The War for Spain

By John Mauldin | April 14, 2012

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I fully intended to ignore Spain this week. Really, truly I did. I had my letter all planned, but then a few notes drew my attention, and the more I reflected on them, the more I realized that the inflection point that I thought the ECB had pushed down the road for at least a year with their recent €1 trillion LTRO is now rushing toward us much faster than ECB President Draghi had in mind when he launched his massive funding operation.So, we simply must pay attention to what Spain has done this week – which, to my surprise, seems to have escaped the attention of the major media. What we will find may be considered a tipping point when the crisis is analyzed by some future historian. And then we'll get back to some additional details on the US employment situation, starting with a few rather shocking data points. What we'll see is that for most people in the US the employment level has not risen, even as overall employment is up by 2 million jobs since the end of the recession in 2009. And there are a few other interesting items. Are we really going to see 2 billion jobs disappear in the next 30 years?

But first, a personal note. My friend and fellow writer/economic blogger Mike "Mish" Shedlock's wife has ALS, better known as Lou Gehrig's disease. I have talked at length with him the past year as the disease progressed. It is a truly evil affliction. Mish has stayed the course, working with his wife, and now the options will soon be down to her communicating with a device that follows her eye movements to choose words on a computer screen. I cannot even imagine the pain of living with a loved one in the condition.

Mish is not asking for anything for his family, but he is sponsoring a raffle for ALS research. Please consider buying one or more tickets, or making a small donation to the Les Turner ALS Foundation. The money will go to research to find a cure, so that someday no one has to go through such pain. Thanks.

The War for Spain

In my book *Endgame,* co-author Jonathan Tepper and I wrote a chapter detailing the problems that Spain was facing. It was obvious to us as we wrote in late 2010 that there really was no easy exit for Spain. The end would come in a torrent of misery and tears. Tepper actually grew up in a drug rehab center in Madrid – as a kid, his best friends were recovering junkies. (For the record, he has written a fascinating story of his early life and is looking for a publisher.) His Spanish is thus impeccable, and he used to get asked to be on Spanish programs all the time. Until the day came when the government created a list of five people, including our Jonathan, who were basically named "Enemies of Spain," and pointedly suggested they not be quoted or invited onto any more programs.

As it turns out, the real enemy was the past government. We knew (and wrote) that the situation was worse than the public data revealed, but until the new government came to power and started to disclose the true condition of the country, we had no real idea. The prior government had cooked the books. So far, it seems it even managed to do so without the help of Goldman Sachs (!)

In about ten days I will be sending you a detailed analysis of all this, courtesy of some friends, but let's tease out some of the highlights. True Spanish debt-to-GDP is not 60% but closer to 90%, and perhaps more when you count the various and sundry local-government debts guaranteed by the federal government, most of which will simply not be paid. Spanish banks are miserably underwater, and that is with write-offs and mark to market on debts that totals not even half of what it should be. If Spanish housing drops as much relative to its own bubble as US housing has so far (and it will, if not more), then valuations will drop 50%. The level of overbuilding was stupendous, with one home built for every new every person as the population grew. We know that unemployment is 23%, with youth unemployment over 50%. Etc, etc. We could spend 50 pages (which is what I will get you access to) detailing the dire distress that is Spain.

Which brings us to this week. It was only a few weeks ago that most everyone, including your humble analyst, thought that the ECB had bought a little time with its "shock and awe" €1-trillion LTRO. Lots of analysis said there would now be at least a year to put programs in place to deal with the coming crisis.

Yet we may now be fast approaching the Bang! moment when the markets simply refuse to believe in the firepower that whatever governmental entities can muster. It happened with Greece, as it has in all past debt crises. Things go along more or less swimmingly until, as Ken Rogoff and Carmen Reinhart so articulately detail in *This Time is Different,* we wake up one morning to find that Mr. Market has seemingly lost all interest in funding a country at a level of interest rates that is credibly sustainable. When interest rates ran to 15% for Greece, even arithmetically challenged European politicians could understand that Greece had no hope of ever paying off its debt.

When rates rose last year to almost 7% for Italy and 6% for Spain, before the ECB let loose the hounds of monetization, they were approaching the limits of sustainability. Rates came back down as the ECB either bought directly or engineered the purchase of the bonds of the two countries. But now the LTRO effect appears to have worn off, and yesterday interest rates for Spanish ten-year bonds climbed again to 5.99%. There is a large auction for ten-year Spanish bonds next week, which the market is clearly anticipating with a bit of concern. Meanwhile, Italian interest rates are not rising in lock step, which shows that the anxiety is now clearly directed at Spain. Ho-hum, move along folks, nothing to see here in Rome.

