Dr. Frankenstein's Europe

By John Mauldin | May 19, 2012

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"Had I right, for my own benefit, to inflict this curse upon everlasting generations? I had before been moved by the sophisms of the being I had created; I had been struck senseless by his fiendish threats; but now, for the first time, the wickedness of my promise burst upon me; I shuddered to think that future ages might curse me as their pest, whose selfishness had not hesitated to buy its own peace at the price, perhaps, of the existence of the whole human race."

– The musings of Dr. Frankenstein about his creation of a monster, in Mary Shelley's 1818 novel, *Frankenstein*

And later the monster answers:

"Shall each man," cried he, "find a wife for his bosom, and each beast have his mate, and I be alone? I had feelings of affection, and they were requited by detestation and scorn. Man! You may hate, but beware! Your hours will pass in dread and misery, and soon the bolt will fall which must ravish from you your happiness forever. Are you to be happy while I grovel in the intensity of my wretchedness? You can blast my other passions, but revenge remains – revenge, henceforth dearer than light or food! I may die, but first you, my tyrant and tormentor, shall curse the sun that gazes on your misery. Beware, for I am fearless and therefore powerful. I will watch with the wiliness of a snake, that I may sting with its venom. Man, you shall repent of the injuries you inflict."

In the classic novel by Mary Shelley (written when she was just 19!), she writes about a young doctor (the Frankenstein of the title) who defies nature and creates an ungainly monster, piecing together parts that were not designed to fit each other. Even though he gives the creature life, it eventually turns on him and his family. The unhappy monster, which develops into quite the rationalizing being, demands that Dr. Frankenstein create a female version of himself so they can flee civilization and find happiness. When Dr. Frankenstein decides not to follow through on his initial promise to do so (thus the first quote), the monster seeks revenge. It does not end happily.

The European Monetary Union was a triumph of hope over reason, pieced together from very dissimilar countries which, while sharing common borders, have very different cultures and

economies. That it would eventually face an existential crisis was foretold by numerous critics at the time of its creation. The euro has never been a real currency. It was and still is an experiment, fashioned and shaped by a generation with noble ideas and vision, but tied together by an unworkable structure. Can its foundation be reworked into a solid structure? Or will natural centrifugal forces pull it apart? The difficulties that are faced are somewhat akin to fixing the engine of a jet plane while it is flying at 30,000 feet.

In today's letter we explore the options that the eurozone faces in order to stay together, and what it all means for some of the countries involved. While I have written for a very long time about the probability of Greece exiting the eurozone, the actuality is fraught with risk, not just for Europe but for the world economy. What happens in the next few months will impact us all for a very long time. Indeed, this is one of those years, as Lenin noted, when decades happen. There is a lot to cover, and in future weeks we will go into more detail, but today let's just step back and see if we can get the larger picture.

There Is No Easy Grexit

The term du jour for the possible exit of Greece from the eurozone is "Grexit." It is a rather ugly sounding word for what will be an ugly process if it happens. A Grexit has several serious implications. (I wonder how the Chinese translators will render Grexit.)

The first is the risk of contagion. When Bear Stearns went bankrupt, the immediate question by the market was not how much did we lose, but who is next? As it turned out, it was Lehman. The rest is history. But it was a recent lesson that is still quite vivid in the memory of traders and investors.

Grexit calls into question the very existence of the European Monetary Union. Is it a union from which there may be no exit, an "all for one and one for all" union, or is it a club that one can choose to belong to or to leave? Certainly, it's a club that offers very distinct privileges, but also one that imposes very high costs on both the member who leaves and the members who stay, who must pick up the bar tab of the fleeing member.

There are those who argue that there is no treaty provision that allows for the exit of a member of the eurozone. Therefore, under the rules, you simply can't leave. That is a nice concept in theory, but each member of the eurozone still thinks of itself as a sovereign country with full rights of self-determination, including the right to be self-destructive.

It is kind of like telling South Carolina in 1861 that there is no provision in the US Constitution for a state to secede from the Union. South Carolina and ten other states soon decided they did indeed have that right, and the bloodiest war in US history was fought over that question. People who think they are part of a sovereign country tend to be jealous of that idea and resist any suggestion that there may be limits on their sovereignty. And while no one thinks that the rest of the eurozone would resort to any sort of coercive action, the manner in which Greece is allowed to leave (or pushed out the door) is of the utmost importance.

