"This Country Is Different"

By John Mauldin | July 1, 2013

"This Country Is Different"
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Croatia, Geneva, Las Vegas, and Rhode Island

> Panics do not destroy capital; they merely reveal the extent to which it has been destroyed by its betrayal into hopelessly unproductive works.
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> – John Mills, "On Credit Cycles and the Origin of Commercial Panics," 1867
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> Hyman Minsky developed an economics of financial instability, of instability bred by stability itself…. Minsky's approach, very different from Godley's, is conceptual rather than statistical. A key virtue is that it puts finance at the center of economic analysis, analytically inseparable from what is sometimes called real economic activity, for the simple reason that capitalistic economies are run by banks.
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> To grasp what Minsky is about, it seems to me, is to go immediately beyond the coarse notion of the 'Minsky moment,' a concept which implies falsely that there are also non-Minsky moments. It is to recognize that the financial system is both necessary and dangerous, that strict financial regulation is both indispensable and imperfect.
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> – James Galbraith, 5th annual Dijon conference on post-Keynesian economics, Copenhagen, May 2011

I find myself finishing this letter on an island off the coast of Croatia, on the backside of the middle of nowhere. But it is the perfect place to contemplate my recent experience in Cyprus. Through the efforts of your fellow readers, I was able to meet a wide variety of people and have some in-depth discussions on the crisis that has enveloped Cyprus. And while the details are different, of course, there is a pattern to the weave, so to speak, that calls to mind various aspects of the crisis that began in 2008. And perhaps that pattern will give us a glimpse of what else may be coming our way.

You must first realize that Cyprus is a very small country, some 800,000 people. Among the leadership, everyone knows everyone. There is much to admire, as we will see. But Cyprus has had a gut-wrenching crisis, proportionately more dire than any in other European countries recently; and precedents are being established here for how future problems will be dealt with in the Eurozone and elsewhere.

To start a two-day marathon of meetings, I sat down Tuesday morning with two brothers, Symeon and Andreas Matsis. Symeon was until a few weeks ago a board member of the Bank of Cyprus, the largest bank on the island and now the focus of the financial crisis. He made his career in the governmental sector, where he was the general manager of the Planning Bureau of the Ministry of Finance. Andreas Matsis is a local businessman who until a few weeks ago sat on the board of the Central Bank of Cyprus. He is a successful entrepreneur who was also until recently the president of one of the local chambers of commerce. They are both in their early 70s, soft-spoken and totally engaging and forthcoming. Our one-hour meeting stretched to two hours.

Symeon carried a copy of *This Time Is Different* by Rogoff and Reinhart. It was dog-eared and full of notes. "I am reading it so I can try to understand what happened to us. The more I read the more I understand that they were describing Cyprus. And we did think that 'This country is different.' Which is why the crisis has been such a shock to our local culture."

And such a shock. The next evening, I dined with a group of families, eating the local version of Greek cuisine, course after course after course. While they were all severely financially distressed, to a person they believed that Cyprus would come back, and they offered reasons why one should still do business is Cyprus. They were not sure what they would do, as their livelihoods were in danger, yet they faced the future with the strong resolve to figure it out. "Our parents lost everything in 1974 (when Turkey invaded the north portion of the island) and then came here and built a good new life. We can do this."

One of the women at dinner was a charming lady who had retired in January after a career at the Bank of Cyprus. Note this was less than three months before the crisis in mid-March. She had her entire pension and life savings in the Bank of Cyprus, which she totally trusted. And now it looks like she will lose at least 60% of those savings. It could have been worse. She could have been at Laiki Bank. There the losses may be 100%.

The country has instituted capital controls, and she has access to only about 10% of her savings. At some point she will get all the remaining money but cannot move it out of the country until the capital controls are released.

"If you could get it today, would you leave it in the bank?" I asked.

