What Will Germany Do?

John Mauldin | June 25, 2012

This week all eyes are on Germany, and the question is "What will Germany do?" We are going to look at four quite-short essays. Two are from GaveKal, one is from Dennis Gartman, and the last is from Kiron Sarkar – all on this very topic.

One of the reasons I really like to read the research from GaveKal is that they are very public when their analysts disagree, and you get to listen to the back and forth. Some of the best analysis I see is when Charles and Louis Gave (father and son) and Anatole Kaletsky do email battle with each other while they are on three different continents. This time it is Anatole and one of their analysts, Francois Chauchat (whom I have not had the pleasure of meeting), differing on whether Germany should (or even can!) leave the eurozone.

I should note that it is not unusual for there to be intense debates in serious research houses. Happens every day, and perhaps often during the day. When you are playing an "A"-level game at one of the best research houses, you are typically not a shy, retiring type. What is less than usual is for that debate to be played out in public for clients to see. While a strong, useful consensus may be reached, I find the sturm and drang of the debate to ofttimes be just as instructive.

Anatole thinks Germany should leave, and you find yourself nodding your head, and then you read Francois and you sit back. This is a very complicated issue.

I continue to believe that Europe in general and Germany in particular have no good choices. They can only choose between Disaster A, which is keeping the eurozone together, and Disaster B, which is breaking the eurozone apart. Either will cost trillions of euros and mean much pain. It is not a choice of pain or no pain. It is simply a decision as to what type of pain you want and in what doses you want to take it. Choose wisely.

Then Dennis Gartman weighs in this morning. For those who know Dennis, he is never shy about voicing his opinions when he writes every market day at 3 AM Eastern Time, from wherever in the world he is. But he is not married to any positions. His favorite quote seems to be from Keynes, which is (loosely), "When the facts change then so do my opinions." And then he tells everyone about the change and why. You have to love that.

But this morning he was exceptionally strong in his opening piece about Europe and Germany. After reading the notes from GaveKal, absorb Dennis's pithy analysis.

And finally there is a one-page summary note from Kiron Sarkar, which he sent me while we were exchanging emails today. (With m on my iPad 3 in Tuscany. There is an Italian company that sells a SIM card for the iPad that gives unlimited monthly data for €20. Awesome! Pay attention, AT&T).

This is a real feast for those who love to think about what's behind the headlines. I love it.

As noted above, I am back in the village of Trequanda in Tuscany. I do so love this place. Such peace and such views. Real, meaty food for the soul, while your body gets amazing Italian cuisine! The first of our guests arrived today, and the conversation while dining al fresco, gazing over the Tuscan hills soaking up the sunset, was so fascinating. My version of relaxing and recharging, even if it was with a nonalcoholic beer (sigh!).

Have a great week; I know I will. I see lots of fresh tomatoes and mozzarella in my immediate future. And lots of great conversations and time to read and think.

Your wondering why I only booked two weeks analyst,

John Mauldin, Editor
Outside the Box

It May Be Time To Say "Auf Wiedersehen"

By Anatole Kaletsky

Now that the Greek election is over, with the pro-bailout parties gaining enough seats for a slim majority, Europe can return to the regular cycle of panic, relief, disappointment and renewed panic, that we have observed for the past two years. **This time, however, the relief rally may be even shorter than usual, since the market's attention will soon shift from Athens to Madrid, Paris and, above all, Berlin**. Since Greece has no chance of meeting its financial targets, the new government will soon need significant new concessions from the troika. Assuming that Germany resists such concessions, as well as the much larger ones that will soon be required by Spain, the fundamental contradiction of the euro project will again be brought into focus. A single currency can only be sustained within a fiscal and political union that can mutualise and monetize the debt— something that Germany refuses even to discuss.

If this situation persists, then one of two things could happen. The debtor countries could resign themselves to permanent depression and bankruptcy as they sink further into debt traps and Greek-style crises which will ultimately push them out of the euro one by one. Or they could turn the tables on Germany. Instead of letting Germany impose its economic and political philosophy on Greece, Ireland and Portugal—and in the near future on Spain, Italy and probably France—the

Club Med countries could unite and impose their economic philosophy on Germany.