(What follows now is a mix of the facts as I read them and speculation on my part. I admit I may be reading more into the information, as I squint at it at 3 AM, than is justified. But then again, there is a substantial amount of history that suggests I am not totally off base…)

Spain Goes "All In"

I came across this tidbit from typicallyspanish.com, and my antennae started to twitch (hat tip Joan McCullough). The key is the second paragraph. (Hacienda is the common name of the Spanish tax ministry, otherwise known as the Agencia Estatal de Administración Tributaria.)

"Spain led the loss in the number of self-employed workers in Europe in 2011. One in two of the self-employed to lose their jobs in the EU over the year was Spanish. Seven out of ten self-employed in Spain do not employ anyone else. Over 2011 Europe lost a total of 203,200 self-employed workers, 0.6% fewer than in 2010.

"Following the news that cash business transactions over 2500 € are to be banned, Hacienda has said they will not fine anyone who admits that they have been making payments of more than 2,500 € over the previous three months. The cash limit is part of the Governments anti-fraud plans which have been approved today, Friday. Those Spaniards who have a bank account outside the country now face the legal obligation of having to inform Hacienda about the account. The Government hopes its anti-fraud measures will bring in 8.171 billion €."

My fellow US citizens will be saying to themselves, "So what? We have to report our foreign bank accounts, and any large cash transactions are flagged." But gentle reader, this is much different. This is new law for Spain, basically currency control writ large, and bells have to be going off all over Europe.

First of all, note that Greece never tried to require its citizens to report cash transactions or to list foreign deposits. This is the new Spanish government revealing serious desperation. The government's back is to the wall. They have to know they will not collect the taxes they need to generate, but are going to try anyway to demonstrate to the rest of Europe (read Germany) that they are doing everything they can.

In a side note, on Wednesday, Spain's interior minister introduced new measures to thwart plots using "urban guerrilla" warfare methods to incite protests. And the local papers are printing op-eds by economists talking about how the effort to comply with German austerity demands will just make the economy worse, and that the government is not taking into account the resolve of labor unions to oppose them. "Germany is the problem." It pains me to say this (truly it does), but this is what we were writing about Greece, not all that long ago. We are seeing footage of demonstrations, verging on riots. It is a familiar pattern.

Second, let's review what I wrote a month ago. I noted that the LTRO money was being used by Spanish banks to buy Spanish government debt (and Italian banks were buying Italian government debt, etc.). The intention was to help the two countries specifically and Europe in general to finance their debts and allow banks to shore up their capital as part of that effort. But what that does is yield the unintended consequence of making a breakup of the eurozone easier, as it helps get Spanish and Italian debt off the books of German and French banks.

The only reason Germany and France, et al., cared about Greece is that their banks had so much Greek debt on their balance sheets, in many cases more than enough to render them insolvent. Bailing out the banks directly would have been costly, so better (thought the European leaders) to do it with bailouts from funds created with guarantees from the various governments (which is a backdoor way to get it from taxpayers) and the European Central Bank. A crisis was avoided and there was a more or less orderly Greek default – which anybody who bothered to look at the math saw coming well in advance.

A further side note: Spanish-bank borrowing from the European Central Bank doubled last month, “revealing a dangerous dependence on emergency funding that on Friday triggered renewed turmoil in financial markets.” *(The Telegraph)* And the Spanish stock market is down some 30% over the past year.)

So, in the effort to make sure that everyone pays their taxes and to stop tax fraud, the Spanish government is going to find out which of its citizens have moved their money out of Spain. And let’s be clear, money has been flying out of the banks of Spain and Portugal (and to some extent Italy) as it did, and still is, in Greece.

And it will be easier to track that offshore money than you think. Some people, I am sure, moved their money into cash and then out of the country. But others simply wired the money, thus leaving a trail. Spanish banking regulators can easily require they be given that information, and what bank will say no to the regulators? Spain does not collect taxes from its citizens if they are residents of a foreign country (as the US does), but it can tax everyone who lives in Spain. And if you live in Spain and decide to diversify your risk among a few other countries? I am not sure of Spanish tax law, but I reasonably assume you are supposed to report all your income from whatever source. (Otherwise there would be no one investing with Spanish banks, brokerages, and investment advisors –if it were legal not to report foreign investments, then everyone would invest outside of the country.)

