Thoughts from the FRONTLINE
John Mauldin's free weekly investment and economic newsletter

A Dysfunctional Nation

By John Mauldin | June 9, 2012

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dysfunctional [dɪsˈfʌŋkʃən^{ə}l] *adj*

> **1.** (Medicine) *Med* (of an organ or part) not functioning normally
> **2.** (especially of a family) characterized by a breakdown of normal or beneficial relationships between members of the group

European leaders launched the euro project in the last century as an experiment to see whether political hope could become economic reality. What they have done is create one of the most dysfunctional economic systems in history. And the distortions inherent in that system are now playing out in an increasingly dysfunctional social order. Today we look at some rather disturbing recent events and wonder about the actual costs of that experiment. What type of "therapy" will be needed to treat the dysfunctional family that Europe has become? And maybe I'll throw in a "fun" item to finish with, so let's get started.

A Dysfunctional Nation

Michael Lewis has documented quite tellingly in *Boomerang* the dysfunctional country that is Greece – how citizens avoid taxes, how over 600 categories of workers can retire at the age of 50 with full pensions, and how fraud and corruption are endemic. Other stories have surfaced about how few doctors report more than 10,000 euros of income and how few professionals pay their property taxes.

Recently, when the current Greek government committed to actually collect some taxes in order to get more loans, a bureaucrat decided that a great way to collect property taxes would be to include them in people's electricity bills, a move that caused an uproar. Lawsuits followed, as the national power company tried to cut off electricity for nonpayment. In a country where it can take a decade for a legal matter to get on a court docket, a court rather quickly took up the case and ruled it illegal for the power company to cut off service for non-payment. This ruling led to a massive financial loss by the power company as people simply stopped paying their electric bills.

The government had to step in with a rather large chunk of cash to keep the power on. As of May 1, the power company announced, it would no longer collect property taxes. The natural gas company threatened to cut off supplies to the electric utility for nonpayment, and emergency meetings are being held to **"…** avert the collapse of the natural gas and electricity system."

The credit system in Greece is in a shambles, and there has been an open bank run this year. Reports that hospitals cannot get necessary life-saving medicines abound, as there is no more credit to be had from most manufacturers. Unemployment is at 22%, and youth unemployment is over 50%. "A collapse in the country's economy has forced many Greeks to turn to black market barter economies and has left millions financially devastated, with no hope of finding an income stream for the foreseeable future." (infowars.com)

The last election resulted in no possibility of a governing coalition, and new elections are scheduled for next weekend (June 17) – except that the employees who run the elections are threatening to strike if they are not given more pay. The head of the government workers union said Thursday that the union will hold a two-day strike on June 16-17. He also said municipal employees will refuse to do any election-related work until then. We will now see whether the courts will declare such a strike illegal and whether the members will honor a court decision. (http://www.washingtonpost.com/business/greek-municipal-workers-call-electoral-strike-threatening-to-derail-crucial-june-17-vote/2012/06/07/gJQAlhOjLV_story.html)

Greece was already in enough turmoil, with no clear winner emerging in the last polls that were taken this week. (Note: It is against Greek law to publish the results of a poll less than two weeks before an election.) And then there was the "debate."

I assume that by now you have seen the video of the televised debate among representatives of the seven Greek parties. In a bit of poor planning, the very nationalistic Golden Dawn party head, a rather solid-looking young body builder, was seated next to the Communist Party leader, who is a lady. A few insults were exchanged, some water was thrown in the face of a rather pleasant-looking young lady (a representative of a leftist party) across the table from the Golden Dawn guy, there was a slap on his arm with a folder by the Communist Party leader; and then they were on their feet and Mr. Golden Dawn was repeatedly slapping and then punching Ms. Communist Party.

If for some reason you have not viewed this short but exciting clip, here is a link: http://www.rt.com/news/greek-politician-slaps-rival-278/ . Or you can Google "golden dawn greek slap" and get a link to a report in your language of choice. If you choose the German version from *Der Spiegel,* you can hear the word *neo-Nazi* repeated several times by the German reporter.

