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By John Mauldin | Dec. 10, 2011

We have come to the end of yet another European Summit that was supposed to be the one to fix the problem. If you are confused as to what happened then you are not alone. Was it something we will look back on in ten years and say "This was where it all started," or will it be viewed as just another meeting in what will prove to be a string of even more meetings? I will argue that both views are the correct answer, depending on your frame of reference.

But what did come out of the meeting was that some very clear lines were drawn. Will those lines look like the one that Colonel Travis drew with his sword at the Alamo, where those who crossed and joined him knew their fate? Or will it be more like the fabled French Maginot line, thought to be impregnable, which Germany simply went around? Stark comparisons, I know. But then, the choices and sides of the lines you choose to be on offer very stark consequences.

I should acknowledge that I spent a great deal of time the last two days reading and talking with friends from around the world, trying to make sense of the omelet that we were served in Europe. Exactly what is in it? This letter is somewhat speculative on my part, taken from my gathered impressions over the week and informed by my readings over the years. I will use some simple analogies to try and make things clear. And I know that using such simple devices has its limitations, but those are the tools that I have to work with. They will have to suffice. I hope they also inform.

But first, and speaking of conversations, as part of my discussions on Europe I have scheduled two Conversations next week, one with Lacy Hunt and the other with Barry Ritholtz and Jim Bianco. They will be recorded and transcribed as soon as we can, so that subscribers to Conversations with John Mauldin can listen in before the holiday season arrives. Plus those fabulous archives, with Mohamed El-Erian, David Rosenberg, George Friedman (hmm, I need to do another one with him soon – so much is happening!), Richard Yamarone, Gary Shilling, Nouriel Roubini, and many more. You can "eavesdrop" on my earnest chats with my friends about what's on our minds, just like being at the table. And for the holidays, if you use the code CONV when the signup process asks for one, you get $50 off the regular subscription price. You can subscribe (and learn more) at http://www.johnmauldin.com/conversations/landing/. Join us! And now, let's jump right in.

There are two main points to be taken away from this week's meetings. First, the Germans really took control. This has been coming for a long time, and it's not like we haven't discussed it in these letters. Second, Britain either opted out or was shown the door, depending on your point of view. That is the real game-changer, long-term, for more than the obvious reasons. Let's start with what did not happen, which I think the markets will figure out soon enough.

A Player to Be Named Later

There is a phrase in baseball that is rather infamous. It is "a player to be named later." This refers to when a team decides to trade Player A for Player B but Player A is, at least on paper and in the mind of the fans, clearly superior to Player B. It does not matter what the reason for the trade is. Player A could be a troublemaker, or the team could have developed a new and better (or cheaper) player for that position, or they think they see a problem getting ready to happen. But if it was just a straight-up trade, the fans would get angry. So, to get the deal done and keep the fans happy, the owners of Player B agree to give the other team "a player to be named later." Management tells the fans, we are going to get full value at some later date. Just trust us.

All too often, the player they eventually get is someone the other team wanted to get rid of anyway, or a young player deep in the minor leagues with – that most dicey of terms – "potential"; but sometimes it works out for both sides. Not often, but often enough that it does provide a minimal rationale for the team trading away Player A. Fans are ever hopeful that management knows what they are doing, even after years of being shown that they are clueless.

Not unlike the markets, which salivate over each new announcement from Europe that tells us that all will be well. Trust us, and buy more tickets, or bonds, or stocks. Whichever.

This week's meetings gave us some rather important decisions. But what they did not do was give us a real solution. What we got was "a player to be named later."

The important decisions? The first was that Germany finally got France to go along with its view of how the future of Europe should look. There would be no more bailouts of any type without serious reforms. Sarkozy is in a bind. French banks are essentially so bankrupt that they are too big for France to backstop all alone and maintain its AAA rating. Plus, France's deficits are nontrivial and its ability to raise taxes with any real effect is rapidly dwindling. France needs help. Merkel simply held her ground. In the end, Sarkozy had to agree. To not do so would doom the European experiment and any French hopes for future relevance (more later).

The meetings between Sarkozy and Merkel and "announcement" give Sarkozy the political points he needs to demonstrate that he did not actually cave in. I am sure he in fact did get a few points in, here and there. But not the key points and certainly not what he was asking for this past summer. But he has elections coming up in five months. He can't appear to be weak when negotiating with the Germans.