Let me hazard a modest prediction: We will see a rather sudden and substantial need for physical cash in certain other “peripheral” countries, as now their citizens may not want to leave trails as they go about opening foreign bank accounts. What is to keep Italy from doing as Spain has done? Or Portugal? Or France? Or Germany?

Let me be clear about something. I am not suggesting that people should not pay their taxes. If you choose to live in a country, you should pay the taxes that are required. What Spain is trying to do is simply make sure that all their citizens pay the proper amount of taxes. If there was already 100% compliance, there would be no need for new regulations like Spain’s. And the same goes for the US. Our penalties are rather stiff for not paying taxes, more so, I’m guessing, than in most of Europe. I have on more than one occasion noted that the national sport of Italy is tax avoidance.

My friends in Spain tell me a lot of business is done in cash. But that is the case in the US and almost everywhere I go. There are a lot of (ahem) “independent” taxi drivers, services, etc. that do not take anything but cash. Maybe they report everything, but I do not bother to ask. (When I was a waiter in college, did I report all of my tips? I was required to report a minimum amount of income for each hour worked, but did I report everything? Since it has been 40 years and the statute of limitations has run out by now, I might admit to missing a few dollars here and there.)

I imagine there are quite a few Spanish citizens who are not sleeping well this weekend. And more than a few people tossing and turning in other countries as well. If the next month comes and goes without any sign of unusual cash movement in Europe, then I will owe the peoples of peripheral Europe a big apology for doubting their willingness to pay their taxes. Or maybe it will turn out that they were better at "avoidance" than your average American, and planned their movements far in advance…

Let's get back to the central point. Spain is too big to fail and too big to save. The bond markets are clearly getting nervous, much sooner than was planned. Spain is clearly attempting to demonstrate that it will do everything in its power to comply with the new European austerity rules. Yet Prime Minister Mariano Rajoy has warned that the situation has created "a vicious circle that strangles Spain."

Rajoy delivered a strongly worded speech to parliament, insisting that it was "as clear as day" that Spain would not need a Greek-style bailout. But in recognition that the country is losing market confidence, he appealed to other European leaders to be "careful with their comments" and remember that "what is good for Spain is good for the eurozone." *(The London Telegraph)*

One can look at the amount of money Spain will need to refinance in the coming year and look at their financial ability, then look at how much can possibly be raised by the European community, even under the proposed new structures, and readily come to the conclusion that there is simply not enough money to save Spain if the market goes Bang!

The only possible solution I see is for the European Central Bank to step in with some new program. ECB President Mario Draghi has demonstrated a marked ability to come up with new, creative ways to kick the can down the road. Finding the money to bail out Spain is hopefully in his book of tricks. As fellow central banker Ben Bernanke has noted, Mario has a printing press. And the LTRO showed he knows where it is and how to use it.

"We Are Not Greece"

The German Bundesbank is saying as loudly as it can, "QE? Nein!!" But I count only two German votes among the 23 that compose the board of the ECB. Spain is demonstrating to its European brothers and sisters that it is doing all it can. "We are not Greece" is the clear statement. And "We need and deserve your help." Yesterday, Rajoy pointedly noted again that "What is good for Spain is good for the eurozone."

One should not underestimate the willingness of politicians who are viscerally committed to a certain action (in this case European unity) to spend someone else's money in the pursuit of that action. Especially if that money is a hidden tax in the form of debt monetization.

The markets are moving up the time table on the next large monetization of Spanish (and eventually Italian?) debt. Germans will shout that this is inflationary, and for them it probably will be. But much of the rest of Europe is in the grip of deflation. Spain is clearly in a classic Keynesian liquidity trap. This is what can happen when you have very different economies operating under one monetary roof. This is not simply a banking or sovereign-debt crisis, it is about a massive trade imbalance and huge differences in the productivity of labor. The trade imbalance between the south – Portugal, Spain, Italy, and Greece – and the north (mostly Germany) must be solved before there can be any resolution of the economic crisis. This is Economics 101, which European politicians seem to have slept through.