This exchange provokes a few thoughts. First, incidents of violence and vigilantism in Greece are rising, along with the lawful public demonstrations. Whatever veneer of civility that was left was ripped away by the boorish behavior of the Golden Dawn representative.

Second, this fracas will now dominate the national conversation. Rather than focusing on what they should do about remaining in the eurozone, accepting or rejecting austerity, and putting together some sort of coalition that can govern the country, they will be focused on this event. Nine days before an election in which no party seemed to have a clear lead or a path to a ruling coalition, the results are now even more in question. Golden Dawn had some 6% of the Greek vote. Will it maintain that percentage? If not, where will its votes go? Will this help or hurt the mainstream conservative or left-of-center parties?

Whether it be families or nations, such a level of dysfunctionality almost always ends in tears. The "slap" is just one more telling incident in a country that is on the brink of self-destruction. It is very possible that the winner of the election will be a party that wants to reject austerity but believes that the rest of Europe will give them the money they need to continue to pay their public employees, maintain services, and keep the government functioning. The reasoning seems to be that Europe will do that because they need the Greeks to continue to pretend that they will pay off their national debt to the European governments and ECB.

Why are we still fixated on Greece? Even though Greece is small, it matters; because if Greece leaves the euro then the markets will immediately ask, "Who's next?" And while a year ago everyone thought the answer was Portugal, the market is now looking hard at Spain, which is on the same path to insolvency that Greece was only a few years ago.

Spanish government leaders are now beginning to admit they must have help, as it appears they will soon be frozen out of the bond market, if that has not happened already. As I have written, it will take a massive commitment of European (read German) money to save Spain, and it's not a one-time commitment. It is not just 100 billion euros to re-fund Spain's banks. If Spain gets frozen out of the market, adding another €100 billion in debt will not make things better, when there is a nearly 10% fiscal deficit, unemployment as bad as Greece's, and an economy that is in freefall.

Europe is going to have to buy all Spanish debt for years. And not just new debt but all the old debt that is coming due and must be refinanced. We are talking hundreds of billions of euros. And if there is a bank run on the order of Greece's? The number just keeps getting bigger. To think it will be anything like the €46 billion being talked about by the IMF today is to simply ignore economic reality.

That money will have to come from somewhere. Either the ECB will have to monetize it directly (possible but not likely) or a pan-European entity like the ESM will have to be allowed to become a bank and then apply to the ECB for loans and a capital infusion in order to then bail out Spanish (and other) banks.

It is obvious, at least to your humble analyst, that if the eurozone is to survive several things must happen. First, there must be something created on the order of a European FDIC. Banking guarantees and regulation must become a European responsibility, not a country responsibility. How would it have worked if the rest of the US had decided that New York should bail out its own banks, when they had their crisis in 2008?

Second, if the ESM is allowed to become a bank, then what will those guarantees look like? Because the original agreement of member countries to back a specific and limited amount of debt will now be increased ten-fold. And that will mean something in the neighborhood of €4-5 trillion.

How could they need that much? The answer is, because it will not be just Spain. Can Italy be far behind, given the unfolding European recession? And the French banks? France itself, given the new policy direction of its government and its own massive unfunded liabilities?

Assume it is just €4 trillion, spread over a few years. Germany will be responsible for at least 25% of that amount, or about 40% of their GDP. And that assumes that Spain, Greece, Ireland, et al. will be good for their portions.

Will Germany want to take on such a massive new debt? The periphery countries already owe the German Bundesbank over €1 trillion. German debt-to-GDP is already at 80%. German credit default swaps are rising in cost.

If Germany takes that first step, it must be prepared to keep marching, because to stop at any point will mean even more pain, since they will still be responsible for their share of any debt created after that first step. As they say at the poker table, "In for a dime, in for a dollar."

Certainly, if they are to take on such a debt, there must be guarantees of fiscal control by the nations who need help.

And that means a tighter fiscal union. When the euro was created, European leaders thought that a common currency would naturally lead to a fiscal union. Monetary unions without fiscal union always become dysfunctional.