Germany would have liked to have all 27 EU members agree to a major treaty change, essentially giving up some sovereignty to a new European entity (or the current one with more teeth) that could enforce budgetary controls on individual members. Britain could and would not agree. So, since we don't want to kick anyone out, Germany simply goes around the Maginot

Line of the present treaty and says it will get an agreement from each individual country. They will each write into their national constitutions or laws binding rules that commit them to fiscal controls and austerity. If you want to be in the club you have to play be the rules. If you don't agree, you cannot be part of the eurozone and get access to the central bank and larger agreements on aid.

Each member has to take steps to help themselves before they can apply to the EU for help. If you want the ECB to buy your bonds and support your markets, then you need to get control of your fiscal situation. The carrot and the stick. The carrot is 1% financing for your banks, which can then buy your bonds at 4-5-6% (depending on the country). That makes it easier for your banks to get whole.

Remember, it is not just French banks. Almost without exception, every European bank has bought massive amounts of various European government bonds. Leverage of 30 to 1 is common. (This has the rather bizarre effect of making large US banks look conservative.)

And why not? The regulators actually encouraged the banks to buy government bonds. Since everyone knows that sovereign nations, within Europe at least, cannot default, then that debt is pristine. Why reserve capital against possible losses when there was no possibility of loss? Just a quick and easy spread.

So even if you are a country with a reasonable fiscal balance sheet, your national balance sheet can get a huge hole blown in its side if you have to bail out or nationalize your banks. And what if you are Italy?

Your debt-to-GDP is already 120% and rising. The market has weighed you in the balance and found you wanting. Without ECB intervention your interest rates would already be north of 7-8%. My friend Nouriel Roubini (who grew up in and studied in Italy) makes a long and detailed case that Italy needs to go ahead and write down at least 20% of its debt today. But if rates went up, then the write-down might need to be even greater. But who owns the lion's share of Italian debt? You got it, Italian banks. And in order to keep them afloat you would have to raise capital to borrow money to bail out your banks, so they could write down your debt. That is the problem with debt spirals; they can spin out of control rather quickly. Just ask Greece. Or Ireland.

And if you can't print your own currency? You are in double jeopardy. You can't simply use the old-fashioned, tried and true method of devaluing your way out of your problems, the way Italy used to do with such regularity.

You Can Check Out but You Can't Leave

But as numerous commentators have made clear, leaving the eurozone is not an easy answer. It is a nightmare of Biblical proportions. Like the Hotel California, you can check out any time you like, but you can't leave. Not without a paying hefty bill.

And that bill would in all likelihood plunge you into a depression for a number of years. Very high unemployment. Unfunded pensions and much-reduced health care. Shortages of all kinds until some balance was struck on how to get “hard currency” to pay for the things you want to import. While a country like Italy (or at least northern Italy) has enough exports to get “cash flow” for needed goods, countries like Greece and Portugal would be up the proverbial creek without propulsive means. With a banking system in massive disarray, if it even survives, where does credit come from to trade?

Eventually these things sort themselves out, but eventually can be a long time, especially if you need money for medicine or energy or anything your country does not produce in its own currency region. Not many European countries are self-sufficient within their own borders. They all rely on each other. Not unlike the various states within the US.

What about businesses that are owned or controlled outside your country? What about those businesses your own countrymen own outside your country? Let’s say you are a business with 50% of your income in Greece and 50% outside of Greece. Greece leaves the euro. Does the 50% that is in Greece now pay its European vendors in drachma for that portion of its business? Think that might not result in a lawsuit against the business you own outside of your country, if it tried to pay in euros for the Greek portion of its debt? Will the new Greek government let you control your “foreign” corporation in euros, without making you convert anything remotely tied to Greece into drachma? How? Who decides?

It is an easy political stance to say, “We should go back to the drachma and lira and peso.” It makes for nice, nationalistic demagoguery. But if you start thinking about the consequences, it gets much harder. When you walk to the edge of the abyss and look over, you can’t see the bottom. It is a long, long, long way down.

So, it’s obvious that the correct decision is to stay in the euro. But that means a different set of problems. Germany just made it clear that if you want to stay and have access to financing of your debt, you will have to adhere to some very stringent rules.

But simply stating the obvious was not going to give the markets what they wanted, so we got some “details” on the new rules. The thing that stood out to me was that the agreement is for a limit of a 0.5% structural deficit, with a European institution having the ability to over-rule your budget if it gets out of line.

In the spirit of the game, “a player to be named later” is a pretty good description of a structural deficit. The technical definition of a structural deficit is that a country (or a state or city) posts a deficit even when its economy is operating at full potential. That is the opposite of a cyclical deficit, which only occurs when an economy is not performing to its full potential, as would be the case if the economy was struggling through a recession. At the risk of oversimplification, let me try and give you an example.