She looked down and said quietly, "No, I would have to move it. I have children that will need that money for going to college abroad and then for help in buying homes. I can't take the risk that the money will not be there."

She pointed to one of the unique and positive features of Cyprus. Until recently, there was no university on the island. Everyone went abroad to college, typically then staying on in the country where they were educated and getting work experience before returning with skills and contacts. Cyprus is a country of accountants and lawyers, engineers, and other professionals.

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The Bank of Cyprus made about 40% of the loans extended to businesses in Cyprus. It is now out of business itself. There are some solvent banks with available funds, but they can't make loans, because if capital controls are lifted, it is likely that a significant number of Cypriots would, like the lady mentioned above, move their money. There's no question that money will fly out of the country if trust is not first restored. But with no available bank financing, in addition to capital controls, businesses are closing up left and right. Unemployment, which was basically unknown before, now stands at 15% and is likely to go to 20%. If there is no functioning banking system for new loans, that makes doing business very difficult; and buying and selling property, outside of the cash market, is at a standstill.

But which will arrive first? Trust and a new beginning or capital flight and a long nightmare? It is a chicken and egg sort of problem with no easy answer, and one which I will attempt to bring some thought to later.

"This Country Is Different"

But to in order to delve further into this conversation about Cyprus, we are first going to return to France. Last week I wrote from France, where I suggested that France was on its way to becoming the next Greece. I got a very impassioned letter from a French citizen who made the case that France is not Greece. "As a Frenchman I am more than used to this mainstream French bashing, and I hoped from such an article to read about new facts or data." And he made one point on which I need to allow him to correct me:

> You say, "French President F. Hollande is worsening the situation by undoing what Sarkozy did well (putting back the retirement age from 62 to 60)." Not true. The legal age for retirement in France is still 62; FH did not change that. Had you looked a bit deeper into the details you would have understood that he only made a minor adjustment for the people who started working very early in life. The cost of this was nearly €200 million (1% of the 2020 estimated deficit of the pension system). And … the French government is currently working on a reform to balance the pension budget by 2020. The first pension reform by a socialist government ever…

He then went on to list the ways that France is not Greece. And if you take them at face value, there are indeed many ways that France is not Greece. And neither is France Spain; nor is it Italy, Ireland, Portugal, or … Cyprus. Yet all these Eurozone nations do share similar problems. What the writer basically maintains is that France is somehow different – that its circumstances are different and that the government is in some way more serious.

But serious about what? My friend Kiron Sarkar notes today:

> **The French auditor, the Cour des Comptes, states that France has only "a small chance" of meeting its revised budget target of 3.7% of GDP this year and will have to cut back on spending.** Furthermore, they added that the extended deadline of 2015 to reduce debt to GDP to 3.0% would require France making a "big effort". There is a chance that the French economy would contract this year, they reported. The current administration in France is not going to cut back. I just can't see how France and/or the EZ

> deals with these issues. Today, French June consumer confidence came in at 78 M/M, lower than the 81 expected and the 79 in May."

It is not the differences that are at issue, it is the similarities. And at the root of the Eurozone crisis is too much debt. Too much bank debt. Too much sovereign debt. Too much bad debt.

The quote from John Mills at the beginning of the letter returns to mind:

> Panics do not destroy capital; they merely reveal the extent to which it has been destroyed by its betrayal into hopelessly unproductive works.

The most important book on the topic of the problems that have come to the fore in the last decade is clearly Rogoff's and Reinhart's brilliant tome, *This Time Is Different,* which examines 260+ financial crises over the last few centuries. While each is different in the particulars, they *all* have at their root too much debt and insolvent governments and/or banks. There is not some magic number that shouts, "Too much. This far and no further!" but the fundamental issue is clear.