Or there will have to be direct monetization of the debt by the ECB, which goes against the policy that Germany thinks it agreed to.

Either way, it is a very large change in position for Germany.

There are three problems that Europe must solve. They have a sovereign debt problem and a resulting banking debt problem. Both of these are evident and there might be some solution, given time and money.

But the third problem is the more difficult one. That is the trade imbalance between Germany and the peripheral countries and the differing levels of productivity of their workers. Trade deficits must be brought into line. The usual way to do this is through currency devaluation by the country with the trade deficit. That is not possible for the countries in the eurozone. So, the only other way is for the workers of an uncompetitive country to accept lower wages. Since no one thinks they are underpaid, that will happen slowly and painfully and mean a protracted recession or depression.

Which leads to voter frustration and frayed nerves that spill over into dysfunctional actions. It also leads to political changes.

Let's hold that thought for a moment. In the weekend *Financial Times,* my friends Niall Ferguson and Nouriel Roubini have written an op-ed calling for a European banking authority and tighter fiscal union, if the eurozone is to survive. http://www.ft.com/intl/cms/s/0/c49b69d8-b187-11e1-bbf9-00144feabdc0.html#axzz1xHuDXIr4

Let's look at a few paragraphs from the op-ed, with its leading question:

One Minute to Midnight?

"Is it one minute to midnight in Europe?

"We fear that the German government's policy of doing 'too little too late' risks a repeat of precisely the crisis of the mid-20th century that European integration was designed to avoid.

"We find it extraordinary that it should be Germany, of all countries, that is failing to learn from history. Fixated on the nonthreat of inflation, today's Germans appear to attach more importance to 1923 (the year of hyperinflation) than to 1933 (the year democracy died). They would do well to remember how a European banking crisis two years before 1933 contributed directly to the breakdown of democracy not just in their own country but right across the European continent….

"But now the public is finally losing faith and the silent run may spread to smaller insured deposits. Indeed, if Greece were to leave the eurozone, a deposit freeze would occur and euro deposits would be converted into new drachmas: so a euro in a Greek bank really is not equivalent to a euro in a German bank. Greeks have withdrawn more than €700m from their banks in the past month.

"More worryingly, there was also a surge in withdrawals from some Spanish banks last month. The government's bungled bailout of Bankia has only heightened public anxiety. On a recent visit to Barcelona, one of us was repeatedly asked if it was safe to leave money in a Spanish bank. This kind of process is potentially explosive….

"Until recently, the German position has been relentlessly negative on all such proposals. We understand German concerns about moral hazard. Putting German taxpayers' money on the line will be hard to justify if meaningful reforms do not materialise on the periphery. But such reforms are bound to take time. Structural reform of the German labour market was hardly an overnight success. By contrast, the European banking crisis is a real hazard that could escalate in days.

"Germans must understand that bank recapitalisation, European deposit insurance and debt mutualisation are not optional; they are essential to avoid an irreversible disintegration of Europe's monetary union. If they are still not convinced, they must understand that the costs of a eurozone breakup would be astronomically high – for themselves as much as anyone.

"After all, Germany's prosperity is in large measure a consequence of monetary union. The euro has given German exporters a far more competitive exchange rate than the old Deutschmark would have. And the rest of the eurozone remains the destination for 42 percent of German exports. Plunging half of that market into a new Depression can hardly be good for Germany.

"Ultimately, as Angela Merkel, the German chancellor, herself acknowledged last week, monetary union always implied further integration into a fiscal and political union. But before Europe gets anywhere near taking this historical step, it must first of all show it has learnt the lessons of the past. The EU was created to avoid repeating the disasters of the 1930s. It is time Europe's leaders – and especially Germany's – understood how perilously close they are to doing just that."

The Triumph of Hope

When the Eurozone was created it was the triumph of hope over the reality of political and economic discord. Somehow, countries that had different languages, customs and national characteristics; that had fought each other for centuries; and that all had different views of themselves in relation to the rest of their fellow Europeans, were supposed to come together into a fiscal union, because they now shopped with the same money.