With every day that passes, and especially since the French election, it is becoming clearer that the problem country for the euro—the odd man out in terms of economic structure and the chief obstacle to any political resolution of the euro crisis—is not Greece, Spain or Italy. It is Germany. It is Germany that refuses even to talk about mutual debt and banking guarantees. It is Germany that insists on self-defeating fiscal austerity and intolerable political conditions for the debtor countries. It is Germany that vetoes quantitative easing by the ECB, which could cap bond yields and relieve deflationary debt traps. And it is Germany that makes the other euro countries uncompetitive, discourages devaluation of the euro against the dollar and refuses even to relax its own domestic fiscal policies to reduce its trade surplus and support growth.

Suppose then that Angela Merkel refuses to make any compromise on debt mutualisation or ECB monetisation when a political or market crisis next strikes one of the debtor countries, as it surely will. The obvious answer would be for the Club Med governments to point out that Germany has become the obstacle to a resolution of the euro crisis. Mrs Merkel could then be asked, one last time, to abide by majority decisions that are necessary for the survival of the euro and in the interests of all its members. If she refused to do this, Germany could be politely asked to leave. And if Mrs Merkel refused to fall in line or voluntarily leave the euro, the other countries could easily call her bluff by creating conditions that would be unacceptable to the German public. The obvious way to do this would be to force a vote in the ECB for unlimited quantitative easing to monetise government debts.

German public opinion would surely oppose this, but they could not prevent it because Germany has just two votes on the Council of the ECB —and even assuming support from Austria, Finland, the Netherlands and Slovakia, the German faction would command only 6 votes out of 23. If the two German ECB representatives were forced to resign in protest (again!), it is easy to imagine German public opinion demanding immediate withdrawal. A new Deutschemarks could rapidly be issued by the Bundesbank and, while the German banks and insurance companies would suffer large losses because of a mismatch between their euro assets and their New D-Mark liabilities, they could be readily recapitalised by a government suddenly freed of the contingent liabilities imposed by the rest of the eurozone.

This kind of euro break-up triggered by German revaluation would be much less disruptive than a "break-*down*" caused by devaluation in Greece or Spain. In the case of a German revaluation, there would be no contagion or capital flight, as there would be if Greece, then Spain, then Italy and France were knocked out of the euro one by one. There would be no lawsuits by disgruntled creditors.

Best of all, from both the legal and the economic standpoint, the legacy euro created by a German withdrawal would survive as a *more* viable common currency for the remaining countries of the eurozone. With Germany outside the euro, France, Italy and Spain could rapidly devalue their way back to competitiveness within Europe—and also internationally, by encouraging the new euro to devalue rapidly against the dollar, yen and RMB. Without German opposition, the ECB could imitate the Fed and the Bank of England, buying bonds without limit so as to slash long-term interest rates. And if quantitative easing produced an even weaker euro or higher inflation, so much the better, since the Club Med countries have always relied on devaluation to promote export growth and inflation to eliminate debts.

A break-*up* of the euro caused by Germany's departure would be very bullish for practically all global risk assets, with the obvious exception of German export and bank stocks. German bonds would also suffer huge losses, since the German government could decide to repay its bonds in legacy euros, rather than redenominating all its obligations into appreciating new Deutschemarks. For a government that had just spent hundreds of billions on recapitalising its banks for the losses they suffered in France, Spain and Italy, it would be tempting to burn foreign bondholders, rather than offering them a further currency windfall.

Germany Has To Stay: A Riposte

By Francois Chauchat

In his Reuters column last week (see **here**), and his recent Daily, Anatole argues that it may be more logical for Germany to leave the eurozone, rather than Spain or Italy. Germany is indeed the main outlier in economic terms; if it were removed, intra-euro zone economic dispersion would be much lower. However a scenario where Germany is the only country that exits is not just improbable—it is also undesirable:

- Germany has long been considered by the other Europeans as the main vector of reforms, and a catalyst for change in France and Southern Europe. While Germany hardly fits the Anglo-Saxon ideal of a flexible, free-market economy (although more so since the inception of Gerhard Schroeder's reforms), the country is a more acceptable model for Europe's laggards than that provided by the US or the UK. If Germany leaves, which textbook would guide the economic policy of the South? Mao's red book? Economic history, as well as simple logic, shows that lasting growth cannot be achieved on the sole basis of devaluation and money-printing. Without supply-side and welfare state reforms, a Latin Union would have no economic viability. In this respect, we had a foretasteof how things "work" in the south when Germany was weak and busy fixing its own problems during the counter-shock years of the unification (1995-2005). The cost of capital plunged in Europe, and instead of taking this opportunity to reform their economies at a lower cost, France and Southern Europe did exactly the opposite: vested interests largely dictated stupid economic policies of social-clientelism. I do not want to see what would happen if

the debt problems of these countries are fixed through devaluation and quantitative easing.