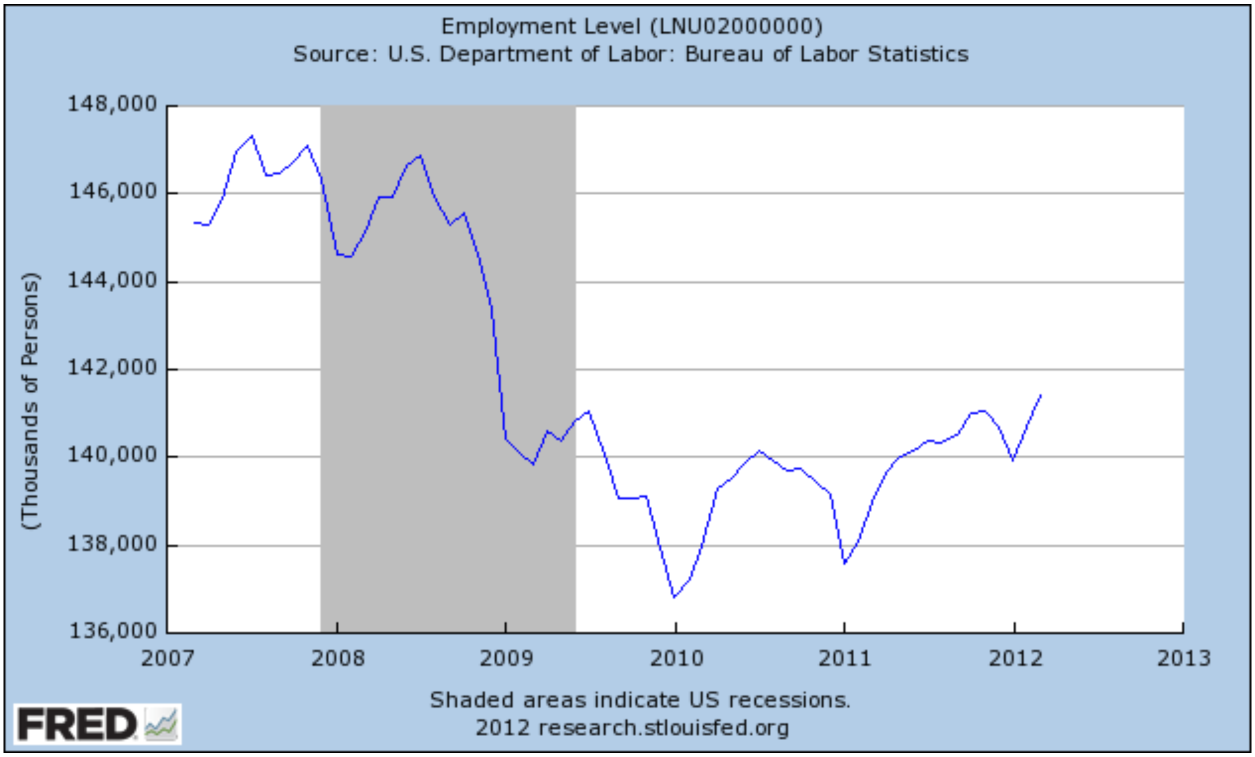
There will be the attempt to create some sort of fund to buy Spanish debt, but it will prove to not be enough. And given recent market movements, it may not be able to happen fast enough. It will not surprise me if the ECB uses the promise of such a fund as a pretext for acting sooner.

And yes, this will lower the value of the euro. We will have to see how far Europe is willing to push the process. Greece will soon default again (they are in a depression and have a national election in early May), Portugal is still moving toward being bailed out, and the Irish are growing tired of having to repay the British, French, and Germans for bailing out their failed banks. Think bailout fatigue isn't growing among European voters? Stay tuned…