Let’s assume you are running a nice little manufacturing business, making the proverbial widget. You are running 24 hours day, seven days a week, making just as many widgets as you possibly can and turning a nice profit. Then you come in one Monday morning to find your largest customer has gone bankrupt and you've lost a big chunk of your business. Your profit has now vanished and you are losing money. Your business is in a "recession." When you were nicely profitable you were considered to have a structural surplus, but now that you're losing money (but still cranking out the widgets) you have a structural deficit.

What do you do? If you have savings, you dip into them while you try to scare up new business to replace what you lost. You cut expenses. Then, if you have to, you go to the bank and try and convince your friendly local banker that what has happened is just temporary – you will soon have a new customer and even more business, if they will just loan you some money to make it through this tough period. You agree to make even more cuts in expenses, and even pledge to take a pay cut and move in with your in-laws if things get worse.

The first time around, because you have been such a good customer for so many years, have always paid your loans back, and everybody loves your widgets, he gives you the money. And the next month you ask for more. And then more. Pretty soon the banker wants more collateral and a higher interest rate, or maybe he calls your loan and you have to go elsewhere and pay a higher rate. IF you can find someone to loan you money.

Now, you didn't trot out the term *structural deficit* when you asked the banker for a loan. But that is what you had. And if you are a country, and you are running a 2% structural deficit when GDP is growing as fast as it can, then eventually the bond market (the national equivalent of your local banker) says, we think the risk of lending you money is rising, and we want more interest. (Yes, I know, the actual rate of interest is also affected by the cost of money and a host of factors. But the relative rate is a function of perceived risk.)

When you went to the banker, you gave him your "best case" so he would give you the money. And he takes your best case and tries to decide how much risk there really is. Can he trust your books? Your accountants? Can you make him believe in your basic business model?

When it is just one business, it is relatively simple to gin up the model and figure the risk. But for a country? With millions of people and thousands of businesses? And international trade? And commitments made by politicians, which can change with each election cycle, depending on the mood of the voters?

Calling for a limit of a structural deficit of 0.5% is pretty serious. But it's a good basic common-sense rule, when you think about it. If your country was growing at 5% nominal GDP (that includes inflation) then a 0.5% structural deficit would mean that your debt-to-GDP ratio was going down each year. You would be in actual fiscal surplus and paying down debt, much as the US did in the late '90s, before we went into recession. (Remember the good old days, only last decade, when Greenspan [and others] openly speculated as to what would happen if we actually paid off all our debt?)

Then, if you went into a recession of 2%, your actual deficit would still only be 2.5% (plus inflation). You could still borrow money against future good times, when you could again pay the debt down. IF – a very big if – you limited your structural deficit to 0.5%.

The problem comes when Europe decides how to actually define what potential growth is for each country. And that is not going to be easy, because potential GDP growth is not the same for each country. Germany will have a different potential from Greece, and Finland from Portugal, and Estonia from Italy. Who gets to decide what potential is for each country?

Germany Is Saying that Europe Needs a Dad

This is kind of like dealing with my kids and school. What I expect from one of my kids might not be realistic for another. And trust me, the ones that get held to a higher standard because I don't think they are living up to their potential will let me know that I am not being fair. But Dad has to make a decision based on his best judgment.

Under the current treaty, everyone was supposed to keep their fiscal deficits under 3%. (The fiscal deficit is the actual cash deficit relative to GDP.) But when the first real recession came along, everyone ignored the rule. Even Germany. And there were no sanctions. Now, Germany wants everyone to agree to real sanctions and fiscal controls.

Germany is saying that Europe needs a dad. Someone who can make each country live up to its potential or take away its privileges. Otherwise, it's not unlike (being simplistic again) a parent allowing the kids to not do their homework, forget their chores, and go ahead and use the car and credit cards. And then, when the grades come in and the credit card bills come due, the parent decides it's time to enforce some rules. Do your homework first, and then we give you the keys to the car. And your credit card has a very serious limit. And no sneaking out of the house. This time we mean it!

That all sounds well and good, but the details, as I read them, say that their fellow students all get to vote on whether the parents are being reasonable. But to be fair, let's look at what we were actually told. This is from the weekend edition of the *Guardian* (emphasis mine).

"Here are the main points of the agreement, reached in the small hours of Friday after overnight talks.

"• EU leaders described the deal as based on a new 'fiscal compact' and 'on significantly stronger co-ordination of economic policies in areas of common interest'.

"• Eurozone states' budgets should be balanced or in surplus; this principle will be deemed respected if, as a rule, the annual structural deficit does not exceed 0.5% of gross domestic product.