The ***BANG!*** Moment comes, say R&R, when a wary bond market refuses to buy debt at a price that is financially sustainable for the debtor. In that moment, confidence and trust are lost. Can France pull back from that precipice? Surely. Nothing is hopeless, and my French correspondent is no less hopeful that his mother country, France, will avoid a crisis than I am hopeful about the US. Somehow, I must confess, I really do think that the US is different and will see the warning lights and pull back from the brink. At the same time, I squirrel away a little gold every month, just in case. I guess at the end of the day I truly don't trust the bastards. (By the way, I am happy to see the gold price drop, because that means I get more pieces of gold for my pieces of paper. But then, I am not buying gold as an investment but as central bank insurance. I like it when my insurance premiums go down.)

So what can Cyprus teach us? Many things actually. First, as Symeon said, they truly believed that "This country is different." And for good reasons.

The business of Cyprus is business. They produce very little in the way of exports and have no natural industries. For millennia they have been traders. In the '70s and '80s they joined the "nonaligned movement." Remember that? (Croatia, then part of Yugoslavia under Tito, was part of that movement.) At the time, the Cypriot leader went around the world creating mutual double tax treaties (DTT). I am told the country is party to something like 50 of them. They basically eliminate the taxation of the same income in two countries, allowing offsets. (India has some 88 DTTs.)

At one time, Cyprus was an English colony and therefore has a history of English law and accounting. The country boasts a large number of highly trained legal and accounting professionals whose services are very competitively priced compared to the cost of the same services in London or other major financial centers. Everyone speaks English, as well as at least one other language. Twenty-five percent of the world's shipping fleet is registered (flagged) and run from Cyprus, a carve-out that was allowed when Cyprus entered the EU. Some of the best beaches in all of the Mediterranean are on the island. The climate is marvelous.

Following the ruinous invasion of Cyprus by Turkey in 1974 and the deportation of Turkish Cypriots from the Greek side and vice-versa, the country recovered and grew year after year after year. The growth of the banking industry was quite pronounced in the last decade, with salaries growing apace with employment. The beginning of the end had its roots in the Greek debt crisis, because Cypriot banks had bought large amounts of Greek government debt with their massive foreign deposits. For all intents and purposes, the default on that debt bankrupted Cypriot banks. Money rapidly fled the island, and the Central Bank of Cyprus had to issue relatively massive amounts of emergency liquidity assistance (ELA) to Laiki Bank and the Bank of Cyprus.

As I wrote in January, everyone knew that Cyprus was a major problem. But Europe waited until a new Cypriot government was elected and then lowered the hammer. Partly, the problem was a matter of timing. The Irish, by contrast, were lucky that they had their banking crisis early. Spain is too big and systemically important to be allowed to become another Cyprus and has so far been spared. But Cyprus is tiny, and apparently the leaders of the EU decided to try an experiment: Let's make the depositors rather than taxpayers pay for the risky behavior of bad banks.

To give this decision some context, in March I wrote:

> When we woke up to the Eurozone pronouncement that all depositors in Cypriot banks, no matter the size of their deposits, would take a loss my reaction was somewhat akin to John McEnroe shouting, "You can't be serious!" to a line judge whose call he infamously questioned.
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> While there was no official deposit guarantee in place in Europe, the implicit guarantee was €100,000, a number that had become all but sacred during the recent banking crisis. To wake up and find that European leaders not only did not consider this protection to be implicit but also planned to demand losses from all depositors, was quite the shock. I think this may have been the single worst "call" by European leaders since the beginning of the crisis in 2008.
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> Let's look first at what actually transpired. Cypriot banks held deposits of roughly €68 billion, four times the size of the total national GDP, while the total size of the banks was roughly eight times GDP. The "Troika" seemed to feel that Cyprus needed €17 billion in bailout money to be able to handle the crisis. But after finding hundreds of billions for Greece and Spain, they were only able to offer tiny Cyprus €10 billion (€10 billion is the equivalent of offering the US $8 trillion, give or take a few euros, just to keep it in perspective), and demanded that depositors in Cypriot banks be levied for most of the remaining €7 billion. They offered a formula by which small depositors would lose somewhat less than 10% and large depositors somewhat more (the actual number varied day by day).

