

"The Red King"

"He's dreaming now," said Tweedledee, "and what do you think he's dreaming about?"

Alice said, "Nobody can guess that."

"Why, about *you*!" Tweedledee exclaimed, clapping his hands triumphantly. "And if he left off dreaming about you, where do you suppose you'd be?"

"Where I am now, of course," said Alice.

"Not you!" Tweedledee retorted contemptuously. "You'd be nowhere. Why, you're only a sort of thing in his dream!"

"If that there King was to wake," added Tweedledum, "you'd go out — bang! — just like a candle!"

– Lewis Carroll, *"Through the Looking Glass"* (1871)

Never trust the storyteller. Only trust the story.

– Neil Gaiman, *"The Sandman, Vol. 6: Fables and Reflections"* (1994)

He felt that his whole life was some kind of dream, and he sometimes wondered whose it was and whether they were enjoying it.

– Douglas Adams *"The Hitchhiker's Guide to the Galaxy"* (1979)

In dreams begin responsibilities.

– W.B. Yeats *"Responsibilities"* (1914)

What happens to a dream deferred?

Does it dry up

like a raisin in the sun?

Or fester like a sore --

And then run?

Does it stink like rotten meat?

Or crust and sugar over --

like a syrupy sweet?

Maybe it just sags

like a heavy load.

Or does it explode?

– Langston Hughes, *"Dream Deferred"* (1951)



We're all familiar with the Queen of Hearts from Alice in Wonderland, less so with the Red King. He's sleeping all the while, and when Alice goes to wake him up she's warned off by Tweedledee and Tweedledum, who tell her that everything in Wonderland – including Alice herself – is perhaps just the dream of the Red King. Wake him up and maybe, just maybe, everything goes ... poof!

Europe is once again nearing a potential Red King moment, something last seen in the summer of 2012. Then the wake-up call was a series of national elections, particularly in Greece. Today it's a restructuring of the European financial system, a process started in 2012 with the recapitalization of Spanish banks, continued with the depositor bail-in of Cypriot banks, and now at a tipping point with the imminent ECB regulatory control over all large EU banks.

Mario Draghi is Alice, and the dream is a unified European identity triumphant over individual national identities, symbolized and crystalized in a single currency, the Euro.

The Red King? Well, that's us.

A quick recap of our story so far. The European sovereign debt crisis of both the summer of 2011 and the summer of 2012 was also a banking system crisis. In fact, you really can't separate the two. European sovereigns in the South and the periphery are, as a general rule, poorly capitalized and highly levered, and so are their banks. The massive spike in sovereign rates we all witnessed in countries like Portugal, Spain, Italy, and Greece was exactly like a run on the bank, just on a national scale. It's a collapse in confidence in the solvency of the sovereign, manifested as a liquidity crisis. This is the Red King having a nightmare.

Front and center in this nightmare are the actual banks in countries like Portugal, Spain, Italy, and Greece, which suffer actual runs and massive deposit outflows. These banks must be recapitalized to survive, but who exactly should be on the hook for this recapitalization if it ultimately fails? It's all well and good to say that Europe as a whole should create a common fund to accomplish these recapitalizations, but is it really fair for German taxpayers to pay the price for a Spanish bank's insolvency, particularly when those taxpayers (or their representatives) have zero insight into how bad the mess really is and zero oversight over efforts to get out of the mess? But if you make the Spanish government a guarantor of the Spanish bank's recapitalization, all you're doing is adding to the debt burden of the Spanish sovereign, which just makes the nightmare worse.

Everyone agrees on the best recapitalization solution – an EU banking union, where all the big banks, regardless of nationality, are guaranteed by the entire EU – but you can't just go straight to a banking union in one fell swoop. First you need an EU banking regulator, someone who the German taxpayer trusts to take a hard look at the Spanish bank's books, to force changes in the Spanish bank's management and balance sheet if warranted, and to watch the Spanish bank like a hawk to make sure that this new German money doesn't fall into the old Spanish rat hole of bad loans and highly questionable banking practices. **This super-regulator is the ECB, or at least that's what Draghi promised as part of his ["whatever it takes" pledge in 2012](#), and now here we are, two years later, and it's time for Draghi to make good on that promise.**

So what makes the summer of 2014 different from the summer of 2012? If Draghi sang a lullaby to the fitful Red King two years ago with his "whatever it takes" pledge, why won't he do the same today by following through with a no-muss-no-fuss ECB regulatory take-over of major EU banks?

