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By John Mauldin

How often did we as young kids go down the street kicking a can? "Kicking the can down the road" is a universally understood metaphor that has come to mean not dealing with the problem but putting a band-aid on it, knowing we will have to deal with something maybe even worse in the future.

While the US Congress is certainly an adept player at that game, I think the world champions at the present time have to be the political and economic leaders of Europe. Today we look at the extent of the problem and how it could affect every corner of the world, if not played to perfection. Everything must go mostly right or the recent credit crisis will look like a walk in the Jardin des Tuileries in Paris in April compared to what could ensue.

From the point of view of not wanting to so soon endure another banking and credit crisis, we must applaud the leaders of Europe. The PIIGS collectively owe over $2 trillion to European and US banks. German, French, British, Dutch, and Spanish banks are owed some $1.5 trillion of that by Portugal, Ireland, Spain, and Greece by the end of June, 2010. That figure is down some $400 billion so far this year, which means that the ECB is taking on that debt, helping banks push it off their balance sheets. For what it's worth, the US holds, according to the Bank for International Settlements, about $353 billion, or 17%, of that debt, which is not an inconsequential number.

Robert Lenzner notes something very interesting about the latest BIS report, out this week:

"What's curious, though, is that for the first time the BIS has broken out a new debt category termed 'other exposures, which it defines as 'other exposures consist of the positive market value of derivative contracts, guarantees extended and credit commitments.' These 'other exposures' — quite clearly meant to be abstruse– amount to $668 billion of the $2 trillion in loans to the PIIGS.

"So, bank analysts everywhere; you now have to cope with evaluating derivative contracts that could expose lenders to losses on sovereign debt. Be on notice!"

What did I write just last week? That it is derivative exposure to European banks that is a very major concern for the world and the US in particular. It is not just a European problem. I predicted in 2006 that the subprime problem would

show up in Europe and Asia. This time around, European banks present a similar if not greater risk to the US.

A collapse of a major European bank could trigger all sorts of counterparty mayhem in the US banking system, at least among our major investment banks. And then people would want to know which bank was next. This is yet another reason why the recent financial-system reform was not real reform. We still have investment banks committing bank capital to derivatives trading overseen by regulators who don't really understand the risk. Who knew that AIG was a counterparty risk until it was? Lehman was solid only a month before until it evaporated. On paper, I am sure that every one of our banks is solid – good as gold – because they have their risks balanced with counterparties all over the globe and they have their models to show why you should go back to sleep.

Kicking the Can Down the Road

And that is why I applaud the ECB for stepping in and taking some risk off the table. We do not know how close we came to another debacle. Does anyone really think Jean-Claude Trichet willingly said, "Give me your tired, your poor, your soon-to-default sovereign debt?" Right up until he relented he was saying "Non! Non!" He did it because he walked to the edge of the abyss and looked over. It was a long way down. Bailing out European banks at the bottom would have cost more than what he has spent so far. It was, I am sure, a very difficult calculation.

I remember writing a letter not so long ago, quoting Trichet on that very topic. He was vehemently opposed to any ECB involvement in something that looked like a bailout. And then he wasn't. I do hope he writes a very candid memoir. It will be interesting reading. The reality is that there was nowhere else to turn. There were no mechanisms in the Maastricht Treaty for dealing with this situation. What I wrote the following week (or thereabouts) still stands. This was and is a bailout for European banks in order to avoid a banking crisis. Many European banks, large and small, have bought massive sums on huge leverage of sovereign debt, on the theory that sovereign debt does not default. Some banks are leveraged 40 to 1!

The ECB is now earnestly continuing to kick the can down the road, buying ever more debt off the books of banks, buying time for the banks to acquire enough capital, either through raising new money or making profits or reducing their private loan portfolios, to be able to deal with what will be inevitable write-downs. It they can kick the can long enough and far enough they might be able to pull it off.

There is historical precedent. In the late '70s and early '80s, US banks figured out that if you bought bonds from South American countries at high rates

of interest and applied a little leverage, you could practically mint money. And everyone knew that sovereign countries would not default. That is, until they did.

Technically, every major bank in the US was insolvent then. I mean really toes-up, no-heartbeat bankrupt. So what happened? Mean old Paul Volker – he who willingly plunged the US into recession to vanquish the specter of inflation – allowed the banks to carry those South American bonds on their books at full face value. He kicked the can down the road. And the banks raised capital and made profits, shoring up their balance sheets.

In 1986 Citibank was the first bank to begin to write down those Latin American bonds. Then came Brady bonds in 1989. Remember those? Brady bonds were as complicated as they were innovative. The key innovation behind their introduction was to allow the commercial banks to convert their claims on developing countries into tradable instruments, allowing them to get the debt off their balance sheets. This reduced the concentration risk to the banks. (To learn more about Brady bonds, and a very interesting period, go to http://en.wikipedia.org/wiki/Brady_Bonds and also google "Brady bonds.")