> The Cypriot parliament totally rejected the Eurozone proposal. Not one vote was cast for the deal. And when you look at the numbers, as any politician does, you can see why. This is an island of 1.1 million men, women, and children. There are (were) 370,000 bank accounts, with 360,000 of those containing fewer than 100,000 euros (per Dennis Gartman). In the recent presidential elections in Cyprus, there were 445,009 voters and a voter turn-out rate of 81%. Thus, a huge majority of voters had accounts with less than €100,000 in them. Call me cynical, but I think any politician could figure out which side of this fence to land on.
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> It now appears that "only" €5.8 billion is needed for the bailout, so the 10,000 or so accounts holding more than €100,000 will be docked an average of €580,000. "The tottering banks hold 68 billion euros ($88 billion) in deposits, including 38 billion ($49 billion) in accounts of more than 100,000 euros – enormous sums for an island of 1.1 million people, which could never sustain such a big financial system on its own." (NBC World News).
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> On the surface it looks like large depositors will lose about 15%. And if the *Financial Times* is right (and the betting line is heavily on their side), a significant majority of that money is Russian. Much of the remainder is tax-haven money (more on that later). "Not so bad," you might think; "things could be worse."
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> Well, actually they are worse. Some EZ officials suggest that the losses of large depositors could range up to 40%, and the Cypriots themselves suggest 30%. That is because if you are a Greek bank with a Cyprus branch your deposits are exempt from the levy. The logic behind that decision is just too arcane to explain in a brief letter that prides itself on rational explanations. Which is another way of saying that I actually couldn't understand it myself. But then, I'm just a country boy from West Texas, not a European financial wizard.

I was not the only one who was surprised. So were the Cypriots. There is still a sense of having lived through a surrealistic nightmare when you talk to them. They simply find it hard to believe that the EU would do what it did.

What's the Deal?

I spent part of my first night in Cyprus and another few hours the next day with [Michael Sarris](#), who was finance minister from 2005-2008, after retiring from a long and very successful career with the World Bank. He ushered in the euro, oversaw the country's budget from a deficit to a surplus (talk about austerity!), and reduced inflation. When the country dove headlong into crisis, the new president asked him to become finance minister again (though Sarris was not a member of the president's party), and he accepted, only to leave after one month.

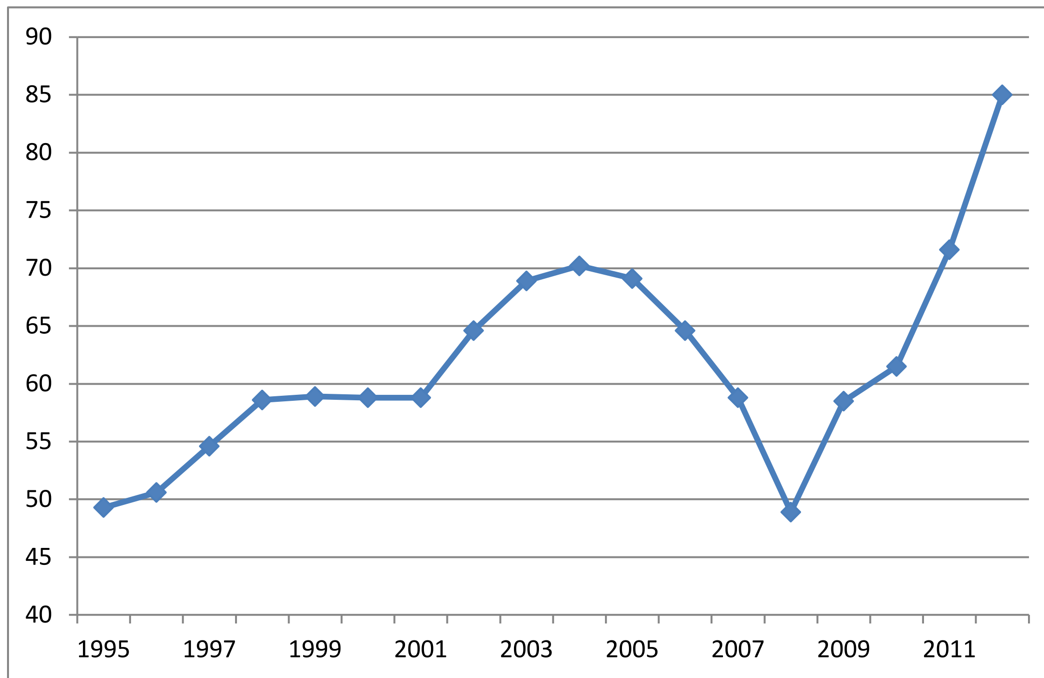
What happened? He went to Europe, negotiated the best deal he could get, and brought it back,