Rather than simply creating a free-trade zone and allowing for a common understanding and economic integration to develop over time, the European leaders wanted to jump-start the process. And they had numerous critics. Many of the best and brightest in the economics world pointed out the problems.

The reality is that the euro has never been a real currency. It is still an experiment. If it is even around in five years, it will be a true currency, as it will have endured its first real crisis. The peripheral countries used the low interest rates of the euro to borrow heavily (both privately and publicly) and got in trouble, and now the true costs of the euro project are being revealed.

A break-up will cost multiple trillions of euros. Keeping the eurozone together will cost multiple trillions of euros. But keeping the eurozone together will also cost countries a substantial loss of sovereign independence. When voters all over Europe signed on for the euro project, they did not think they were giving up their national independence and the right to control their own budgets.

Will Spain or Italy or Germany be willing to allow a European institution to set their budget priorities and limits? To set their retirement policies and health care? To tax them independently? That is what is meant when one talks fiscal integration. Germany is now a minority on the ECB and is beginning to realize it has lost control. Will its voters want to give up political control and become a minority in a "United States of Europe"?

That is the true problem. When real economic difficulties arise, as in Greece or Spain, voters tend to get rather touchy. Tensions rise. And the center does not hold.

George Soros said this week that Europe has three months to resolve its problems. Nobel Laureate Joseph Stiglitz said Soros was being optimistic. A decision is going to have to be made quite soon about Spain, and likely before it becomes clear whether Greece will stay in or leave the euro. And that makes it difficult to give Spain aid that is not offered on equal terms to those Greece got. Monetizing Spanish debt (however you want to do it or whatever you want to call it) when Spain is running an almost 10% deficit, when it had agreed to a little over 5% only a few months ago, will not sit well with Greece.

But it now seems that Europe is unlikely to get the time it needs, absent some rabbit pulled out of its monetary hat to allow Spain to borrow money at rates that it can afford. The Endgame approaches. It will be a long summer.

I get asked all the time if the euro will break up. The honest answer is, we really don't know. I think the economically rational thing to do in the very long term is for some countries to figure out how to leave the euro, but that is more a political question than an economic one. And if you can tell me what politicians and voters will do in a political crisis and deepening recession, then your crystal ball is less foggy than mine.

I think it is 50-50. The drive to hold the euro together will go head to head with national self-interest. Right now, it depends on whom you ask as to what answer you get. But I do not think we will be asking the question much longer. Soon enough, we will know.

To be clear, Europe has no good choices, only a choice among very distressing and expensive options. This will not be good for them or for the world. I think we are already seeing a global slowdown, in great part due to Europe. Let us hope they get the answer right, whatever it is.

A Quadrillion Here, A Quadrillion There

Everett Dirksen was a Republican Senator from Illinois back in the '50s and '60s. He is credited with saying "A billion here, a billion there, and pretty soon you are talking about real money." It seems that thorough research does not turn him up actually saying that line, although researchers do note that one reporter said he had asked Dirksen about it and received the reply, "Oh, I never said that. A newspaper fella misquoted me once, and I thought it sounded so good that I never bothered to deny it."

But that quote has slipped into the US national memory, and whether or not he said it, it does make a real point. And that was back in the early '60s, when a billion dollars was not just a rounding error in the national budget.

Today we have become rather casual in our use of the word *trillion.* "A trillion dollars" slips so easily off the tongue, but it is too big a number for most of us to even fathom. Estimates of the total stars in our galaxy run between 100 and 400 billion. A trillion barrels of oil would fuel the world for over 30 years. One trillion seconds is almost 32,000 years. The mind boggles. Yet today we think almost nothing of adding a trillion dollars every year to the already bloated US debt! In fact, economists like Paul Krugman fume that we are not adding more trillions to the debt each year, as if debt brought no consequences. By this thinking, Greece should not be made to have to suffer austerity because it has taken on too much debt. Rather, other nations should be taxed to give Greece the money to go even deeper into debt that it cannot and most likely will not repay.