So it worked. Kicking the can down the road bought time until the banks were capable of dealing with the crisis.

Different Cans for Different Folks

The ECB has chosen a different way to kick that old can (and a large and noisy one it is!), but it is not without consequences. Trichet has let it be known that dealing with sovereign-debt default issues should not be the central bank's problem, it should be a problem for the European Union as a whole. And I think he is right, for what that's worth.

If the ECB were to keep this up, even in a deflationary, deleveraging world it would eventually bring about inflation and the lowering of the value of the euro against other currencies. That is not the stuff that German Bundesbankers are made of. So they have been pushing for a European Union solution.

At first, the political types came up with the stabilization pact in conjunction with the IMF. But this was never a real solution, other than for the immediate case of Greece … and then Ireland. It has some real problems associated with it. It could deal with Portugal but is clearly not large enough for Spain. It is worth nothing that the political leaders of both the latter countries have loudly denied they need any help. Hmm. I seem to remember the same vows just the week before Ireland decided to take the money.

One of my favorite writers, Michael Pettis penned this note:

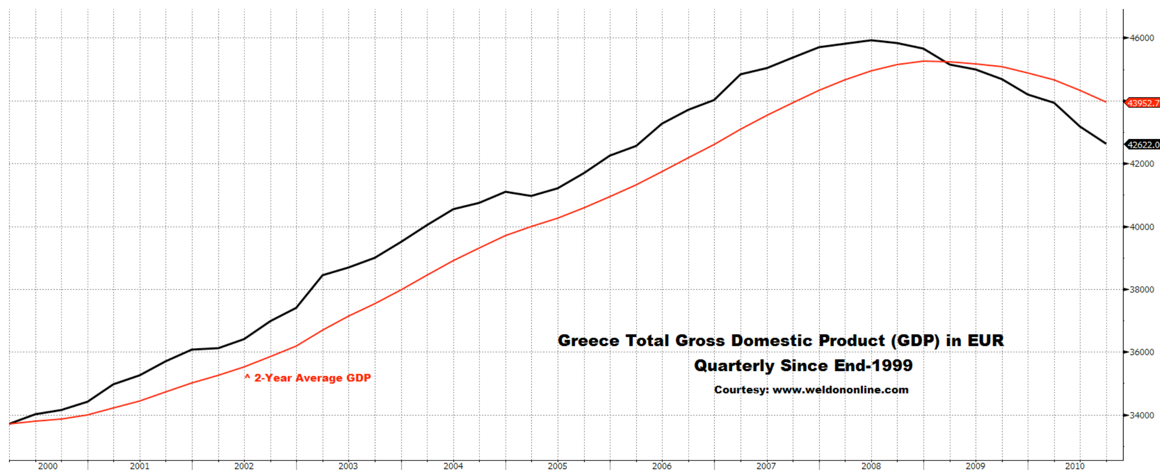
“Its official – Spain and Portugal will need to be bailed out soon. How do I know? In one of my favorite TV shows, *Yes Minister*, the all-knowing civil servant Sir Humphrey explains to cabinet minister Jim Hacker that you can never be certain that something will happen until the government denies it.”

Ultimately, the EU has three options. But before they get there – or maybe better said, before there is a crisis that forces them to get there – they will continue to kick the can down the road. They are really very good at it. We will consider those options in a little bit; but first, let’s look at just one aspect of the problem that will lend some context to the various paths among which they must choose. And that will take us on a detour back to our old friend Greece, where this all started.

More Debt is NOT the Solution to Too Much Debt

Greece is being forced into an austerity program in order to be able to continue to borrow money. But it has come with a cost. Unemployment is now at 12.6%, up from less than 7% just two years ago. And Greek GDP continues to slide. Let’s look at some charts and data from my favorite slicer and dicer of data, Greg Weldon (www.weldononline.com for a free 30-day trial).

Notice that Greek GDP is down over 7% for the last 9 quarters, and there is no reason to believe there will be a reversal any time soon.



A declining GDP is just not good for the country, but it also makes it more difficult for Greece to get back into compliance with its EU fiscal deficit-to-GDP requirements. The problem is that GDP is declining faster than the fiscal deficit. Normally, a country would devalue its currency (and thus its debt), maybe restructure its external debt (or default), and then try to grow its way out of the crisis.

Let's go back and look at what Iceland did, as compared to Ireland, which is trying to take on more debt to bail out its banks, that is, to bail out German and French and British banks.

This is what I wrote a few weeks ago, and it bears repeating:

Look at how upset the UK got when Iceland decided not to back their banks. Never mind that the bank debt was 12 times Iceland's national GDP. Never mind that there was no way in hell that the 300,000 people of Iceland could ever pay that much money back in multiples lifetimes. The Icelanders did the sensible thing: they just said no.

