

Management *Insights*

A 'UNITED STATES OF EUROPE' OR FULL EXIT FROM THE EURO?

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Ozymandias

By Percy Bysshe Shelley

*I met a traveler from an antique land
Who said: Two vast and trunkless legs of stone
Stand in the desert. Near them, on the sand,
Half sunk, a shattered visage lies, whose frown,
And wrinkled lip, and sneer of cold command,
Tell that its sculptor well those passions read
Which yet survive, stamped on these lifeless things,
The hand that mocked them, and the heart that fed;
And on the pedestal these words appear:
"My name is Ozymandias, king of kings:
Look upon my works, ye Mighty, and despair!"
Nothing beside remains. Round the decay
Of that colossal wreck, boundless and bare
The lone and level sands stretch far away.*

It is indeed ironic that at the time the euro faces its greatest existential crisis, the European Central Bank has broken ground on its new headquarters in Frankfurt. This when the core design flaw at the heart of the European monetary union has become manifest to a number of leading market observers, practitioners, economists and journalists. What was once deemed the fantasy of a few extreme euro-skeptics has now become respectable mainstream opinion. A fiscal/monetary half-way house divided cannot stand. That seems to be clear, and the prophetic warnings of the great English Romantic poet, Percy Bysshe Shelley, are more relevant than ever.

So how does the European Monetary Union avoid the fate of the great Ozymandias? Both former Federal Reserve Chairman Paul Volcker and Bank of England Governor, Mervyn King, have recently suggested a fully fledged supranational fiscal union to complement the supranational central bank, the ECB. As conceptually elegant as this appears, is this truly is the best option for Europe going forward?

A "United States of Europe" could well represent something, if not as extreme, as that of Yugoslavia, before it disintegrated in the 1980s. The relatively rich republics of Yugoslavia (Slovenia and Croatia) resented policies that transferred of wealth to the relatively poorer republics, like Serbia, Macedonia, Montenegro, or the autonomous region of Kosovo. Once Tito's organizing genius disappeared, the linkages stitching the country together became frayed and eventually snapped as old grievances manifested themselves in newer forms. The same type of evolution could happen to the Europe Union if it underwent a supranational fiscal union, where the rich countries feel they are being unfairly burdened -- the beginnings of which are already in evidence.

The great achievement of the EU has been to reduce the probability of violent nationalist conflict among some of its members to a vanishing small probability while improving the economic lot of its members. But in spite of the salesmanship surrounding the adoption of the single currency zone, much of this reduction in the propensity toward violence and economic growth took place before the adoption of the euro. It may be time to consider the notion that giving up the euro is a wiser alternative in the long run, unless someone can synthesize some kind of third option, which hardly seems likely in the current political context.

Underlying the great European project has been one key unstated, but historically obvious goal: how to deal with the so-called “German problem”. Broadly defined, this issue has been a question of dealing with a country that has historically been too powerful for its neighbors, with the conspicuous exception of the post-World War II era, when the country was dismembered until reunification in 1990.

The period of 1865-1871 was much like the period in the aftermath of the downfall of the Soviet Union. The political map of Europe changed more dramatically than at any time in the previous 50 years. The most momentous change during this brief spell between 1865-1871 was the emergence of a united Germany. After 1870, Germany became the most powerful state on the Continent, following the defeat of both Austria and France. The fact that this was the result of Bismarck’s skillful diplomacy and the efficiency of the Prussian military machine inevitably gave rise to uncertainty as to Germany’s future intentions. Such fears seem well grounded when in April 1875 Germany seemed to be preparing a pre-emptive strike to check France’s recovery. After warnings from Britain and Russia, however, Bismarck was quick to reassure the powers that Germany was committed to the cause of peace. Consequently, the “German Problem”, although latent, was not raised in an acute form for another two or three decades.

The “Great Power” club in many respects mirrored the future complications of the EU, insofar as it encompassed the genuine military and economic powers, such as Germany, Britain, France and Russia, the fading pseudo-empire of Austria and a whole host of lesser powers, such as Turkey and Italy. The latter, in another interesting historic parallel, was granted admission to the great power club as a matter of courtesy, since it failed to qualify for membership according to the normal tests applied. Italy, in fact, was deemed “the least of the great powers” as its reunification was still incomplete. In terms of population and economic resources, the country ranked sixth in Europe, whilst its industrial production as late as 1901 was only the equivalent of Belgium and Luxembourg. Even in 1913, its industrial muscle was only a fraction of that of the leading powers.