So, I must admit that when I came across this next item, it gave me pause. We turn now to a report published by Bloomberg and authored by my friend Dr. Gary Shilling, talking about the massive debt that has been accumulated by Japan. Gary argues that Japan is reaching a critical point where its debt cannot be financed except by extreme monetization by its central bank, because turning to world markets to sell the debt will drive up interest rates to unsustainable levels. I have made similar arguments, but that is a topic for another letter. Today, I want to quote just one paragraph. (http://www.bloomberg.com/news/2012-06-07/strong-yen-won-t-survive-japan-s-fiscal-cliff.html)

"As Japan's government debt of 1,085 trillion yen matures over time, it will be subject to any higher refinancing rates. The average maturity of Japanese government debt is six years and 11 months. Yet 17 percent of that debt matures this year, 52 percent in the next five years and 76 percent in the next decade. Markets anticipate, so Japanese bonds throughout the spectrum will probably plummet in price and leap in yield at the first sign of a current-account deficit, maybe even before."

One thousand trillion yen. 32,000,000 years' worth of seconds. Yes, I know a yen has a few extra zeros in relation to the dollar, but we are talking about one quadrillion yen.

Are we really ready for the word *quadrillion* to enter the lexicon in what is supposed to be the developed world? In the case of Japan, we are apparently there. A hundred years ago, a deficit of US$1 billion would have been unthinkable. We actually had balanced budgets for most of our first 200 years, except during wars and economic crashes. And now we talk trillions, albeit in the wake of inflation that has made the word *trillion* less than it was 100 years ago. Will our grandchildren in the latter half of this century talk quadrillions? Or quintillions? Is that even thinkable? Let's just hope the word *quadrillion* doesn't come into common parlance any time soon.

New York, Chicago, Italy, and Singapore

I leave for New York Monday afternoon, arriving in time to have dinner with Art Cashin, Barry Ritholtz, Barry Habib, Rich Yamarone, and a few other friends, before I spend the following day speaking at a few private events with my partners from Altegris. I am back in Dallas Wednesday and home till the middle of next week, when I make a quick trip to Chicago for the Morningstar National Investment Conference, again with Altegris.

Then Friday evening I leave for Tuscany (with a night in Madrid) for two weeks. I will be writing from there and catching up on my reading, but a vacation for me is staying in the same place for two weeks. I will have some friends in, as well as some family, with a few side trips here and there, but I'm hoping to relax some.

I expect to be writing this letter as usual from Tuscany, although right now Ed Easterling and I are talking about revisiting some work we did in 2002 on secular bull and bear markets. We both believe we are still in a secular bear, but the question now is, when will it end? The original work was published in this letter and in *Bull's Eye Investing* and is the core of that book.

Wiley recently released an edited, smaller version of the book, called *The Little Book of Bull's Eye Investing,* which updates the main points. Given that the single most important thing for an equity investor is to know what long-term secular cycle we are in, the material is most topical. (And if you are asking what a secular cycle is, then you REALLY need to read the book). I like the way the book turned out. You can order a copy at http://www.amazon.com/Endgame.

I think it will take us at least two weeks to cover the topic, but it is important and will help us all think about something besides Europe, even if I am sitting right there in the middle of it.

On a personal note, many of you know that I quit drinking alcohol about ten months ago, for health reasons. It has helped. One of the side benefits, I thought, was that I could expand my diet somewhat, since I was no longer consuming all those calories in wine and scotch. I added bread and desserts and a lot of red meat. Then this week I got the results of my latest blood tests. It seems I now have a cholesterol problem. Nothing that changing my diet can't fix, but I have to admit, I was enjoying indulging myself and not really gaining any weight. Oh well. A little moderation is good for the soul, or so they tell me.

Oh, and we're getting really close to the launch of **Mauldin Economics**, with a brand-new website and an investment newsletter that will turn some heads. Stay tuned!

It really is time to hit the send button. The sun is coming up and I need to get some sleep. (I procrastinated much too long tonight.) My grandson (Henry's son) has a birthday this weekend, so the family will gather on Sunday for brunch and a party. It will be good times. But I see chicken, not steak, on my menu. Have a great week.

Your needing to eat more fish analyst,

John Mauldin

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