Random Europe

John Mauldin | August 13, 2012

It is a lazy summer day here in Texas, and the market and investment news front is rather quiet as well. But that will change before too long. We should enjoy the relative calm while we can, because Europe will soon be back in full crisis mode, coming off the summer. In today's Outside the Box we'll look at three brief pieces that may give us a preview of the near future, as well as an incisive retrospective on the recent past.

The first is from Roubini Global Economics. It's part of a longer piece by Megan Greene, looking at what lies ahead in Europe. The fun & games there promise to ramp back up all too quickly. Then we have another extract from a longer piece by Kiron Sarkar, looking at Germany, that echoes some of the themes from last week's Thoughts from the Frontline. The German leadership has not really been transparent with their people, but then you can't hide trillion-dollar commitments very easily.

Finally, we wrap with Ambrose Evans-Pritchard's latest column, which I think is one of the better ones he has done in years. I would call it a must-read. Under the title "Five years on, the Great Recession is turning into a life sentence," he concludes with:

"As for our [the developed world's] debt mountain, we have barely begun the great purge. Michala Marcussen from Societe Generale says the healthy level is around 200pc of GDP for advanced economies. If so, we have 100 points to cut.

"This cannot be achieved by austerity alone because economic contraction would tip us all into a Grecian vortex. Such a cure is self-defeating.

"Much of the debt will have to be written off. Whether this done by inflation (1945-1952) or default (1930-1934) will be the great political battle of this decade. Pick your side. Pick your history."

When you come to the Endgame of the Debt Supercycle, something must indeed be done with all the excess debt that has been accumulated. Different countries will choose different options, but no matter the choice there will be pain. It remains to be seen how that pain is spread around.

In the US, Romney has evidently decided to stop playing small-ball politics and turn the discussion into a referendum on the direction of the country. Both sides think this discussion will be to their advantage, which, if it were not my home country with consequences for my kids, I would find somewhat entertaining. But, as I wrote almost two years ago, this is a national discussion we absolutely must have. The issues are complicated, and there are no easy answers when you have to move out of the realm of theory and into the messy real world. Workable solutions to our big fiscal problems will be a much harder "sell" to the American public than either side currently thinks, as the majority of Americans, according to the polls, would like to eat their cake without paying for it. It is not clear what our choices will be when the true consequences are understood. I will comment further on this topic on Friday.

In the meantime, have a great week. My congratulations to my British friends on a marvelous Olympics.

Your getting ready to kick back a little analyst,

John Mauldin, Editor
Outside the Box

EZ: The Drama Ahead in September

By Megan Greene, Roubini Global Economics (www.roubini.com)

As usual, this has been a lazy August, but we do not expect the quiet to last. Indeed, for the second September in a row, developments in the eurozone (EZ) have the potential to be highly dramatic.

Greece: The troika is due to return to Athens in September and make a ruling on whether to release additional tranches of funding to Greece. If the troika decides to cut the taps off—and we don't think it will—then Greece would default and exit the EZ. The Greek government aims to renegotiate the second bailout program when the troika returns to town in September. If the troika plays hardball and does not grant the Greek government any concessions, then the governing coalition would likely collapse. Also in September, the Greek parliament will have to pass a number of measures to generate €11.5 billion in savings for 2013-14. With a high degree of austerity fatigue in Greece, we can expect social unrest.

Portugal: With Portugal starting to slip on its fiscal targets, we expect Portugal to begin negotiations on a second bailout package. Currently, Portugal is meant to return to the markets in 2013 but, with bond yields well above sustainable levels, we regard this as highly unlikely.

Spain: The auditors Deloitte, KPMG, PwC and Ernst & Young are due to present their full reports on the capital needs of Spain's financial sector in September. The findings of this report will be used to determine the exact amount the Spanish banking sector will need to borrow from the EZ's bailout fund, the European Financial Stability Facility (EFSF).