In the 19th century, the German problem was largely held in abeyance through the skillful diplomacy of Bismarck. The constitution which arose in the aftermath of Germany’s unification narrowly confined executive authority to the Kaiser and the Chancellor, at the expense of a cabinet system of government. None of Bismarck’s successor’s was able to exercise the power and influence of the so-called “Iron Chancellor”, with the result that Germany’s policy became increasingly erratic, given Kaiser Wilhelm II’s incapability of providing intelligent coordination needed to give coherence to government policy.

This absence of coordination of government policy had particularly deleterious effects in the realm of foreign policy, where the attitude of Germany’s leaders toward Britain (as the dominant naval power of the day) revealed a basic indecision as to whether a world policy should be conducted in association or confrontation with the United Kingdom. Germany’s clumsy diplomacy, its opportunistic drive for colonies in Africa and the increasing inclination to engage Britain in a naval arms’ race (which became very acute by 1908) all revived the “German problem” and culminated with two disastrous world wars.

Whereas in 1919 Germany had been left with greatly reduced armed forces and certain types of weaponry had been forbidden, in 1945 the country was completely demilitarized. The baronial estates of the Junkers, a class that had played such a key role in German history, were parceled out. Heavy industry in the East Germany (the Soviet Zone) was nationalized, and it in the west it was placed under strict control. Thus, the military, the Junkers and the industrialists lost most of their power and influence brought about by this fundamental change in the social structure of the country which was brought about by total defeat, rather than by the 12 years of National Socialist ‘revolution’. This would remain the case until the time of the German “Wirtschaftswunder” under Adenauer and Erhard.

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The perpetuation of Germany's division was facilitated by the conflicting aims of the occupying powers. Whereas the Western Alliance (notably France) saw no viable alternative to the division of Germany, Stalin still hoped to add a united Germany to the Soviet sphere of influence. This ambition was largely arrested as the Americans broke the Berlin Blockade. Additionally, the SPD, which had historically been a leading light in the Socialist International, under Kurt Schumacher, proved itself to be fiercely nationalistic and violently opposed to a policy of integration if it meant being swallowed up as a Soviet satellite. In this regard, they were supported by moderate conservatives such as Konrad Adenauer, who were committed to a policy of integration with the western powers and refused to pay the high price in the loss of freedom and security that a policy of national integration was bound to entail. West Germany's ascension into NATO (and the corresponding formation of the Warsaw Pact) ensured that the dismemberment of Germany post W.W. II was entrenched, which again meant that the German problem was held in abeyance.

But it was not long before the foundations of the modern German state and its corresponding philosophic and market biases began to take shape again. A key figure was Ludwig Erhard, an economist, who had remained relatively unscathed during the Nazi years, but who had valuable connections in industry and banking. He became the leading advocate of the "social market economy". Erhard was fully committed to the freedom of the market and the free play of supply and demand, but he also insisted that the state had to intervene to ensure that free competition was not unduly hindered by cartels and monopolies, and that an extensive welfare state should provide assistance to the less fortunate. This is the vision that ultimately triumphed in West Germany (despite the political strength of the SPD, which had remained completely untainted by any Nazi association), and as the Federal Republic of West Germany it took part in the Council of Europe, the Schuman Plan and, in February 1952, the European Coal and Steel Community, the first forebear of what is now the European Union. Its industrial renaissance became particularly pronounced as a consequence of the economic boom triggered by the Korean War and set the foundations for the re-emergence of Industrial Germany as a major player in the formulation of German and, by extension, European economic and foreign policy.

The reunification of Germany in 1990 ushered a period of geopolitical change every bit as dynamic as the original unification of Germany under Bismarck in 1871. But so too did the response to the hitherto dormant German problem, as reunification loomed as a reality in the wake of the collapsed Soviet empire. British PM Margaret Thatcher harbored grim visions of a "Fourth Reich", whilst French President Francois Mitterrand feared that a united Germany would be an economic colossus that would overshadow France. German Chancellor Helmut Kohl (the first Chancellor from Germany's post-war generation), responded to these concerns by incorporating a vision of a Germany strongly bound within the strictures of the (then) European Community and then the European Union. In Kohl's vision, the German problem would become a non-event, as the country would be firmly entrenched as part of a broader "United States of Europe".

With the Treaty of Maastricht, which was negotiated in December 1991 and signed the following February, Germany's sovereign powers were further reduced, in spite of the country's tremendous post-war economic successes. Equally significant, the Treaty was passed in the absence of nationwide referendum, a conspicuous early illustration of technocratic vision trumping popular legitimacy. This was and remains one of the key flaws inherent in the so-called European project.

