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Subject: Hello Darkness, My Old Friend

So ... did you see the footage of Spanish riot police bull-rushing the austerity protesters, then beating them with clubs? How about the Molotov cocktails in Athens? Japanese water cannons on Taiwanese fishing boats? All-out civil war in Syria?

Political fragmentation within and between nations took another big step forward this week. This is something that I've written about at length over recent months, as I believe it is the singular force for profound structural change in the world today.

Spain has entered a domestic political crisis, where the legitimacy of the Spanish state is in question. That's a big deal. By "state" I don't mean a political sub-region, like Alabama or Andalusia, but the sum total of the political structures that maintain monopoly control over the lawful use of force within that nation. Control over the lawful use of force within the geography we call "Spain" has been a bloody issue for ... well, centuries ... and it's been a settled question for only the last 30 years, with the last coup d'état attempt in 1981. This is the political context for the Catalanian election / independence referendum called for November, and it's the political culture that informs the Madrid protests.

Political context and political culture matter. They matter a lot. But because there's no variable for political culture that you can insert into an econometric algorithm, you won't find a single economist talking about this. Because 99.99% of the people who trade in the markets today, much less the machines, have no idea of the significance of a tricorne hat, or of what the Guardia Civil means in Spain, there's no place for political context in the market's assessment of the situation. Good. That gives me the opportunity to start building up my short positions again. I'm in no rush. Political regime change is a slow moving process, and there are plenty of twists and turns still to come. But Spain and Europe and the world crossed a threshold this week, and it's a one-way passage to a path that is more volatile, more fragmented, and has more tail risk than the path behind.

The escalation of the Spanish "problem" from an economic crisis to a political crisis may not be the beginning of the end for the current Spanish state or centralized efforts to build a stronger European state. But it is certainly, as Churchill would say, the end of the beginning. Going forward, there is now an explicitly political, popular dynamic to all of the problems which were heretofore largely perceived (certainly by the market) as being coldly economic in nature, amenable to the policy prescriptions of the mandarins in Brussels and Frankfurt, to be administered without complaint to the patient in Spain and Italy. Now we see clearly what happens when the austerity policies created in the sterile lab of economic theory are released into the heat and dirt of politics in the real world. My belief is that we will see the same, or rather the same futility, if and when the ECB OMT program is released from stasis.

Of course, this isn't the first example of a popular, occasionally violent, political revolt against austerity policy within a modern European nation – just look at Greece. But it's one thing to have riots and a failed state in a single country, particularly one that is small and relatively distant (in many respects) from the rest of Europe. With Greece as the sole example of failed policy, you can make the argument, as Czech President Vaclav Klaus did earlier this week, that Greece is a "victim of monetary union", a special case, an anomaly, and that their exit from the euro would be no big deal. But it's another thing

entirely when riots and questions of state legitimacy break out in Spain. No one will be making the argument that a Spanish exit from the Euro is no big deal. At least we can stop worrying about when the Greek “contagion” would spread to a too-big-to-fail nation – it just happened.

Here’s what a failed economy and a failed state looks like in Greece, as described by articles from *Ekathimerini* over the past week alone:

- 1) *Bad Loans Climb to Record Level of 57 Billion Euros* – “Nonperforming loans have reached a record level of 57 billion euros ... with one in every four loans not being repaid for more than three months.”
- 2) *Firms Owe Billions in Taxes and Loans* – “The total amount owed by entrepreneurs and the self-employed to the state, social security funds, and banks is 194 billion euros, just short of the country’s gross domestic product, according to data compiled by the National Confederation of Greek Commerce.”
- 3) *Greek Retail Sales Plunge Amid Recession* – “Greece’s statistical authority says domestic retail sales dropped eight percent in July compared with a year earlier ... July and August are when Greek retailers offer summer sales, which normally boosts turnover. But according to separate estimates from Greece’s national trade confederation, turnover during the two-month sales period dropped 20 percent compared with a year earlier, and a total of 36 percent since the summer of 2010.”
- 4) *Nearly a Third of Businesses in Central Athens Closed Due to Recession* – “Greece’s deep recession has forced almost a third of businesses in the capital’s commercial district to close down ... Tens of thousands of small businesses, which make up a big chunk of the struggling economy, have shut since Greece secured a 110 billion euro bailout package in 2010 in exchange for promises of painful austerity measures.”
- 5) *List of Politicians Being Investigated for Corruption Made Public* – “Prime Minister Antonis Samaras is expected to make an official statement on a brewing political scandal after a list containing the names of more than 30 politicians that were investigated for corruption by the Financial Crimes Squad (SDOE) was leaked. The list, which includes the names of 11 former ministers, 10 former deputy ministers, and 12 former or current MP’s, has been passed to prosecutors.”