- Politically, the consistency of any Latin Union would not be superior to that of the current eurozone. A Latin Union would be led by France. Just writing or reading this sentence, you have lost the Spaniards. Spain is a proud country, which historically sought alliances with the North againstFrance almost each time there were power redistributions in Europe. Moreover, most French and even many Italians would be extremely uncomfortable participating in a union that has lost its bad cop. If the French and others today agree, reluctantly, to pay for the Greeks, it is because they know that the Germans and the Dutch pay too! And finally, what do we make of Belgium? I doubt that even the Walloons would be enthusiastic about a Latin Union.

- Germany would lose too much. First, its financial sector would see hundreds of billions disappear on the devaluation of the euro versus the revived Deutschemark. Most banks would thus have to be nationalized. And it would do no good to lighten its exit cost by paying its external debt in euros rather than its new currency. This would just push the DM even higher, and so German banks would lose even more on their €500bn exposure to Southern Europe, France and Belgium. In addition, the Bundesbank would have to bear an even higher cost on the unwinding of its €700bn claim on the Target2 interbank liquidity system. Indeed, when you add these two claims together, you get €1.2trn, which is more than the €1trn of German public debt held by non-resident investors. All the potential gains of keeping external debt in euros rather than denominating it in DEM would be eaten up by the losses in the banking sector. And on top of these direct losses would need to be added indirect financial losses, the economic costs of litigation, and, last but not least, the collapse of the profitability of the export industry in a country where exports accounts for 45% of GDP.

- Most people outside continental Europe do not realize how deeply national laws, regulations and political projects are permeated with European directives. Breaking up the euro would thus be like unscrambling an omelet, and this is not just a monetary omelet. Even an exit of Germany alone would still call into question the viability of many legal, economic and political aspects of the European Union. The disruption would be considerable.

- Finally, Germany would feel both guilty and orphaned to leave the most ambitious European project ever conceived.

Theoretically and practically, the only scenario in which a euro break-up could be done at an acceptable cost would be a clean, general and well-organized break-up where all euro members would have secretly pre-agreed on the terms, and that would keep the project of European integration alive (see **An Alternative Euro End Game** [subscribers only]). The probability of this ideal scenario is, unfortunately, not much higher than the one we have just discussed.

Ill News

By Dennis Gartman

Concerning the EUR, the week begins with some ill news, as the "troika" officials that were to visit Athens have chosen to "postpone" their meeting scheduled for today with the new Greek government. Further, it appears that when the pan-European Summit meeting begins later this week (and the debate in the media and in TGL for the next several days shall be about this impending meeting, rest assured of that), any hopes that Ms. Merkel will accede to the demands of Mr. Hollande that more financing be made available and for the advent of EUR-bonds will be dashed. Hollande has been pushing, for example, that the EUR-zone's bailout funds be allowed to buy sovereign debt on the secondary market, without having to invoke so-called "emergency borrowing procedures." Mr. Hollande wants the ECB to have the day-to-day ability to buy such debt as is necessary; Ms. Merkel is openly opposed to even considering such action. To this point, Ms. Merkel won't even debate it, much less move to allow it, leaving Mr. Hollande rather openly ... and embarrassingly ... flailing in the economic and political wind. As one anonymous French economist at a leading French bank said over the weekend,

"There is a real conflict here and the future of Europe is at stake. Mr. Hollande has exerted the maximum pressure on Merkel but if she remains intransigent and only agrees to the growth pact, I believe he will cave in and give her wants she wants."

What Ms. Merkel wants is nothing short of German oversight and ultimately dominion over all future sovereign debt issuance, oversight of the European banks themselves, and German supremacy on nearly all fronts economic and political. In Ms. Merkel's world ... and here she is merely reflecting the general philosophy of the German people themselves ... if Germany's checkbook is going to be relied upon, then German oversight shall be demanded by the German government, as demanded by the German people.

We found it interesting and exemplary of the problems attendant to Europe when, at a meeting last week of Merkel, Hollande, Monti, and Rajoy, Ms. Merkel sat on one side of the table, faced by the French, Italian, and Spanish prime ministers on the other. One side has the "gold," the other side has the debts and, as is always the case, he who has the "gold" has the power. Even Tony Montana understood that simple fact when he said, in his famous soliloquy in *Scarface,* that "In this country, you gotta' make the money first. Then when you get the money, you get the power. Then when you get the power, then you get the women." In Europe, we've come to this: Germany has the money and it has the power and that, simply, is that.