Italy: The Italian general election campaign will begin in earnest in September. Although polls point toward a center-left-led coalition, Italian politics is at its most fluid state since the early 1990s and, with so many voters still undecided, it is impossible to call the election.

Germany: The German constitutional court is due to vote on the legality of the ESM (the successor to the EFSF) and the fiscal compact on September 12. We expect the court will deem the ESM legal but, if this does not occur, it would serve a major blow to EZ policy makers, who have committed the ESM to potentially purchasing sovereign debt in the primary markets.

France: The French government is scheduled to unveil its 2013 budget in September. Markets will be disappointed if it does not include large spending cuts, but the announcement of further austerity risks riling trade unions and stoking civil unrest.

Netherlands: A general election is scheduled for September 12. Recent opinion polls suggest the ruling right-of-center VVD will be unable to form a right-of-center majority government. Consequently, coalition negotiations are likely to be protracted. The left-wing, euro-skeptic SP may win enough votes to be the second-biggest party. This would make it more difficult for the new Dutch coalition to secure parliamentary support for additional support measures for peripheral EZ countries.

Eurozone: There is a progress report on establishing the ECB as a single banking supervisor due out in September. Given that many details have not been hammered out yet, there is a chance that the progress made on this first step toward a banking union will disappoint.

In terms of the broader EZ developments, we expect the Greek government to collapse by the end of the year, and a Greek exit in early 2013, followed by an exit by Portugal by end-2014. Moreover, we expect Spain to receive official support from the EFSF/ESM in late 2012 after the ESM has been fully ratified (the second half of September at the earliest), while Italy will hang on longer but will eventually need support as well.

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And from the notes that my friend Kiron Sarkar sent me today:

German newspapers sets out 5 major problems for Mrs Merkel, now that she has returned from holiday. They include;

a) Increasing reluctance to provide further aid to Greece from members of the FDP (her coalition partner) and the CDU's Bavarian sister party (the CSU). In addition, there is the matter of the decision by the German Constitutional Court as to whether the German President can sign off on the fiscal compact and the ESM – generally, the German press is raising the issue of conditionality;

b) Issues in respect of renewable energy, childcare and gay rights;

c) The weakening support for her coalition partner the FPD – now has just 4.0% of the vote in recent polls. You need at least 5.0% to gain any representation;

d) Mrs Merkel's sister party the CSU is getting more populist, given impending State elections next year. They are opposed to a further Greek bail out;

e) Recently, Mrs Merkel had to rely on support from the opposition SPD and the Greens to get her EZ/Euro rescue efforts passed in Parliament, due to defections from her own coalition. However, Peer Steinbruck, a leading member of the SPD and former Finance Minister, states that Mrs Merkel cannot count on their continued support, without offering "concessions";

Dutch retail sales decline materially. June retail sales rose by +1.0% Y/Y, as opposed to expectations of +2.5% and +1.6% in May. The markets have ignored Holland – dangerous. The Dutch are becoming more Euro sceptic, given their economic problems and general elections are due in mid September. They are also one of the remaining 4 countries in the EZ, which has a AAA rating, the others being Germany, Finland and Luxembourg. However, Moody's have stated that Germany, Holland and Luxembourg risk losing their AAA status. The Dutch have been particularly hawkish on Greece.

Over the weekend, I read numerous articles which (for, effectively, the first time) keep bringing up the subject of a referendum (in respect of the EZ/Euro) in Germany. Yes, the SPD has proposed a referendum and Schaeuble, a month or so ago, talked about it. However, the increase in calls for a referendum has surprised me. In addition, there is increased speculation (including on Bloomberg today) that whilst the the Constitutional Court will allow the German President to sign off on the fiscal compact/ESM, they may impose conditions which (severely?) impact the ability of Mrs Merkel/Germany to act. As you know, I believe that the Constitutional Court will allow the President to sign off on the fiscal compact/ESM, but remain concerned about (restrictive?) conditions. Any such conditionality will clearly be a major negative. In addition, the ECB have stated that they will only act if the relevant countries first seek support from the EFSF/ESM. Any material limitations which, for example, do not allow the ESM to be leveraged, due to conditions imposed by the Constitutional Court (it's far too small at present), will be a major problem.