"• Such a rule will also be introduced in eurozone member states' own national legal systems**; they must report national debt issuance plans in advance**.

"• As soon as a eurozone member state is in breach of the 3% deficit ceiling, there will be automatic consequences, including possible sanctions, **unless a qualified majority of eurozone states is opposed.**

"• **Voting rules in the ESM will be changed to allow decisions by a qualified majority of 85% in emergencies**, although that remains subject to confirmation by the Finnish parliament."

The actual consequences and sanctions fall into the category of "a player to be named later." Care to make a side "over/under" bet that the details on those will not be agreed on, or even talked about in public, before the French election? I'll take the over, thank you.

Will the markets wait for six months? With more promised meetings every month and more announcements of coming announcements? Did this really even kick the can down the road? Today Dennis Gartman told me he thinks this was a big deal in the can-kicking department. This weekend's *Financial Times* quotes traders saying it won't work. As for me, I'm up way too late on a Friday night / Saturday morning. We shall see.

An Empty Seat at the Table

Merkel said that British Prime Minister David Cameron was "never really at the table with us." He came to the summit wanting special deals for "the City" (the financial district in London, similar to Wall Street), in order to agree to treaty changes. Sarkozy and Merkel said no.

It was a simple calculation on their part. Getting a referendum on a treaty change through Britain was going to be tough, even with special deals. So why agree? And allow Britain a veto on any future deals? Why not just go around the Maginot Line and get every country that wants to be in the new club to agree to constitutional rules on it own?

From the British perspective, the proposed new EU rules would seriously hurt one of its main "industries." Not going along with treaty changes does not mean Britain is leaving the EU, at least at this stage. And while Britain needs Europe, Europe also needs Britain. I keep reading that Britain is the #1 export market for Europe. And while Sarkozy might want to see if he can get a few rules changed that would help his banking industry, the fact is that Europe needs the City, at least for now. You can't simply build up overnight the infrastructure and human capital to do what the City does. It took decades. It can be done, but not easily or cheaply. And certainly not by banks that are just a few government defaults away from being nationalized.

Germany Takes the Long View

I think that Germany is taking the long view, and it's one that I can understand. For all their strengths, there are real problems in the near future, and they center in the demographic issues they face. Steve Stough wrote:

"The German technical apprenticeship system is good, but the population of people trained through that system is in decline. This past summer, Germany tried an open-borders policy for manufacturing labor, hoping to import more eastern Europeans and Turks to work in German manufacturing. The target was 1.1 million migrant workers by the end of 2011. The actual number was closer to 200,000 and is now dwindling again. Improving economic and other freedoms in the East have staunched the westward flow of migrant workers, at least of the kind that Germany needs, and the situation has become critical. The coalition government is now proposing a 'blue-card' immigration plan, whereby migrant workers can become permanent German nationals."

Here is what I wrote some eight years ago about the demographic problems of the developed world, in *Bull's Eye Investing:*

"… looking at the data, the five main economies of the European Union spend about 15 percent of their GDP on public benefits to the elderly. This will rise rapidly to almost 30 percent by 2040 if they intend to maintain those benefits at current levels. Japanese benefits will rise 250 percent to 27 percent in 2040 from today's 'mere' 11.8 percent.

"How do you pay for such increases? If the increase were paid for entirely by tax hikes, not one European country would pay less than 50 percent of its GDP in taxes, and France would be at 62 percent. By comparison, the U.S. tax share of GDP would rise from 33 percent to 44 percent (according to the report; I assume this includes all level of taxes). Japan's taxes would be 46 percent of GDP….

"It should be clear to everyone that such an outcome would be an utter economic disaster. Taxes for the working population would be consuming 80 to 90 percent of their income. It would be an economic death spiral. Whatever economic growth might be possible in an aging United States, Europe, or Japan would be completely squelched by such high taxes. The 'giant whooshing sound' would be that of young workers leaving for more favorable working and tax conditions.

"If the increase in benefit costs were paid for entirely in cuts to other spending projects, Japan would see its public benefits rise to 66 percent of total public spending, France and the United States to 53 percent, and Germany to 49 percent. What do you cut? In the United States, you might cut defense spending, but there is little to cut in Europe and Japan. Education? Welfare? Parks? Transportation? Medical or health programs for the working? A mere 10 percent cut in benefits pushes approximately 5 percent of the elderly population into poverty in Europe—think what a 20 percent cut in benefits would do. Japan is ranked in the middle of the vulnerability pack, despite its poor economic outlook, because more than 50 percent of the elderly live with their children. The three most vulnerable countries are France, Italy, and Spain….