Germany's finance minister, Mr. Schaeuble, was busy over the weekend ahead of the meetings he will be attending later this week, appearing on television and speaking with the press. He said in an interview with the German TV network ZDF that Greece simply hasn't done enough to make

good on promises regarding fiscal austerity and meeting certain debt/GDP ratios that it made in exchange for bailout funds. Mr. Schaeuble said that the process goes far deeper and that the root causes of Greece's problems have to be resolved. He said,

"We have to fight the causes.... [and] anyone who believes that money alone or bailouts or any other solutions, or monetary policy at the ECB – that will never resolve the problem. The causes have to be resolved.

"It's not going to help to take money to it. The decisive thing is to credibly fight the causes of the crisis. It's succeeding very well in Ireland and Portugal. It's not succeeding very well in Greece. But it must succeed in Greece. There's no other way to do this.

"Greece hasn't tried enough so far, that has to be said quite clearly. That has to be said with respect for the domestic political difficulties. But no one on earth who has followed this issue would think that Greece has fulfilled what it has promised ... [however] Italy and Spain are different on this question. They're making great reform efforts."

At this point we should remember that Mr. Schaeuble has played, is playing, and in the future shall play the "bad cop" in the usual "good cop/bad cop" tandems that so often develop in situations like this. Ms. Merkel ofttimes looks to be the "good cop" in relation to Schaeuble.

Mr. Soros is "bad copping" this morning, too, as he has made it clear in one press conference after another in the past several days that he believes Europe is truly at risk of collapsing unless something material and timely is done to allow the ECB to buy pan-European debt in the open market. He has called upon Europe's leaders to swiftly create a "European Fiscal Authority" that would have the ability and the authority to buy Italian and Spanish debt, but only following actions by the Italian and Spanish governments to achieve credible material budget cuts. Mr. Soros has said that unless this authority is created and announced before the impending European Summit ... which begins on the 28th, by the way ... the result "could be fatal" for the EUR. Ms. Merkel has made it clear that she is not willing to agree to such a proposal until such time as full fiscal union is established; and that, as we understand it, would require major changes to Maastricht and the other treaties that are at the very heart of "Europe" as we know it presently.

And finally, this note from Kiron Sarkar, who I think is in Ireland today:

In addition to the existing monetary union, the Germans want fiscal union, leading to political union – in that order.

Political Union is the clear goal. They understand that the EU (and not even Germany), cannot compete with emerging countries such as China, India or developed countries such the US, in the future, given their natural strengths, without a political union. In addition, they do not want any more EU fudges, fixes or compromises, so common within the EU in the past.

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Germany also understands that the EU/EZ, as currently structured, is flawed and that Europe needs true political union. Indeed, the Germans are increasingly suspicious of the EU bureaucracy, as they believe it is a bloated, overpaid and incompetent organisation – totally true and very much the views of the UK, for a very long time. The EU leaders were previously selected by EU heads of state on the basis that there were the least effective (and therefore would pose the least problem to them), so why should anyone be surprised. Why did the Germans take so long to understand you could well ask.

The Germans (Mrs Merkel) are prepared to open up their cheque book (though you must understand that it is not unlimited), but only if they believe that EZ countries will stick to pre agreed fiscal targets ie their money will make a difference. France, designed the EU to suit itself, but essentially it created an intergovernmental club, rather than a supranational organisation as today's WSJ very rightly says. In addition, the French ensured that they "parked" their people in the senior most positions possible.

The French, on the other hand, do not want to transfer sovereignty to another organisation, but, in my view, will have to. They are relatively weak and getting weaker. President Hollande's promises are unaffordable. Just today, the French minister of finance admitted that France needs to find between E7bn to E12bn of savings to reach its agreed budget target this year. How can Hollande's wild (and expensive) promises be accommodated. They cant. However, the French are known to take to the streets, which could make this issue explosive. Unlike Sarkozy, Hollande at the end of the day, will give in, though the domestic political pressure he will face will be enormous. Changes to the French constitution, which will be necessary if there is to be political union, will be particularly difficult. Most of the other EZ countries will be more amenable.

Mrs Merkel is facing increasing anti EU/EZ pressure at home – the only good news is that her main opposition is very much more pro EU/EZ. For her to act like the "Iron Lady" will play well with the voters in Germany – not a minor issue for a politician who is seeking reelection in late 2013.

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