Monetary union meant that the Deutschmark would be replaced by the euro and the all-powerful Bundesbank by a European central bank. Europe was to have a common foreign and defense policy and the frontiers between the member states of the European Union were open. Even Germany provinces were granted increased powers under the Maastricht Treaty, which allowed them to make direct representation to Brussels, as opposed to Berlin.

But there was a bigger problem, embodied in the question of membership in the EMU itself. In spite of the many benefits offered by a single market underpinned by a single currency, a strong case could be made that the euro's long-term viability was more readily achievable in a smaller zone consisting of a more limited group of nations with a more cohesive set of economic and political philosophies. The "small is beautiful" school (of which the Bundesbank was surely a core member) argued that pooled national sovereignty, greater monetary and fiscal co-ordination, were surely more feasible where the countries involved had comparable political and economic structures and similar social outlooks. A large expansion of the euro zone amongst a larger group of heterogeneous nations with substantially different ideological and historical traditions substantially complicated the drive to converge, as can be seen in the current crisis.

By contrast, the “big and broad” advocates of the euro zone maintained that the bigger the euro-zone, the more likely the currency could compete with the decaying dollar standard as a viable reserve currency alternative. This is questionable. The euro was launched in the face of substantial regional disparities amongst the 12 founding member countries (both in terms of unemployment rates and per capita income levels). Indeed, it is difficult to think of comparable examples of a single-currency zone in which the disparities of economic performance were on anything like the scale of those within the EU as was currently constituted amongst the original 12 members. By way of illustration, unemployment in April 1998 varied from 2.1 per cent in the central region of Portugal to 2.6 per cent in the Aaland region of Finland, 27 per cent in Calabria, Italy, and 29.9 per cent in Andalucía in southern Spain.

Why, given the obvious post-war successes of West Germany’s institutions, its economy, its industrial strength, did the newly reunified Germany agree to so many restrictions?? And why did Germany ultimately accede to the vision of a broadly based euro zone – especially given the distinct lack of enthusiasm of the country’s powerful central bank and in spite of the massive regional economic disparities present in Europe – both of which threatened the longer term viability of the monetary union?

Clearly, this can be better understood by viewing the country through the prism of the Three Germanys.

Germany 1 is the Germany of the Bundesbank: the segment of the country which to this day retains huge phobias about the recurrence of Weimar-style inflation, and an almost theological belief in sound money and a corresponding hatred of inflation. It is the Germany of “sound finances” and “monetary discipline”. In many respects, these Germans are Austrian School style economists to the core. In their heart of hearts, many would probably love to be back on an international gold standard system.

Germany 2 is the internationalist wing of the country, led by Helmut Kohl. They are probably the foremost exponents of the idea that Europe can rid itself of the “German problem” once and for all if Germany firmly binds itself to a “United States of Europe” and continues to construct institutions that broadly move the EU in this direction. It is questionable whether this vision has survived significantly beyond the tenure of Helmut Kohl himself.

One can see the inherent tension between these two Germanys. Bundesbank Germany would never allow vague, internationalist aspirations to dilute the goal of sound money, low inflation and fiscal discipline. One could envisage most looking askance at the Treaty of Maastricht and the corresponding threats to these ideals.

Which brings us to the key third variable in German politics: Germany 3, Industrial Germany, the Germany of Siemens, Daimler, Volkswagen, the great steel and chemical companies, the capital goods manufacturers. Clearly, these companies benefited substantially from the economic stewardship provided by institutions such as the Bundesbank, along with the broad adherence to Erhard’s social market economy. But they also recognized the benefits entailed by a completely open and integrated European market (still the largest component of their sales). Currency union, even if it meant admission of fiscal profligates such as Italy and Spain, also minimized the threat of competitive currency devaluation, given the implementation of a European wide euro (as opposed to the narrow currency zone which represented the limits of the Bundesbank’s internationalism). Industrial Germany rightly perceived that a broadly based euro zone which incorporated chronic currency devaluers such as Italy, permanently entrenched their competitive advantage. And with the support of this key component of German society, Chancellor Kohl, was able to embark on the huge institutional transformation embodied in the Maastricht Treaty.

But what kind of a union? The creators of the euro were like parents fixing an arranged marriage. They knew that they were locking together countries with very different economies and political cultures. But they hoped that, over time, the new partners would grow together and form a genuine union.