As you know, one of my biggest concern remains that Mrs Merkel has not sold the idea of the EZ/Euro to the German's, preferring to do deals in dark, smoke filled rooms with the doors firmly bolted. I continue to believe that this is a very dangerous and high risk strategy. In addition, a number of German politicians report that Mrs Merkel says one thing in public, but does the opposite in private. That game has ended – the spotlight is on her and on her actions. There is no question that Mrs Merkel and most German politicians are keen to support the EZ/Euro. However, with increasing opposition from her own party and coalition partners and the SPD's statement that they want (presumably political) "concessions" for on going support, (which Mrs Merkel will clearly need), the Risk/Reward situation is changing.

Recent polls suggest that the Germans understand that the costs to their economy will be far greater if the EZ/Euro breaks up, but it looks as if the support is slipping. Populist politicians are playing to the crowds, which will aggravate the situation.

The impending Dutch elections remains a serious threat and is being ignored – dangerous.

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And now to Ambrose:

Five years on, the Great Recession is turning into a life sentence

By Ambrose Evans-Pritchard, International business editor

Five years into the Long Slump it almost seems as if we are back to square one.

Some date the crisis to August 9 2007, the day it became clear that Europe's banks were up to their necks in US housing debt. The ECB flooded markets with €95bn of liquidity. It seemed a lot of money then. The term "trillion" was still banned by the Telegraph style book in those innocent days. We have since learned to swing with the modern dance music from central banks.

China is sufficiently alarmed by the flint hardness of its "soft-landing" to talk up trillions of fresh stimulus. The European Central Bank is preparing to print "whatever it takes" to save Spain and Italy. Markets are pricing in an 80pc chance of yet more printing by the US Federal Reserve in September or soon after.

There is no doubt that the three superpowers acting in concert can launch a mini-cycle of growth early next year – assuming they deliver on their rhetoric – but the twin headwinds of debt-leveraging and excess manufacturing plant across the globe cannot easily be conjured away.

The world remains in barely contained slump. Industrial output is still below earlier peaks in Germany (-2), US (-3), Canada (-8) France (-9), Sweden (-10), Britain (-11), Belgium (-12), Japan (-15), Hungary (-15) Italy (-17), Spain (-22), Greece (-27), according to St Louis Fed data. By that gauge this is proving more intractable than the Great Depression.

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For me, the defining moment was twelve days later when yields on 3-month US Treasury bills to crashed from 3.76pc to 2.55pc in just two hours. At first we thought it was a mistake, a screen glitch. Nothing like this had happened before, not during the crashes of 1929 or 1987, or after the Twin Towers attack on 9/11.

Investors were pulling money out of America's $2.5 trillion money market industry in panic. This was the long-feared heart attack in the credit system, even if the economic malaise behind it did not become clear for another year.

The original trigger for the Great Recession has since faded into insignificance. America's house price bubble – modest by European or Chinese standards – has by now entirely deflated. Warren Buffett is betting on a rebound. Fannie and Freddie are making money again.

Five years on it is clear that subprime was merely the first bubble to pop, a symptom not a cause. Europe had its own parallel follies. Britons were extracting almost 5pc of GDP each year in home equity by the end. Spain built 800,00 homes in 2007 for a market of 250,000. Iceland ran amok, so did Latvia and Hungary. The credit debacle was global. If there was an epicentre, it was Europe's €35 trillion banking nexus.

Monetarists blame the ECB and the Fed for keeping money too tight in early to mid 2008, pushing a fragile credit system over the edge. They blame "pro-cyclical" regulators for aborting recovery ever since by forcing banks to raise asset ratios too fast. They are right on both counts.