"In France 67 percent of the income of the elderly population comes from public funding and in Germany it is 61 percent, compared with 35 percent in the United States and Japan. These percentages are projected to rise only slightly over the coming decades, but because the elderly population is growing so rapidly, actual outlays will soar. Not surprisingly, if you add in medical costs the percentage of public spending increases significantly, even assuming no new benefits."

Germany has made the correct calculation that the only way they can make it in the future is to grow their economy significantly. And they can't do it if they have to finance the weaker members of the eurozone. So they are in effect creating a "coalition of the strong." And if you want to play you will have to get your fiscal house in order. Germany will not kick you out, but you will lose access to financing if you don't get your budget under control.

Losing access to the financial markets when you are already in debt and running large deficits means having to make serious cuts in government services or raise taxes or both. It will mean a recession. The threat of losing access to bond markets and the not-so-gentle nurture of the ECB is very real.

If a country does not agree to new constitutional rules, they will not be eligible for access to the markets. Those new rules have to be approved by the voters, either directly or through their representatives. Leaving the euro may sound good, but in practice? As noted above, a protracted disaster is the alternative. Guaranteed depression. (Perhaps Ireland could leave if they immediately jumped to the pound sterling, or Finland if they went to the Swedish krona, but why, unless things are really falling apart?)

Germany is willing to suffer some volatility and pain in the short run to cement their long-run viability. And they want an alliance of strong countries with them. They are willing to allow the ECB to control debt markets in the short term, while the new rules are being adopted and the adjustments made by the individual countries.

The new rules, when (and if) adopted, will give politicians cover for making the necessary budget cuts and tax increases that no one wants to make now. They can blame it on Brussels – "What else can we do?"

Merkel has drawn the line in the sand. If you cross that line and stand with the Coalition of the Strong, you are committing "your lives, your fortune, and your sacred honor." Well, at least your political lives and your country's fortune. Humor aside, it is a very serious decision with very stark consequences. But in the world of the Endgame, there are no easy choices.

So, nothing changed, in that the can was kicked yet one more time. Still, we may look back in ten years and see that this was the beginning of a very different Europe. Right now, the political leaders seem to be signaling, with the exception of Britain, that they are ready to sign on. I think they actually mean it. And those of us in the rest of the world had better hope they figure it out. A fractured Europe would bring on a crisis that would make the 2008 credit crisis seem like a walk in the park. Especially as the world seems to be getting ready for a synchronized recession. But that's a story for another letter.

New York, Hong Kong, Singapore, and the Lights…

Tonight I wrote to the sound of horses clip-clopping along, pulling wagons through the street, almost under my window. I randomly leased a home on a main street in Dallas to enjoy the Christmas lights, and the horse-drawn carriages are coming out in force. Next weekend we will have "carriage jams." I actually had to briefly stop work on the letter tonight to help a contractor put up lights, so that I won't be the Grinch on my street. And I will admit to walking through the neighborhood tonight, gathering my thoughts and enjoying the lights. They do stir a certain feel in your heart. And the kids were "oohing and ahing." It is a little thing, but it does bring joy. And the clip-clops made me remember the West-Texas country in which I grew up. You can take the boy out of the country, but you can't take the country out of the boy.

Tomorrow night is Lively's birthday party. She is 2 and starting to be seriously fun. And when she goes to bed, the adults will hang around awhile, as Tiffani treats us to a real holiday festival.

Next weekend I fly to LA for a night to go to Rob Arnott's party and watch the boat parade. In and out, with a meeting or two. Home Sunday and then off to New York for two nights for business meetings and dinners with friends. Tiffani and I love New York at Christmas. Talk about lights!

Then I'm home for a few weeks, with lots of writing, and then it's off to Hong Kong for a conference with the *Hong Kong Economic Journal*, and then on to Singapore just to have a "look-see." (These American colloquialisms must drive the translators nuts, especially Ms. Wong in Hong Kong!) I'll be back in time to do the annual Dallas CFA Forecast Dinner. Quite the line-up: Woody Brock, Rich Yamarone, and Mark Yusko. Given the credentials of the panel, I was apparently invited to supply comic relief. But I do my part.

It is time to hit the send button. This is the latest I have ever finished a letter in 11 years, but then I was more mystified than usual, which is saying a lot, as I live these days in a state of perpetual perplexity. If you think you understand these times, then you don't really understand these times. But it's all fun to try and figure out, anyway. And I thank you for allowing me to share my humble musings. It is a privilege. Enjoy your week!

Your baffled and bewildered analyst,

John Mauldin