The "Troika" (the European Commission [EC], the International Monetary Fund [IMF],

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and the European Central Bank [ECB]) has set up budgetary expectations for Greece as a condition of getting loans to pay their current operating expenses. These conditions require Greece to reduce its deficit and balance its budget by cutting government spending and raising taxes, and by actually collecting the taxes that have not been paid. This idea of not spending more than you take in taxes is called austerity by its critics and simple common sense by its proponents.

But the program has resulted in 25% unemployment (50% among youth) and a deep five-year recession, with the likelihood of another 7% dip just this year alone. (Question: How long does a recession have to last until it becomes a depression? Recessions typically last at most two years in developed countries.) Government workers are losing their jobs, and profits are severely down, as are tax receipts.

Greeks recently voted overwhelmingly for parties that want to reject the austerity program in one way or another. It was an almost complete reversal of the margins that the two previously dominant parties tended to get. Those parties agreed on the need to accept the austerity measures, in order to be able to continue selling bonds to European governmental institutions (and the IMF), since the private bond market for Greece had simply ceased to exist, except for relatively small trades by speculators buying bonds that others were forced to sell.

And the government entities represented by the Troika wanted some assurance that Greece would not continue to run huge deficits, but would at some point in the future be able to return to the private bond market. That meant that there had to be a balanced budget. Otherwise, Europe would be funding Greece for decades, which would not sit well with European voters.

Even so, because of the very real pain caused by the austerity measures, Greek voters pushed back and resoundingly voted out the parties that had agreed to the measures. Because so many small parties with such different views garnered votes, there was no way to form a majority government, and so there will be another election June 17. The recent vote notwithstanding, opinion polls show more than 75 percent of Greek voters want to stay in the euro.

There is no way to know what will happen next month; the polls change every few days. And the Greek economy may be in much worse shape by June 17. The government is running out of money to pay its day-to-day bills. We are not talking just your basic police, fire, military, and other government-worker salaries, though those are very much at risk.

The austerity deal requires that Greece actually collect taxes that are owed. One of these is the property tax, which evidently almost no one paid. And some bureaucrat got the "bright" idea (pardon the pun) to collect the tax by adding it to people's electric bills. People tended to pay their electric bills – the power was shut off if you didn't. However, that didn't work out so well. This from the *Financial Times:*

"The government had hoped to raise €1.7bn-€2bn from the levy in the fourth quarter of last year. But a massive unions-led civil disobedience movement against this 'injustice' scuppered that and a ruling that it was illegal to disconnect people's electricity supply for non-payment sent the collection rate even lower. However, the memorandum of understanding with the IMF-EU signed in March demands that Athens collects a range of back taxes, such as the property tax from 2009

which was essentially never collected. So it will be interesting to see how the Troika reacts to these most recent developments. Ironically, the scale of non-payment means that the PPC itself (the power company) has run out of money. Last month it needed a €250m liquidity injection from the government so as to avert a nation-wide energy supply meltdown. So even less of the already-too-small pot of tax revenues is going to the government. The PPC has until end of June to find new sources of funding. It seems unlikely that people who stopped paying power bills last year are suddenly going to start now. While EU-IMF funding is still forthcoming, the overwhelming support for the anti-bailout parties as Greece heads for new elections next month puts an obvious question mark over future assistance. But the PCC experience suggests we really could be moving towards the IOU stage of this crisis as liquidity issues bite."

So let's get this straight. Now the government is running out of money and the power company can't collect enough to pay its bills because Greeks simply aren't made to pay, so the government has to subsidize the power company with money it doesn't have.

The party that leads in various polls is called Syriza. A youngish firebrand has convinced many Greeks that the austerity program must stop but that Europe should and will continue funding them. Let's take this straight from the *Wall Street Journal:*

"ATHENS—The head of Greece's radical left party says there is little chance that Europe will cut off funding to the country, and if it does, Greece will repudiate its debts.

"In an interview, Alexis Tsipras, the 37-year-old head of the Coalition of the Radical Left, also known as Syriza, warns that financial collapse in Greece would drag down the rest of the euro zone. Instead, he says, Europe must consider a more growth-oriented policy to arrest Greece's spiraling recession and address what he calls a growing 'humanitarian crisis' facing the country.