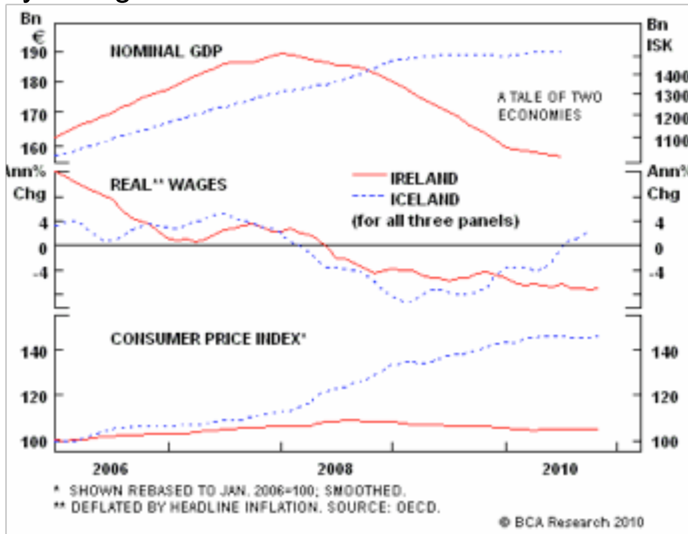
Yet Ireland has decided to try and save its banks by taking on massive public debt. The current government is willing to go down to a very resounding defeat in the near future because it thinks this is so important. And it is not clear that, with a slim majority of one vote, it will be able to hold its coalition together to do so. This is what the *Bank Credit Analyst* sent out this morning:

"The different adjustment paths of Ireland and Iceland are classic examples of devaluation versus deflation.

"Iceland and Ireland experienced similar economic illnesses prior to their respective crises: Both economies had too much private-sector debt and the banking system was massively overleveraged. Iceland's total external debt reached close to 1000% of its GDP in 2008. By the end of the year, Iceland's entire banking system was crushed and the stock market dropped by more than 95% from its 2007 highs. Since then, Iceland has followed the classic adjustment path of a debt crisis-stricken economy: The krona was devalued by more than 60% against the euro and the government was forced to implement draconian austerity programs.

"In Ireland, the boom in real estate prices triggered a massive borrowing binge, driving total private non-financial sector debt to almost 200% of GDP, among the highest in the euro area economy. In stark contrast to the Icelandic situation, however, the Irish economy has become stuck in a debt-deflation spiral. The government has lost all other options but to accept the E85 billion bailout package from the EU and the IMF. The big problem for Ireland is that fiscal austerity without a large currency devaluation is like committing economic suicide - without a cheapened currency to re-create nominal growth, fiscal austerity can only serve to crush aggregate demand and precipitate an economic downward spiral. The sad reality is that unlike Iceland, Ireland does not have the option of devaluing its own currency, implying that further harsh economic adjustment is likely."

This is what it looks like in the charts. Notice that Iceland is seeing its nominal GDP rise while Ireland is still in freefall, even after doing the "right thing" by taking on their bank debt.



Greek five-year bonds are now paying 12.8%. It is hard to grow your way out of a problem when you are paying interest rates higher than your growth rate and you keep adding debt and increasing your debt burden.

Each move to deepen government cuts in Greece will result in further short-term deterioration of GDP, which makes it even harder to dig out of the hole. And Greece is a particularly thorny problem. The taxi drivers are outraged that they might have to use meters. Why? Because that means someone could actually track the amount of money they take in. Government workers are striking over 10% pay cuts. And on and on.

It is the same song but with a different verse for the rest of the countries in Europe that have problems. While Ireland is very different from Greece, assuming massive debt in a deflating economy will only turn Ireland into an ever-

larger burden unless they can get on the path to growth again. Ditto for Portgual, Spain, and….

Et Tu, Belgium?

One country after another in Europe is coming under pressure. This week the debt of Belgium was downgraded, and the accompanying note from Standard and Poor's observed that:

"Belgian's current caretaker government may be ill-equipped to respond to shocks to public finances. The federal government's projected 2011 gross borrowing requirements of around 11 percent of GDP leaves it exposed to rising real interest rates."

At some point, if a country does not get its fiscal deficit below nominal GDP (and this is true for the US as well!) it will run into the wall. Credit markets will no longer lend to it. In Europe, the lender has become the ECB, but that may – and I emphasize may – change with the establishment of a new authority for the European Union to sell bonds and use the proceeds to fund nations in crisis. Under the proposal, each nation would assume a portion of the total debt risk. That may be a tough sale, as it appears there will need to be a treaty change and then country-by-country votes for such a change.