In fact, the European Union was banking on three forms of convergence: economic, political and popular. At the time the euro was launched, there was much hopeful talk that a surge in trade and investment between the euro zone nations would create a truly unified European economy, in which national levels of productivity and consumption would converge on each other. It was also assumed – or perhaps just hoped – that the euro would create political convergence. Once Europeans were using the same notes and coins, they would feel how much they had in common, develop shared loyalties and deepen their political union. The creation of the euro. But they hoped that, in time, ordinary people would embrace the new single European currency.

Finally, the designers of the single currency were hoping for a third form of convergence, between elite and popular opinion. They knew that in certain crucial countries, in particular Germany, the public did not share the political elite's enthusiasm for the creation of the euro. But they hoped that, in time, ordinary people would embrace the new single European currency. This has clearly not been reflected by the reality. Crudely speaking, the markets today are calculating that governments lack the shared political commitment to underwrite the stability of the single currency.

Most rules, regulations, and diktats emanating from Brussels are deemed by the national electorates to be annoying and occasionally inconvenient. But they have hitherto been the object of ridicule and satire, not the stuff of revolution. Rulings, like one which decreed that chocolate may contain vegetable fat, might offend certain chocolatiers in Belgium or France. But for the most part, the European Commission is seen as something distant with little day to day relevance in the lives of most citizens living within the European Union. The implementation of a policy which has profound economic consequences, notably the economic austerity packages demanded of Greece, Spain, Ireland, Portugal, etc., changes everything.

Politically, the interpretation of the euro-zone's stability pact is largely left in the hands of unelected bureaucrats, operating out of institutions which are devoid of any kind of democratic legitimacy. In such circumstances, it becomes difficult to envisage how a recently elected government such as that of Greece, armed with a fresh mandate, could be compelled to delay implementation of a key election promise, without ultimately creating huge popular backlash in a way that potentially compromises the long-term viability of monetary union. People have already started dying in riots in Athens. We also had a brief foretaste of the political reaction in store of that a few years ago in France, as it was precisely this kind of backlash that produced Jean-Marie Le Pen's surprisingly successful candidacy in the penultimate French Presidential election.

Anti EU parties of the sort that Le Pen represents are on the rise across continental Europe. To be sure, at this stage, they largely represent disaffected (albeit significant) minority votes. But an externally imposed fine by a bunch of Brussels bureaucrats could engender significant mainstream political backlash. Voters for the Front Nationale in France, or Vlams Blok in Belgium, are symptomatic of a growing body of opinion which sees the European Union and its attendant institutions characterized by a huge democratic deficit. This in turn has led to an increasing sense of political alienation and a corresponding move toward extremist parties hostile to any kind of political and monetary union in other parts of Europe. Under politically charged circumstances, these extremist parties might become the mainstream.

What the Greek crisis shows is that Europe's brokered marriage is in deep trouble. The partners have not grown together. For a long time, countries such as Greece and Portugal benefited from the illusion of economic convergence through the lower interest rates and stable currency that the euro brought with it. When the European economy was growing, the markets indulged the fantasy that there was little to choose between Greek and German debt. But that has now changed – and Greece has to pay a significant premium on its borrowing, as does Portugal and now Spain.

It is also now obvious that countries such as Greece, Spain and Portugal are struggling to compete with the much more productive German economy. In a currency union they cannot devalue their way out of trouble. The only alternative solution on offer is a long and painful period of austerity to reduce their costs through cuts in wages and living standards, the so-called "internal devaluation" – in reality, a one-off coordinated reduction of wages and prices across the board. It is, in reality, more like an "infernal devaluation." It amounts to a domestic income deflation — as wages are crushed — in order to get the prices of tradable goods down enough so the current account balance increases sufficiently enough to carry the next wave of growth.

This lack of economic convergence has revealed the lack of political convergence around a shared European identity. There is a striking lack of sympathy for the Greeks from Germany, Europe's largest economy. The German position seems to be that the weaker European economies are paying the price for not being as hard-working and skilled as Germans – and must now shape up or ultimately leave the euro.