" 'Our first choice is to convince our European partners that, in their own interest, financing must not be stopped,' Tsipras said in an interview with The Wall Street Journal Thursday. 'If we can't convince them—because we don't have the intention to take unilateral action—but if they proceed with unilateral action on their side, in other words they cut off our funding, then we will be forced to stop paying our creditors, to go to a suspension in payments to our creditors.'

"According to recent opinion polls, Tsipras' party is poised to win the most votes in repeat elections next month, bettering its surprise, second-place finish in an inconclusive May 6 vote that left no party or coalition with enough seats in parliament to form a government."

Call me skeptical, but I fail to see how a young man who has never been at a negotiating table with any of the Troika (and who has apparently never talked with a German banker) can think he can hold Europe hostage.

"Tsipras says that, if push comes to shove, Greece can manage on its own. By not paying its debts, the country will have enough cash to pay its workers and retirees. He also proposes cuts in defense spending, cracking down on waste and corruption, and tackling widespread tax evasion by the rich."

While such a platform might qualify him to run for US president, I somehow don't see it convincing anyone that Greece is on a path to a balanced budget. Especially when he wants to quash the austerity programs that were agreed to, in order to secure the last round of funding.

A Rational Bank Run

The entire issue is made worse by the fact that there is a very real run on Greek banks. The FT reports that €5 billion has left Greek banks in just the last two weeks, some 3% of the total remaining deposits, by my calculation. As *Mervyn King, the governor of the Bank of England* noted during the Northern Rock crisis, "Once a *bank run* has started, it is *rational* to join in."

The more that Greek citizens feel it is possible that Greece will leave the euro, the more likely they are to pull their money from Greek banks and send it abroad. Everyone in Greece is reading about the bank run, and the lines at the banks next week will be longer than the ones this week. And in today's world there is no need to stand in line. The bank run can be entirely executed by computer. You simply open an account in another country and wire the money out.

That means the very cash that is needed by businesses small and large is fleeing the country. There is little investment in equipment or services, beyond what is absolutely necessary. Forget about getting a small-business loan at a bank. The ECB has already said it cannot continue to fund four Greek banks (talk about yelling fire in a crowded theater!), although those banks can get funded by the Greek central bank, which can get money from the ECB.

The primary resource that is needed to create growth is *confidence,* and that is in short supply in Greece. And if you're in another country and thinking about investing in Greece, it makes sense to wait and see what will happen. Maybe prices of things you want to buy will be much more attractive if the banking system collapses. A few months after the collapse, someone will get around to selling the assets and loans of the banks, which may be in drachmas at the time, so your euros or dollars will go a LOT farther. Distressed loans and a currency revaluation? That smells like opportunity.

When Argentina collapsed, last decade, those who went in with cash were able to get some very good properties and deals. I could go down a list of such potential opportunities, but they will be there. At least Greek beaches are not going to be taken away. While it has been 25 years since I was there, I still remember how beautiful they were. There is a reason tourism in Greece is 20% of the economy. And that will be there no matter what currency Greece uses.

I said it was important how Europe deals with Greece, whether it stays in the euro or leaves. If Europe gives in to the demands for more money without a real plan for a path to a balanced budget, then they are sending a message to the voters of Spain, Portugal, Italy, and Ireland. Ireland goes to the polls in a few weeks. Spain already has Greek-like 25% unemployment. The frustration that Spain and the other countries feel with their own austerities is very real and getting worse, and the Troika knows it.

That is the reality that Greece faces. If they vote to stop the austerity, it is likely that

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Europe will simply not fund their loans. If Greece is not going to pay anyway, why not just pay off the loans or write them off? The thinking will be, "Why give them more money to spend when they are not living up to the agreements? These things can't be negotiated with every new government. There has to be some continuity."

But staying in the euro does not solve Greece's most significant problem. Greece has a serious trade deficit. Its workers are not as productive as those in the core of Europe, and relative wages need to come down. And while that is easy to say in the abstract economic world, it is hard to do in the real world. What Greek worker thinks he is overpaid by 30% relative to a German worker? Try and sell that in Athens.

But that is the judgment of the market. And until the trade imbalance is solved, there will be no lasting solution to the Greek crisis. The imbalance will either be solved by a swift change of currency and a revaluation of the new drachma or a slow, tortuous process that could result in more than a decade of recessions and slow growth, with chronic high unemployment.