It will also mean that countries that accept such largesse will endure a very stern hand in their fiscal affairs. This is potentially a very real surrender of sovereignty. Some countries may decide it's worth the price. Others, on the funding side of the equation, may decide they have to "take one" for the good of the European team.

This fund is to be launched in 2013, which gives EU leaders some time to flesh out the idea and sell it.

A second choice is for some countries to leave the euro but stay in the EU. Not all members of the EU participate in the eurozone. Leaving would be hugely messy. It is hard to figure out how it could be done without serious collateral damage. Even if Germany were to decide to be the one to leave, which they actually could, as the new German currency would rise over time, it would also mean their exports would be less competitive within Europe.

A third choice (which could be combined with the first choice) is radical debt restructuring. Convert Greek bonds into 100-year low-interest bonds, giving the Greeks (or Irish or Portuguese …) the time and ability to service the debt, along with real controls on their spending. Of course, that is default by another name, but it allows the fiction. Something like Brady bonds. You hit the reset button and kick the can a long way down the road.

That choice too has political and economic consequences. Someone has to cover the losses on the mark-to-market for those bonds. Who takes the hit?

Let me close with this bit of insight from one of my favorite analysts, MartinWolfe of the *Financial Times* (www.ft.com):

"This leads to my final question: could the eurozone survive a wave of debt restructurings? Here the immediate point is that the crisis could be huge, since one restructuring seems sure to trigger others. In addition, the banking system would be deeply affected: at the end of 2009, for example, consolidated claims of French and German banks on the four most vulnerable members were 16 per cent and 15 per cent of their GDP, respectively. For European banks, as a group, the claims were 14 per cent of GDP. Thus, any serious likelihood of sovereign restructuring would risk creating runs by creditors and, at worst, another leg of the global financial crisis. Further injections of official capital into banks would also be needed. This is why the Irish have been "persuaded" to rescue the senior creditors of their banks, at the expense of the national taxpayer.

"Yet even such a crisis would not entail dissolution of the monetary union. On the contrary, it is perfectly possible for monetary unions to survive financial crises and public sector defaults. The question is one of political will. What lies ahead is a mixture of fiscal transfers from the creditworthy with austerity among the uncreditworthy. The bigger are the former, the smaller will be the latter. This tension might be manageable if a swift return to normality were plausible. It is not. There is a good chance that this situation will become long-lasting.

"Still worse, once a country has been forced to restructure its public debt and seen a substantial part of its financial system disappear as well, the additional costs of re-establishing its currency must seem rather smaller. This, too, must be clear to investors. Again, such fears increase the chances of runs from liabilities of weaker countries.

"For sceptics the question has always been how robust a currency union among diverse economies with less than unlimited mutual solidarity can be. Only a crisis could answer that question. Unfortunately, the crisis we have is the biggest for 80 years. Will what the eurozone is able to agree to do be enough to keep it together? I do not know. We all will, however, in the fairly near future."

My only small disagreement is on whether it will be in the "near future." World champion can kickers can put off the day of reckoning longer than you might think. On the other hand, when that day does come, it will seem to have come so quickly and with so little warning. There is no way to know what the markets will do about this, so it pays to stay especially vigilant and flexible.

Africa, Old Friends, and Pensacola

In a former life that seems ages ago (in the late ’80s), I banged around Africa for a few years, chasing the dream of starting a cellular telephone company somewhere. I had actually won some lotteries here in the US and wanted to see if I could get lightning to strike twice. I went to Africa because no one else at the time was paying attention. I was actually in 15 countries, researching the possibilities and working on licenses. I even got one (which was not good luck, but that is another story).

In the process, I found and hired a US ex-pat attorney based in Kinshasha, Zaire, named Pat Mitchell. He introduced me to lots of people all over, but in particular I became good friends with Kevin O’Rourke, a raconteur with the Irish gift (shared with Pat) of spinning yarns. Both of these guys were larger than life and just fun as hell. It was one of my favorite times in life. A learning experience to be sure, but as I look back on it now, I have fond memories. If I had gone a few years later, I might have had more luck. Those African franchises now are worth multiple tens of billions. Oh well.

Yesterday, Pat called me from his home in Pensacola, Florida, where he is now based, and told me that Phil had just flown in and that I should come on down. I have been threatening to visit Pat for a few years, but time and stuff just happens. It goes so fast.

I sat and thought for a few minutes and realized there was nothing on my schedule that could not wait 24 hours. American has a straight shot in less than two hours. So Saturday night I will be in some bar in Pensacola with my amigos, telling stories and maybe a few lies, talking about the old days, and remembering that it is friendships over the years that make the journey worthwhile.

It is time to hit the send button. I intend to get a good night’s sleep, as I suspect I will need it. Have a great week,

Your somewhat nostalgic for Africa analyst,

John Mauldin