

## Mohamed El-Erian and David McWilliams The Key to Resolving Europe's Crisis

By Robert Huebscher  
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Dealing with a crisis requires three things, according to Jack Welch, General Electric's former CEO. Define your reality – not as you would like it to be, but as it is. Do something about it. Then, third, acknowledge that the crisis wasn't half as difficult as you thought it was. Germany is the key player in Europe's crisis today, and it is still struggling to accurately define its reality.

The crisis in Europe was the focus of two presentations at last week's Strategic Investment Conference in San Diego, hosted by Altegris Investments and John Mauldin. Lack of a common vision and inability to coordinate effectively are undermining progress in Europe, according to Mohamed El-Erian, PIMCO's chief executive officer and co-chief investment officer. David McWilliams, one of Ireland's leading economic commentators, echoed El-Erian's sentiments and highlighted Germany's role in determining the Eurozone's future.

McWilliams, who served as Welch's master-of-ceremonies during Welch's 2001 *Straight from the Gut* book tour, used the former GE executive's framework to illustrate how events in Europe are likely to unfold.

"Germany is the key to everything," McWilliams said, "and the key for Europe is to understand how Germany is going to deal with the crisis over the next couple of years."

### Germany's pivotal role

Germany wants the EU to remain intact to support its export-driven economy, McWilliams said, and the question is how much the Germans are willing to pay for that benefit.

Europe faces a big problem with its middle class, which is suffering from losses in the value of their assets – specifically land and houses. Uncertainty about the future is causing middle-class Europeans to save more and spend less, he said, and retailers are cutting prices. But demand is continuing to fall. For example, new car sales are down 30% in Italy, McWilliams said. Banks are refusing to lend because their balance sheets are too weak and "the economy is seizing up."



Mohamed El-Erian



David McWilliams



Unemployment is rising everywhere but in Germany, and the continent is heading into recession. El-Erian called Germany the “good house in a bad neighborhood.”

Throughout Europe, the initial response to the crisis was denial, according to El-Erian. The reality that Germany still refuses to accept, McWilliams said, is its co-dependence with the weaker European countries. Germany (and other surplus countries, like Austria, Holland and Finland) grew by selling its exports, like Mercedes, to the European periphery, like Ireland, which financed those purchases with debt its governments can no longer service.

The weaker and less competitive parts of Europe are saddled with too much debt, El-Erian said.

“At the moment, the policy is to load us up with more and more debt to pay for debt that we couldn’t pay for in the first place,” McWilliams said. “So we are borrowing from tomorrow to pay for yesterday, not even today. And this, of course, is causing the economies to contract.”

Borrowers and lenders need to share responsibility for the crisis – perhaps lenders more so, since it is their capital that is at risk, McWilliams said. “What has happened in Europe is we have too much debt, too little growth, not enough political leadership, and a lack of political legitimacy,” McWilliams said.

Iceland correctly defined its reality, according to McWilliams. When its crisis came in 2009, it acknowledged that it could not possibly repay its debt. The money wasn’t there, so it defaulted. Default is still an option for some EU members, and McWilliams said that he expects Greece to default at least once more on its debt.

But Germany will control the final outcome, and he said that the average German citizen may not support continued EU membership. If the Union were to collapse, most Germans would be quite happy taking their deutschmarks back and having their savings and other assets revalued upwards.

### **A big dumpster**

McWilliams said Germany needs to have the ECB create “a big dumpster” into which all Europe’s bad assets can be thrown – the mortgage books of the Irish and Spanish banks and the toxic assets held by Greece’s institutions. Without that type of mechanism to absorb bad debts and recapitalize Europe’s banks, “Europe is going to get weaker and weaker.”

El-Erian used gentler language, calling upon the ECB to build a “bridge” to provide liquidity to and improve “asset quality” for the banks. He praised the ECB for the aggressiveness of its LTRO financing, which he called “incredibly powerful.” He said it has expanded its



balance sheet by 30% of GDP, as compared to 20% by the Fed in response to the financial crisis.

Economic thinking in Germany is troublesome, though – Germans want to pursue a path of “expansionary fiscal retraction,” McWilliams said. That entails cutting back on public spending throughout Europe – fewer policemen, for example – in order to reduce taxes and increase personal income. “The world doesn’t work that way,” McWilliams cautioned.

EI-Erian agreed. Europe, he said, needs to find the right policy mix of growth and austerity. “But they are not there yet,” he added.

Europeans are now going to vote on a fiscal treaty. If passed, McWilliams said, it would provide insufficient support for the weaker countries. That will create resentment among the middle class, directed at Germany. Germany will be isolated, he said, and extremism throughout Europe will rise.

If that happens, he said, “All bets – with respect to the euro, the fiscal contract and people’s perception of the ECB – are off.” That, in turn, will lead to a massive flight of capital out of Europe’s periphery, according to McWilliams.

Europe cannot continue as it is currently structured, EI-Erian said. It must evolve into one of two “equilibrium states” – either providing the fiscal support to retain all 17 current members or forcing two or three of the weakest countries to exit. Under the first scenario, “the problem is that politicians have to convince a very skeptical population that it is right to pay for this,” he said. “Under the second one, you have to find a way for a country to exit.”

A breakup of the EU would be “a total mess for every single European economy and for the rest of the world,” EI-Erian said. “But even with a good equilibrium it’s going to be bumpy.”

Germany must pay a price regardless of the outcome – either funding the liabilities of the European periphery or confronting the major instability that would follow a breakup of the Eurozone.

Rather than heeding Jack Welch’s advice, Germany is defining how it would like reality to be, but not how it is.

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