Greek Fatigue

Europe is visibly getting weary of dealing with Greece. Just as Hank Paulson eventually gave up trying to convince Dick Fuld to accept a rescue of Lehman Brothers on realistic terms, Europe may grow tired of being only one election away from yet another Greek crisis. And while Greeks may be tired of austerity, and they are, they have not yet come to the realization that the rest of Europe may not be willing to let them live as they want.

Greece will not be kicked out of the euro, but it is entirely possible and even likely that their funding will dry up without a continued austerity program. And that will eventually push voters to demand a government that promises them a return to their own currency. "How could it be worse?" they will think. But for a year or so it will get worse. Then it will get better. But the changes will be severe.

The Alligator of Bank Runs

If and when Greece exits the euro, the ECB must be prepared to step in with massive funding of peripheral-country banks and sovereign debt. That is not within their charter today; but when the euro is at total risk, that is the only way to save it.

As the joke goes, it is hard to remember that the original project was to drain the swamp when you are up to your neck in alligators. The "alligator" that will immediately face Europe after a Greek exit is bank runs in Spain and Italy. There must be the creation of a European-wide institution to insure deposits, in order to stop bank runs. Inexplicably, Europe does not have the equivalent of an FDIC, but if they are to survive they'd better get one.

Further, a Greek exit will mean even more defaults and losses, not only on Greek government debt but on their private debt as well. I know, the law says the contracts are in euros, not drachmas. But the Greek government will pass a law that says all debt owed by Greek citizens will be paid in drachmas, or something to that effect. And Greek citizens have to obey the law,

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don't they? Exactly who are you going to send to repossess my property (car, home, equipment, etc.)? As we kids used to say when someone wanted to make us do something, "Yeah? You and what army?"

Businesses will get very concerned about doing business with citizens of a country that might leave the euro. If Greece is allowed to set a precedent by leaving, there must be clear rules for the reconciliation of contracts.

And there must be a massive show of support for Spanish and Italian sovereign debt, to convince the market that Germany and the other core countries are serious. We are talking multiple trillions of euros will be needed, if the interest rates on Spanish and Italian debt are not kept in check. That may mean the ECB will have to monetize debt for a time. Or they can change the rules and allow the *European Stability Mechanism* (ESM) to function as a bank, which would essentially allow the ESM to borrow from the ECB a relatively unlimited amount of capital (just 20 times leverage of €400 billion is a LOT of euros). That should buy all the time needed.

And then they have to deal with the whole fiscal union concept. As so many people said at the beginning of the euro experiment, you can't have a real monetary union without a fiscal union. But that is a story for another letter.

So, let's sum up. Greece will either have to continue with austerity to get any more money or leave the euro. The latter is more likely at some point, because sooner or later the voters will elect a government that will make that choice. And it may happen quite soon.

Right now, it would be difficult for the eurozone to guarantee Spanish bank deposits, for instance, and not guarantee Greek deposits. I suppose they could cook up a reason, but it would not be seen as the right thing to do in polite circles. And if a run on Spanish banks happens while waiting for Greece to make up its mind? What then? That will be a crisis on steroids.

Europe is going to either have to abandon the idea of a complete monetary union and let some nations go, or it is going to have to print massive amounts of money. Most likely it would be the ECB that turns on the presses, although making the ESM a bank could be an option if things get really bad. It all depends on how badly the Germans want to keep the euro together and what they will pay for doing so. Right now, the polls say they will do whatever it takes, even if they don't like it. If inflation gets to 4-5%, then let's ask the question again.

And I know some of you are thinking, how can he be talking trillions? Easy. Greece's commitments alone to various European entities (the ECB, their portion of the ESM, EIB, etc.) run to about €500 billion. Add to that what private contract losses would be. Then realize that Greece is quite small compared to Spain or Italy. Yes, I know, Italy and Spain are not Greece; but the bond market is getting nervous. Spanish yields spiked to 6.5% at one point this week. The eurozone must commit to keeping peripheral interest rates low while countries struggle to get their budgets under control. That will not happen overnight, nor will it be cheap. It may cost Europe trillions. As in, more money than anyone can wrap their head around.

(Sidebar: I'm thinking the ECB is going to cut rates shortly.)

And the rest of the world had better hope they get it right. European banks are almost three times larger than US banks and finance much of world trade. A weakened European banking system is not good for anyone. Yes, emerging-market banks, private banks (hedge funds and sovereign funds), and even US banks can step in and, over time, make up the difference. Bu the operative words are "over time." Building up the institutional infrastructure to finance global trade has taken decades. It wouldn't take that long to do it again, but it would not be just a year. There could be large disruptions.