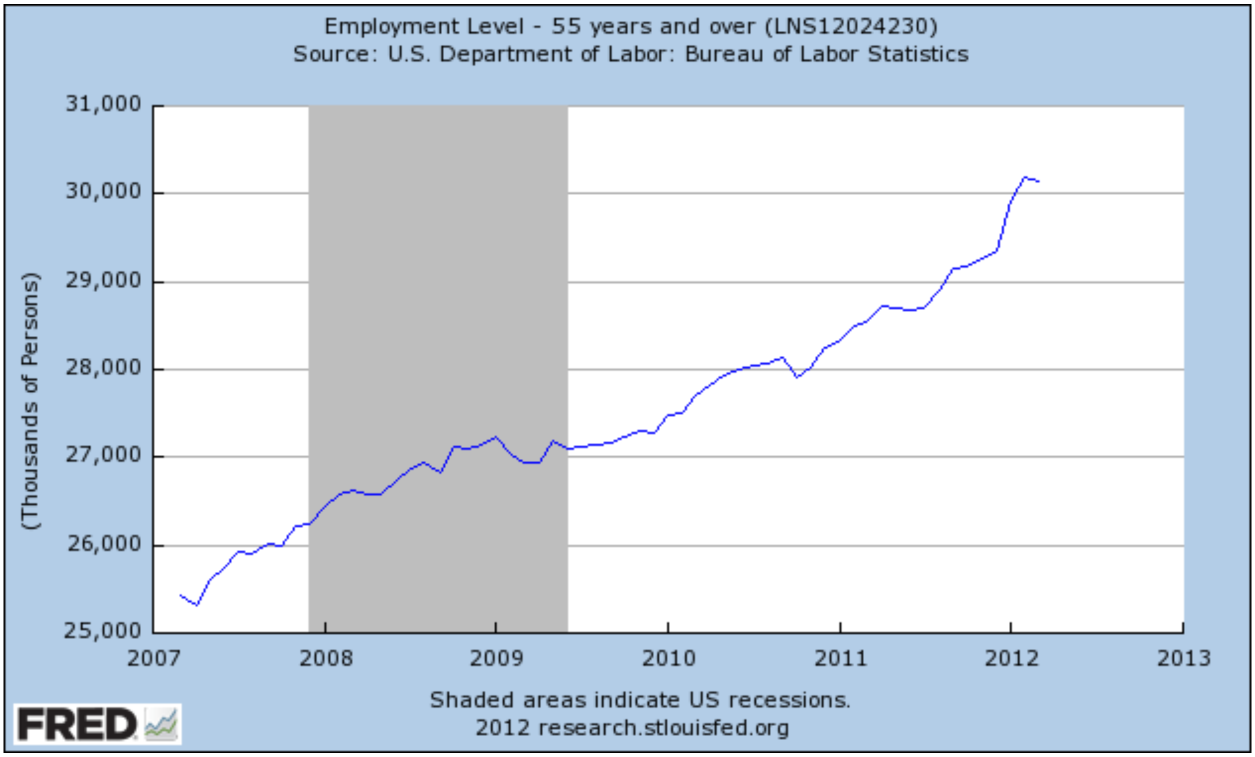
The New Labor Force

I will end this letter with the beginning of what I intended to write originally and hope to finish next week. Work and employment is changing before our eyes in the US and much of the developed world. As the Baby Boomer generation reaches retirement age and finds out that either it cannot afford to retire or does not want to retire, the "trickle-down" effect to younger workers is starting to become apparent in the data.

Let's look at three charts (hat tip to John Hussman, who called this to our attention and got me looking at the details). The first shows the employment level in the US for the last five years. The gray area is the official period of recession. Employment growth since the end of the recession has been only a few hundred thousand jobs a month; but since employment is a lagging indicator, you can claim that we have recovered 4 million jobs since the employment bottom in late 2009 or about 2 million jobs since the 3rd quarter of 2009. It all depends on where you want to start your count. But we are still down roughly 4.5 million jobs since the beginning of the recession. This has been the slowest "recovery" since the end of WWII.