All of this is also now in play in Spain. All of it. Record levels of bad loans. Massive tax avoidance. A collapse in retail sales. Rampant bankruptcies of small businesses. Sweeping criminal investigations of politicians. And this is before Spain undertakes anything close to the austerity policies that Greece has endured for the past two years! If the protesters in Madrid are saying that the current level of austerity is politically untenable, what will they say when austerity actually begins in Spain?

The ECB may build the greatest fortress walls of liquidity support ever seen by man (or at least the greatest ever seen on their side of the Atlantic), but I believe this is nothing more than a Maginot Line. Supra-national monetary policy in the form of liquidity support simply doesn’t engage domestic political forces intent on reclaiming sovereignty from a regime perceived to be illegitimate. It just doesn’t. In fact, if that liquidity support is contingent on additional austerity policies, which it is, then ECB policy makes matters worse. At best, domestic political conflict goes around ECB policy, and it exacerbates the international political conflict between all other regimes in the Euro Zone.

Do you think Monti is happy about what’s going on in Spain? Merkel? Draghi? The entire Way Forward to debt mutualization, bank union, etc. is 100% predicated on the steady, multi-year application of

public sector deleveraging. This ain't happening, because there is no politically legitimate political faction in Spain or Italy that can achieve power or maintain power with a policy of multi-year public sector deleveraging.

Say what you will about Silvio Berlusconi, but he's not stupid and he's as politically astute as anyone in Europe. Here's the text of his interview this week with Alessandro de Angelis:

Once and for all let's be clear: do you want Italy in or out of the euro? What are the scenarios?

"There are three possibilities. The first: convince Germany that we cannot go forward only with austerity. The second: that Germany exits the euro, a hypothesis that is not science fiction since German banks have evaluated the ramifications of an exit from the euro. And third: that the other countries leave the eurozone, which would mean the end of a common currency and the scrapping of Europe."

Which of these hypotheses do you prefer?

"The first: convince Germany."

So how do you get out of this situation?

"The problem is reforming the European Union and giving the ECB the prerogatives of an authentic central bank, including the role of guarantor of the sovereign debt of all the states that have transferred up their right to print currency to the European Union and through it to the ECB, opening up the risk of default on their sovereign debt. Remember, Japan's national debt is 238 percent of GDP; nonetheless their sovereign debt is financed by bonds at 1 percent interest because Japan has a real central bank that prints currency."

So Berlusconi's solution (which I fully expect will be his party's platform position in the forthcoming election), is that Germany must be "convinced" to stop insisting on austerity and to allow unlimited debt monetization by the ECB. Otherwise, either Germany needs to leave the Euro or Italy will leave the Euro.

Right.

Look ... I know that a lot of people believe that Germany will ultimately capitulate and allow the ECB to print to infinity, just like Silvio is demanding. I think that's totally, completely, irretrievably false. It's a myopic view that ignores the political context and political culture of Germany. But maybe I'm wrong. Even if I'm wrong, however, even if Germany looks into the abyss and decides to let Silvio Berlusconi (!) decide the future of Europe, they're not changing their mind without the very real prospect of falling into that abyss. This is why I believe that tail risk has not been eliminated from Europe – as Draghi intended and the market consensus clearly accepts – but, on the contrary, is back with a vengeance.

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