And that is not to mention European consumers and their imports, which would suffer in a prolonged European recession. Which would of course affects world trade and global GDP.

European leaders have given us an experiment called the euro. Will it be like Frankenstein's monster and turn on them? Have they defied the natural order of Europe, or tamed the beast that raged for a thousand years? Have they created something that mankind will dearly wish they hadn't, and suffer for their hubris?

Or will the euro yet become a Hercules, capable of performing astounding feats for the greater good? We are at the critical moment of the experiment, when the results are not yet clear but everyone can see that we won't have to wait much longer.

Who Gets the Old Maid?

A popular card game for children is called Old Maid, which is played with a deck with an extra queen. The cards are dealt and the players trying to match their cards (a 3 with another 3, or a king with another king, for instance) until they can play all their cards. And of course you must trade cards with other players. When one person has no cards left, whoever has the Old Maid (the solitary queen) loses. There is some strategy involved, as if you have the Old Maid early, you might not pass it until close to the end, so it cannot come back to you.

Which brings to mind the balance sheet of the ECB, and leads to some rather dark thoughts. If Greece leaves, then at best the ECB will only get drachmas in return for the euros on the Greek account. IF Greece decides to pay anything at all. (My bet is that if they do pay, there will be strings attached that say the ECB must hold the drachmas for a very long time, so as not to hurt the currency.)

OK, but that increases every remaining eurozone member's commitment by around 2.5% of the remaining balance. And then what if Portugal or Spain leaves? Or, heaven forbid, Italy? Your commitment just grew by a rather large amount. Not to mention your portion of the ESM, EFSF, EIB, etc.

On the way to a Nash equilibrium, the players all try and anticipate the moves and rationale of the other players, plus what their levels of pain tolerance will be. And then they adjust their own positions.

At what point does it occur to the voters of a country that they are taking on more debt than they can bear? How much European solidarity is really there? Is there an unlimited amount of pain

that can be tolerated? I rather think there is a limit; we just don't know what it is, or even if we could ever conceivably get there.

At what point does a country decide it does not want to be stuck with the Old Maid? Will Greece be allowed to walk away from its commitments? And if it tries, what will be the consequences? I know there is no mechanism for any of this, but someone had better be doing some serious planning around it, because you can bet a lot of investors are privately calculating how things will play out. This can all be handled, if you decide to deal with the issues openly.

So what am I worried about? We all know that developed countries do not default on their sovereign debts: the banking regulators of Europe have told us so. And if you can't trust a banking regulator to know what he's doing, then who can you trust?

Atlanta, New York, Philadelphia, Italy, and Singapore

I leave for Atlanta Tuesday and get back Thursday morning. I am then home for a whole ten days before I take off to New York for a meeting and then on to Philadelphia for the CMG Advisor Forum with my good friend Steve Blumenthal. He has assembled an outstanding group of speakers. Details to follow, but if you are an investment advisor you should consider coming. You can call CMG at 610-989-9090.

I have a few other events on the calendar, but the next big trip will our third-annual vacation to Tuscany. I do love Tuscany and am looking forward to seeing friends and relaxing a little bit. Then in July I will be going to Singapore for a speaking engagement, and will try and see more of that country. I really liked it when I went earlier this year.

And speaking of Frankenstein, I think Mary Shelley wrote the first true science-fiction novel, creating a whole new genre of literature. She took what was known as science (or at least scientific lore) and extrapolated into the realm of "what if," giving us a tale that called into open discussion the nature of life and existence. And to do that while still a teenager? When today our students write papers in English classes that leave us wondering about what we allow to pass for literacy in our educational system?

This has come to mind while watching a YouTube video about my friend David Brin's new book which, almost 200 years after Mary Shelley, deals with the very same issues, but with a very modern twist and cutting-edge science. The book is titled simply *Existence,* and it will be out in June. A Science Fiction Hall of Fame writer, David weaves a great story while making us think about the purpose of life. You can see the video (about 4 minutes) at http://youtu.be/cn6GqxeOvn4

It is once again time to hit the send button. It is early Saturday morning and I need to get some rest to prepare for another action-packed week of trying to figure out the ontological meaning of the existential angst in Europe that is caused by the dilemma of Greece. Or, in layman's terms, "What the hell are they thinking?"

Have a great week.

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