Yet the 'Austrian School' is surely right as well to argue that a rise in debt ratios across the rich world from 167pc of GDP to 314pc in just thirty years was bound to end badly. There comes a point when extra debt draws down prosperity from the future. The future arrived in 2008.

A study by Stephen Cecchetti at the Bank for International Settlements concludes that debt turns "bad" at roughly 85pc of GDP for public debt, 85pc for household debt, and 90pc corporate debt. If all three break the limit together, the system loses its shock absorbers.

"Debt is a two-edged sword. Used wisely and in moderation, it clearly improves welfare. Used imprudently and in excess, the result can be disaster," he said.

Creditors and debtors may in theory offset each other, but what actually happens in a crunch is that borrowers cut back feverishly. Creditors do not offset the effect. The whole system spins downwards. It is debt's fatal "asymmetry", long overlooked by New Keynesian orthodoxy.

It is how people behave, and how countries behave. Creditor Germany did not offset the squeeze in Club Med. Creditor China did not offset the squeeze in the US. The world contracted.

But why did the credit bubble happen in the first place? You could argue that it is merely the flip-side of too much saving. The world savings rate has crept up to a modern-era high of 24pc of GDP. That is the most important single piece of information you need to know to understand the great economic drama we are living through.

There is nowhere for this money to go. The funds flood into investment – now a world record 49pc of GDP in China – or into asset bubbles.

So my candidate for chief cause is Asia's 'Savings Glut', and indeed whole the structure of East-West trade under globalisation.

The emerging powers built up $10 trillion of foreign reserves – ie bonds – in a decade. They flooded the global bond market. That is why spreads on 10-year Greek debt fell to a wafer-thin 26 basis points over Bunds in the bubble.

They also flooded Western markets with cheap goods, driving down goods inflation. Western central banks – in thrall to inflation-targeting – cut short-term interest rates ever lower. They set the price of credit too low, forcing pension funds and insurers to hunt frantically for yield to match their books. The central banks compounded the effect.

Western multinationals played their part in this saga. They drove up the profit share of GDP to historic highs, playing off wage rates in the US and Europe against cheaper labour in China, Latin America, or Eastern Europe. That too concentrated wealth among those who tend to buy shares, land, and Impressionist paintings, rather than goods. The GINI coefficient of income inequality went through the roof, as it did in the late 1920s. It is a formula for asset bubbles.

The credit bubble disguised the exorbitant imbalances in trade, capital flows, and incomes. The game could continue only as long as the West in general – and the Anglosphere and Club Med in particular – were willing to run ruinous current account deficits, borrowing themselves into dire trouble.

As soon as the debtors hit the brakes and slashed spending, the underlying reality was exposed. There is too much saving and too little consumption in the world to keep growth, and people in jobs. It is the 1930s disease. On this the Keynesians are right.

None of this would have been any different if banks had been saints. The forces at work are tidal in power.

So this is where we are in the summer of 2012. The imbalances are slowly correcting. Wage inflation has eroded Asia's competitiveness. China's current account surplus has dropped from 10pc of GDP in 2007 to around 2.5pc this year.

Yet Europe refused to adjust. Germany is still running a surplus of 5.2pc, down from 7.4pc in 2007. The North has refused to offset the demand squeeze in Club Med. Indeed, Germany legislated its own internal squeeze through a balanced budget law and imposed this curse on the rest of Euroland. The effect is to trap Euroland in chronic slump, at least until the victims rebel and take matters into their own hands.

As for our debt mountain, we have barely begun the great purge. Michala Marcussen from Societe Generale says the healthy level is around 200pc of GDP for advanced economies. If so, we have 100 points to cut.

This cannot be achieved by austerity alone because economic contraction would tip us all into a Grecian vortex. Such a cure is self-defeating.

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