Odds are he will. But what's different today is that it's his own institution on the line. **What's different today is that a heartfelt speech and a mythical OMT program – [pure Narratives, in other words](#) – are not sufficient.** The ECB actually has to assume responsibility for these banks if Draghi is to move forward with the next step of the Grand Plan, and there's nothing intangible or mythic about that.

I think that the best way to understand the recent spate of write-downs and default notifications from European banks (Erste Bank on July 4th, Espirito Santo on July 10th) is in the context of this regulatory unification of big EU banks. For the first time in *decades* these banks are being examined for real. No more patsy national regulators with their revolving doors and inherited culpability, but a highly professional independent banking bureaucracy looking carefully at every bottle and tin in the pantry because they're scared to death of swallowing some poisonous balance sheet.

The problem for the ECB, of course, is that Espirito Santo and Erste are not isolated incidents, any more than Laiki and Fortis and Anglo Irish and WestLB and BMPS and ... should I go on? ... were isolated incidents. The problem is that no amount of public scrubbing and show trials can change the *fact* that the entire European banking system has been an enthusiastic accomplice to domestic political interests for the past 30+ years, stuffing their collective balance sheets to the gills with loans in direct or indirect service to domestic political demands. What? You mean that 6 billion euros lent to politically-connected business interests in Angola (a Portuguese colony until 1975) were maybe not such a good idea for Espirito Santo? I'm shocked! But precisely because the politically-inspired rot is so widespread,

taking a bank like Espirito Santo into the street and shooting it in the head no more solves Europe's systemic banking crisis than executing Bear Stearns in March 2008 solved the US systemic banking crisis. As Dorothy Parker once wrote, "beauty is only skin deep, but ugly goes clear to the bone." **That's the European financial system: politically ugly, clear to the bone.**

No one understands this sad state of affairs better than Draghi. I mean ... the guy was the head of the Italian central bank, for god's sake. You don't think he was there for the initial unmasking of BMPS? You don't think he is only too aware of the tentacles, excuse me ... I mean board seats, that private companies like Mediobanca have throughout the sector? But this is just the skin-deep stuff. The ugly that goes clear to the bone is the manner in which the modern Italian banking system was designed to carry out political missions. This was the *entire idea* behind Berlusconi's successful privatization of the banking system in the early '90's: he and his pals got control of the really big banks – Unicredit, Intesa, etc. – in order to fund the Italian State, and the Left got control of the next tier of banks – the credit unions – in order to fund their local politically-connected small-to-medium businesses. It might not be crony capitalism at an African level of expertise, which certainly remains the global gold standard, but it's not too shabby, either.

So with apologies to Lewis Carroll, here's the choice facing our modern-day Alice – does she sing a lullaby that keeps the Red King sleeping for a few more years, albeit at the cost of drinking a terrible potion that will turn her into a hideous giant ... or does she let the Red King wake up, shattering the dream and risking the existence of everything, herself included, but preserving the story of her beautiful face and form?

If I were a betting man (and I am), I'd wager on Draghi drinking the potion and keeping the dream alive, no matter how complicit it makes him in preserving a very ugly and very politically-driven status quo. But there's a non-trivial chance that it's just too much to swallow, that becoming the public face of a European banking system that will ultimately come undone in national political elections over the next cycle or two establishes a personal and professional legacy Draghi is unwilling to accept. There are no easy choices here. Does Draghi postpone what I believe is an inevitable day of reckoning over the politically bloated balance sheets of the European banking sector? Or does he accelerate that time table so that he can (perhaps) better control its unwinding? I suspect he'll take the former course and choose delay. But maybe not. This is one of those unlikely events that no one will anticipate in advance and everyone will claim was obvious in retrospect, which makes it a perfect item to examine through an [Epsilon Theory looking glass](#). Curiouser and curiouser ...

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