available to Ireland. So Ireland went along with the bailout to keep from imploding the euro and averting a crisis that would have been biblical in proportions. The future of the euro is now not in their hands, because by taking on the debt they did not blow the euro up. Which could have happened, because European politicians were not ready for such a crisis.

So rather than having to kick the door open for a haircut, they expect the door to be opened for them by the IMF and the ECB. A far more respectable path for those who are very pro-Eurozone. But Irish leaders clearly get that voters expect that something will be done. They have time, as it will be another three-plus years before elections. By then, the crisis will have fully evolved and resolved itself, as far as the political public is concerned. And politicians will take the credit, as they always and everywhere do.

But here is the issue for Europe. The amount of money needed for Ireland is going to be a lot more than they now think, or at least are willing to admit. When Eurozone politicians worry about “contagion,” or one country wanting the debt relief that another country gets, it is a very real worry. And rightfully so, as voters in Portugal or Spain or (gasp) Italy who are burdened by debt that is seemingly intractable will also want relief. It is not just an Irish condition, it is a human trait.

And the money that Europe needs will overwhelm the €440 billion ESFS fund. Stratfor and others think it will take at least €2 trillion. The Boston Consulting Group put out a report that suggest the total number, at the end of the day, will need to be (drum roll, wait for it) over €6 trillion. I don't like their proffered solutions, but their analysis of the debt and the need for relief is sobering.

Whatever the figure, it is staggering. And one the Eurozone is not willing to pay, at this moment. When the crisis hits, who knows? But now, that much is not on the table. There is talk of leveraging the ESFS up to €2 trillion, but that seems odd, as normally you have to have equity to leverage more debt. The ESFS is debt created by promises to pay by the member governments. Are we now at the point where we need to leverage our leverage? It seems to me that is what got us into the problems to begin with.

France is at risk of losing its AAA rating. From my far-removed seat, I think it is almost a certainty they will, as the amount they will have to raise for French banks is enormous. Add another few hundred billion euros for bailout funds for Spain and Italy, and the idea of AAA euro debt goes right out of window. To keep the current AAA, a majority of guarantees needs to be from AAA countries. That is a very touchy issue right now.

Read the following quote from Angela Merkel, Chancellor of Germany and someone who is a believer in a strong, united Europe. This is from a supporter of Europe, mind you.

"While stepping up her rejection of a Greek default, she [Merkel] said that issuance of shared debt by euro countries isn't the solution to the problem spilling from Greece, even though some may long for the 'big bang' to end the debt crisis. 'Whoever believes that has no clue about the economy,' she said. 'No one can say with certainty' what would happen if Greece defaults, she said. 'Before I make a nifty step into an adventure, I have to ask whether we can really handle this and can we oversee what we are doing?'

"Merkel said that her 'entire council' of economic advisers says Greek debt should be restructured, advice that she is not prepared to take.

" 'If we tell a country "We cancel half of your debt," that's a great deal,' she said. 'Then the next guy will immediately show up and say he wants the same.'

" 'You can open any newspaper and see there's a broad international debate,' she said. 'I'm not an economist or a theorist. I and the German government have to consider the consequences of what we do.'

"Merkel, speaking to the last of six regional conferences of her Christian Democrats before the party holds a national convention next month, said that she was 'deeply convinced' that Europe's problems can only be solved jointly.

" 'Solidarity is always cheaper than if we were to go it alone and wind up with the problem Switzerland has – that the currency level is so high that you can't export any products anymore. Today, going it alone is no path to a better future.' " (Bloomberg)

It is getting late and this is already long enough, so a few more quick notes and then I'll save the rest for next week.

Greece will only get more promises and more funds until Merkel gets a call from her accountants, who tell her they have figured out which banks need government funds. The next day she will call Papandreou and tell him to hold a conference announcing the haircut that Greece will get. It will all be orchestrated to the color of their socks.

From what I heard, Europeans banks are worse than even the dire reports you read in the papers. Spreads are widening and liquidity is drying up. Drexia is the tip of the iceberg. I really have to wonder how much France can do in regards to its bank debt. Will the ECB lend them enough money? The answer is yes. But we are talking a great deal of debt for a country with serious fiscal deficits and where government spending is already 55% of GDP, with rising health-care and pension costs. Think French politicians will try and get their unions and public workers to take a 15% pay cut? The French will not be civilized and stoical, like the Irish. They will take to the streets.

We are now in the final innings of the Endgame. Greece is likely to default no later than the end of this year, if not by the end of this month. Which for all intents and purposes they have already done. If you can't get the market to finance you, that means you can't pay your bills without the kindness of strangers. If Greece were an individual or a company, it would be in bankruptcy proceedings. It is now just a matter of time.

Can the euro survive? The short answer is yes, but not without a lot of pain on the part of a lot of people. The drive for a united Europe is strong and may indeed overcome the drive that would tear the union apart. I actually hope so. But it will not be done without a lot of sacrifice. I think the valuation of the euro is at serious risk. And while European markets look cheap on a relative and historical-valuation basis, one needs to ask, compared to what? Long European stocks, short the euro? Maybe, especially if the Germans turn the ECB loose as a way to keep (and pay the price for) the European Union.

I heard no consensus. There are dozens of different plans, enough to make any politician's head swim. Stay tuned.

New York, South Africa, Back to Ireland … and Pushups

I will be in Houston on Friday and leave from the Streettalk conference (https://www.webinstinct.com/streettalkadvisors/) to go to New York for the Singularity Summit over the weekend (www.singularitysummit.com), then meetings Monday and Tuesday in New York, and I'm off to Cape Town, South Africa for two days, one night to speak at the Momentum Wealth Investment Summit Conference. Then home, where I will do a series of conferences for wealth advisors, in conjunction with my partners Altegris Investments. More on those later.

As noted above, I was with David McWilliams while in Ireland (his website is http://www.davidmcwilliams.ie/), and we really hit it off. I like the guy. Besides his economics gig, he writes a column read by almost everyone in Ireland. He did a one-man show which sold out for thirty days at the Abbey Theatre, and is coming to NYC. Go figure.

He talked me into going back to Ireland for the second annual economics festival he does in Kilkenny. From their website: “If you’re like us you’re finding all economics complicated and frightening in equal measure right now. What if we were to put some world class economic thinkers together with some of the best comic analytical minds available and see if they can’t make all this easier to understand in a way that is entertaining, informative and funny?”

I made the note talking with Barry Ritholtz and Bill Bonner this summer that all good economic speakers are frustrated stand-up comedians. And since I can’t actually be all that funny, maybe I can learn something from the professionals. It is quite the deal and sounds like a lot of fun. See me there! http://www.kilkenomics.com/

It is time to hit the send button. This weekend all the kids will be in to celebrate my birthday (which was last Tuesday), and I see some quality family time. Maybe even some pancakes for lunch. Time to indulge. I actually did 65 pushups on my birthday, and in working up to it once did 73. Getting old just means getting better. At least that is what I tell myself! Have a great week!

Your feeling his Irish blood analyst,

John Mauldin