where it was unanimously rejected. In our very fascinating conversation, he admitted that he had basically nothing to negotiate with. The Greeks at least had the ability to threaten that they would default on all their debt and threaten the entire Eurozone system. Cyprus simply did not owe enough money and was not all that systemically important. The powers in Europe (read, the Germans) decided to draw a line and were not inclined, as I and others noted at the time, to bail out what looked to be mostly Russian depositors. Never mind our sad pensioner mentioned above and thousands like her, as well as myriad operating businesses that one day were going concerns and the next day were out of business. No, said the Eurozone leaders, a new principle had to be established.

I asked everyone, including an audience of about 50 people to whom I spoke in the auditorium of the Central Bank of Cyprus, "Do you wish you had taken the deal that Sarris brought back?" Everyone agreed that if they could go back in time they would take it instantly, and that everyone they knew felt the same. But that is hindsight. Now the losses will not be 10% or 30% but 60-100%.

Except, that is, for Greek banks in Cyprus and Greek branches of Cypriot banks. No losses for them. In fact, Cypriot banks were forced to sell their Greek branches to Greek banks at fire-sale prices, compounding the losses to depositors. And even more strangely, the ELA loans to Laiki Bank were forced into the Bank of Cyprus, making the losses incurred by what might have been a salvageable enterprise into a pile of ruins. But the ECB was unwilling to risk losing any money on Cypriot loans and basically commandeered private assets to protect their balance sheet. As I said, I am just a country boy from West Texas, so I clearly can't be expected to understand the reasoning of the wise men who run the ECB. It gives me some small comfort that no one in Cyprus can understand it either.

It is not as if you could not see the Cypriot crisis coming. The data were there, now that we look back on it. While we are running short on space this week (and will continue next week), let me offer one chart on the increase in public debt in Cyprus. Yes, there were some one-off items that Michael Sarris took advantage of to reduce their debt during his tenure, but a 60% increase in debt in four years during the term of Communist Party rule? Alarm bells were ringing.



Next week we will look further at the signs that pointed to the impending Cypriot crisis and scan the present economic landscape to see if we can spot similar portents. The situation is not all bad. There is even some good news for Cyprus.

Is the Trend Your Friend?

As many of you know, I am a long-term believer in managed futures (over 20 years now!), one of the few alternative investment strategies that can produce positive absolute returns in both falling and rising interest-rate environments. The historical benefits of managed futures investing have been well documented. And at times that faith has been well rewarded.

However, the past few years have not been kind to managed futures performance, as we have seen a dearth of trends, amplified volatility compression, whipsawing between risk-on and risk-off market environments, and near-zero interest rates. Such times have often seemed like "the perfect storm." I often get asked whether it is time to “abandon the faith” and find another strategy.

Let me readily admit that if managed futures were a growth stock and you looked just at the chart of recent performance, you (and I!) would not be buyers. It would be a sad nowhere man of a stock. If managed futures were a value stock, though, you might actually think it was time to consider investing. But the key here is that *managed futures are not a stock but a strategy,* one that does not correlate with other asset classes.