Any suggestion that German under-consumption and export-addiction might have something to do with the crisis in the euro-area is brushed aside. Some Greek politicians have responded to German pressure with angry references to the Nazis' brutal occupation of their country during the Second World War. So much for European solidarity. Germany's hard-line position reflects the fact that the third convergence – between elite and public opinion – has also failed to take place. But it also reflects a failure to understand the institutional limitations at the heart of the euro zone. In fact, having lost monetary sovereignty by adopting the euro, Germany has more to gain if it stabilizes its domestic economy by running large deficits during a downturn than if it tries to reap the long-term structural benefits of deficit reduction, as called

for in the Stability Pact. Moreover, there is a broader philosophic problem embodied in the pact. Implicit in the drive to create a “stability culture” is the belief that public debt is invariably an evil, the consequences of which must be stopped at all costs. But as events of the past decade have clearly demonstrated, excessive private sector debt build-up, notably in Asia and the United States, has played a far more destabilizing role in the global economy than fiscal profligacy, which undercuts one of the main rationales for retaining the Stability Pact in its current form. If we say that the government can run budget surpluses for 15 years, what we are ignoring is that this means the private sector will have to run deficits for 15 years—going into debt that totals trillions of dollars in order to allow the government to retire its debt. Again it is hard to see why households would be better off if they owed more debt, just so that the government would owe them less.

An ostensibly moral stance advocating balanced government budgets reveals a profound ignorance of the simple accounting of sector financial balances. Those preferring to impose a “fiscally correct” policy on the peripheral nations should best recognize these accounting realities, and soon. If we are correct that domestic income deflation will be the end result of fiscal retrenchment colliding with private sector attempts to net save, then surely more desperate citizens will turn to even more desperate acts. Rather perversely, the combined effects of fiscal retrenchment, private income deflation, and rising private debt distress are likely to make moral considerations a second or third order concern for many euro zone citizens.

Second, the export sales of German and Dutch companies will fade with the falling import demand of the periphery. As their domestic incomes fall, they will import less. In other words, the fiscal retrenchment the core nations are insisting upon is highly likely to boomerang right back on them.

As it stands, investors have started to recognize that bank in the region are at risk. CDS for Spanish and Portuguese debt have started to widen more dramatically over the past two weeks, although investors still appear overly focused on government debt CDS. Policy makers have also begun to realize Greece is unlikely to be the last country requiring a bail out, while they at the same time sign on for rapid fiscal “consolidation” (read retrenchment) in order to ostensibly avoid becoming the next Greece.

When the euro was launched, leading German politicians used to argue, with evident relish, that monetary union would eventually require political union. The Greek crisis was precisely the sort of event that was expected to force the pace. But, faced with a defining crisis, Ms Merkel’s government is avoiding airy talk of political union – preferring instead to force harsh economic medicine down the throats of the reluctant Greeks.

Ironically, the very ideals which underpinned the creation of the euro – notably the elimination of the “German problem” once and for all and the corresponding threat to any more wars on European soil – are now being exacerbated by the very institutional structures which arose from these ideals. The immediate problem is that we have a monetary union (common currency) without a fiscal union. It works fine when everyone is expanding, but when recessionary pressures set in, the contradiction makes it impossible to shape harmonious EU wide counter-cyclical fiscal and monetary policies. (Another related problem is that the EU expanded far too rapidly, especially in recent years.)

But the increasing tensions now manifest in the current financial crisis paints a picture of a continent increasingly marked by divergence with old historical enmities re-emerging. This suggests that the creation of a supra-national fiscal entity, however institutionally elegant it might appear, is probably unworkable (especially given that it would likely represent nothing more than a “United States of Germany” with a European accent). The middle class and upper middle class citizens of the richer countries, especially Germany but also the Netherlands, Luxembourg, and perhaps France would oppose the establishment

of such an authority, and doubt whether such a consolidation could have fully fledged representation that does not incorporate German domination. Designing such a supranational via a Strasbourg diktat (like the EU Constitution) is probably not possible and certainly not desirable, because it would be a “Yugoslavia” type solution without a Tito, where the supra national authority has the power to directly transfer wealth from the richer countries (like Slovenia and Croatia) to the poorer countries/regions (like Serbia, Macedonia, Kosovo). It seems increasingly apparent that a supranational fiscal agency runs the risk of inflaming nationalist passions and making countries like Germany more vulnerable to demagogic “beggar-thy-neighbor politics. (In this regard, consider the political complications of transferring counter-cyclical money to the states in the US. The problems, politics, and cultures in Mississippi are very different from those in California -- yet the US is far more “unified” culturally, historically, and politically than the EU.) Today’s disputes are nothing new, but the current one differs from previous Euro squabbles, which have always been about issues within the existing treaty framework. This one is not because it does not “build on” Maastricht but goes to the core structural flaws at the heart of the EU. The underlying divisions could be papered over so long as economic times remained good, but in today’s challenging economic environment, these fissures are now re-emerging with a vengeance.

“Pride goeth before destruction and a haughty spirit before a fall.” -- Proverbs 16:18

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