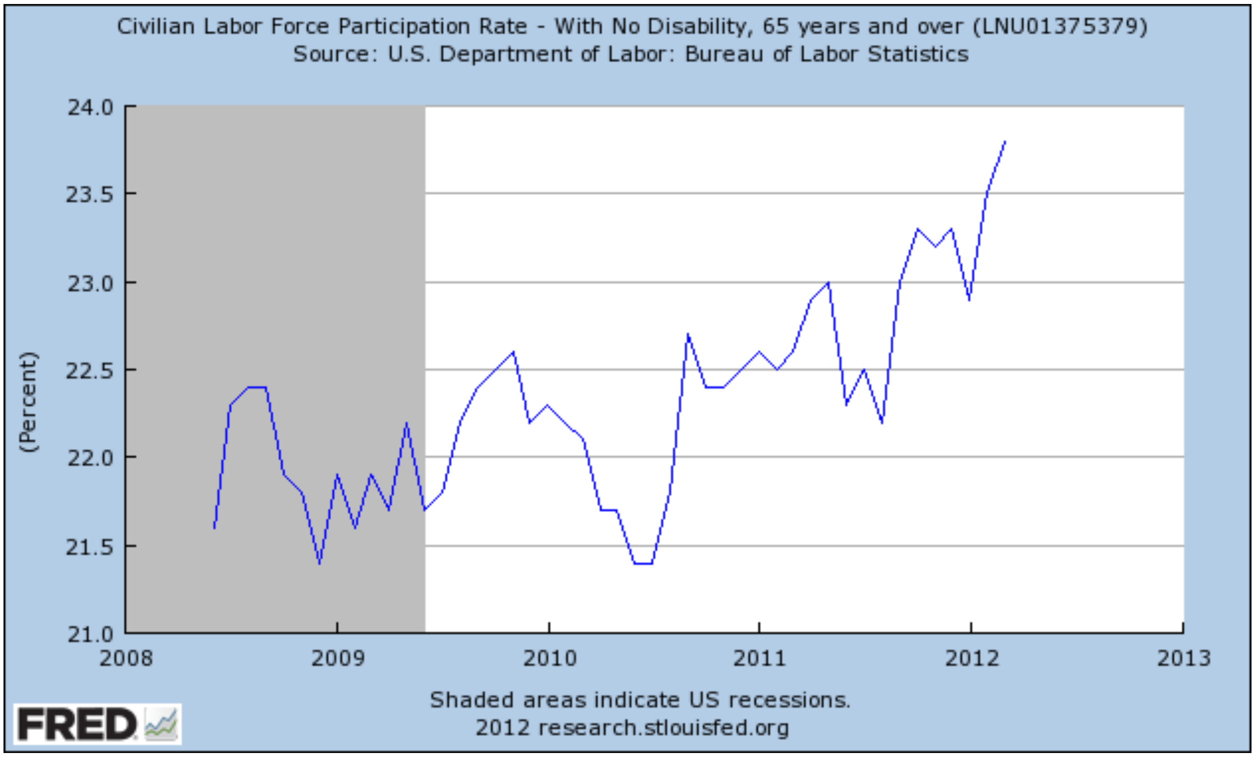


Now let's look at the next chart. This is the employment level for those over the age of 55. Notice that it kept rising all through the recession and especially after. People over 55 have seen their total employment level rise by about 4 million jobs since the beginning of the recession, and over 3 million jobs since the 3rd quarter of 2009. Almost any way you look at it, those over 55 have seen their jobs level improve over those who are younger. If you take the end of the 3rd quarter as your marker, the Boomer generation has seen its jobs level rise by 3 million, while overall jobs rose by just 2 million! Those who are younger are actually falling behind!



And once last chart before we go. Last week we looked at how the civilian participation rate (the percentage of the population who have a job or want a job) for the US has been falling for a decade and especially since the end of the recession. You can attribute a high percentage of the apparent decrease in unemployment to the fall in the participation rate.

Except for one group or cohort. This next chart is the participation rate of those over 65. Their participation rate is rising. The graph is "noisy," but the trend is clear. Whether willingly or out of necessity, older workers are staying longer in the work force. And given the rather lackluster employment growth, they are taking jobs that would normally go to younger workers, which is why we are seeing higher rates of unemployment among the latter. We will go into the why of that next week, but a great deal of it has to do with work skills.



A Little Blue Suede Shoe Trouble

My travel schedule is rather hectic, and I will be on the road some 22 out of the next 26 days. Only in the US, which is easier on my body, but air travel has long lost its romance. Airport security can take the fun right out of travel, not to mention the time. Today I was lost in thought, thinking about this letter as I stood in line. I went through the drill, as I have done hundreds of times, taking out the laptop, taking off the coat and shoes, emptying the pockets, etc. Except this time I forgot the shoes. I went right on through the line with the new body scanners (which for some reason I don't like), then began to collect my gear and noticed my shoes were not in the tray. (And yes, these are the very same blue suede shoes that Swedbank bought me a few weeks ago in Stockholm, when my bags were lost. I have found them to be quite comfortable and stylish travel shoes.)

So I looked down. I was still wearing them. I laughed and remarked about it to the security guy at the tail end of the line and began to leave, when suddenly they stopped everything. Seems I had found a particularly zealous security person. Not only did I have to take off my shoes, but I had to go back through security and get scanned all over again. Next time I will try being funny with a more amenable crowd.

It is time to hit the send button. It is once again late, but I get to sleep a little later here in Frisco, so I can adjust. Have a great week.

Your proud member of the working Boomer generation analyst,

John Mauldin

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