If you believe that we will be in a risk-on/risk-off world for the next 2-3 years with no true trends, then managed futures will remain that "nowhere man." My opinion, though, is that that regime is coming to an end, with the shift in policy that is already underway. I believe we are approaching an era where Minsky and Schumpeter will reign and the clash of arms in an all-out currency war will establish trends that you will want to make your friend. And let me remind you, the currency war we face will be the first in the era of true fiat currencies, without the anchor of gold in the 1930s or the aftermath of Bretton Woods (and the dollar standard) that we saw in the last major currency wars.

From the perspective of the academic economist, this will be a fascinating time. From the perspective of an investor, it has the real potential to be either a huge opportunity or as frustrating a time as we have seen in the last 40 years.

I have written a great deal on managed futures in the past 20 years but have not updated my thoughts in the last few years. Fortunately, my partners at Altegris believe as I do that with crisis comes opportunity. My long-time friend Matt Osborne, one of the founding partners of Altegris, recently wrote a well-researched white paper, "**Is the Trend Your Friend?**," that puts the managed futures strategy into perspective for long-term investors. Matt has been looking at alternative strategies almost as long as I have and gets them as well as anyone in the business. I can only say "ditto" to his work. And "bravo!"

Most importantly, Matt's paper looks ahead and examines the prospects for a rebound in managed futures. As a committed investor in managed futures, I found this paper to be immensely helpful, and I highly recommend it to other managed futures investors and to any investor seeking low-correlation strategies. "**Is the Trend Your Friend?"** is an excellent read.

Croatia, Geneva, Las Vegas, and Rhode Island

I find myself on an island called Zlarin off the coast of Croatia in the Adriatic Sea. Some 200 residents and no cars. In a few weeks the population will swell to 2,000 for a few months. Somehow, my Irish economist friend David McWilliams ended up with a home here, the only "foreigner" on the island (long story). "Don't tell anyone about this place; I don't want them to come here and mess it up," he says. So let's keep that just between you and me. He's in a charming little village built by the Venetians – many of the buildings are centuries old. David's place is the new house on the block, less than a hundred years old. But it has wifi and a bed and comes equipped with a great storyteller – what more could you ask for?

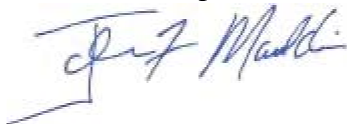
Getting here was an adventure. On Google, the road looked straight. I rode in a taxi, which snaked its way up, down, and around the mountains. It was as curvy a road as I have ever been on, and that says something. I swear the road was intentionally built with waves in it as well. My driver, a pleasant fellow named Sike, was a part-time taxi driver who had the soul of a Formula 1 racer. He clearly believed that the Mercedes he drove was meant to be pushed, as he changed gears about five times a minute. (Yes, I counted.) I mentioned all this to David.

"Oh, there is a straight road, a very marvelous new superhighway that no one takes. The fare is just too expensive." I think I will pay a little extra to Sike on the way back on Sunday.

I go to Geneva on Sunday and will be back in Texas Tuesday night. I will celebrate July 4th with the kids and then go the next day to Las Vegas for a conference on the theme of "investing and poker," during the World Series of Poker. And then I'm home for two weeks before I head to Newport, Rhode Island, where I will once again participate in a small, week-long gathering for the Office of Net Assessment of the Department of Defense, in which we will think hard about future scenarios. I will hang around the East Coast for a few days, meet my youngest son, Trey, in NYC and then hightail it up to Maine for our annual fishing trip with David Kotok and all the economic fisherfolk.

It is really time to hit the send button, as I want to get some sleep and spend the day tomorrow gazing at the Dalmatian coast and catching up on David's latest tales. He does have that Irish gift.

Your wondering where he is analyst,



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