What next for the EU?

By John Mauldin, 26 July 2015

Almost four years ago, in an article on Bloomberg with the headline "Germany Said to Ready Plan to Help Banks If Greece Defaults," we read this paragraph:

> "Greece is 'on a knife's edge,'" German Finance Minister Wolfgang Schäuble told lawmakers at a closed-door meeting in Berlin on Sept. 7 [2011], a report in parliament's bulletin showed yesterday. If the government can't meet the aid terms, "it's up to Greece to figure out how to get financing without the euro zone's help," he later said in a speech to parliament.

Over the last few weeks he took a similar hard line, offering the possibility that Greece could take a "timeout," whatever in creation that is, and only the gods know how it could work for five years.

Reports of the final meeting before the agreement with Greece was reached demonstrated that there is little solidarity in the European Union. The *Financial Times* offered an unusually frank report of the meeting:

'Grexit …. may be the least worst option left?'

> After almost nine hours of fruitless discussions on Saturday, a majority of eurozone finance ministers had reached a stark conclusion: Grexit – the exit of Greece from the eurozone – may be the least worst option left.
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> Michel Sapin, the French finance minister, suggested they just "get it all out and tell one another the truth" to blow off steam. Many in the room seized the opportunity with relish.
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> Alexander Stubb, the Finnish finance minister, lashed out at the Greeks for being unable to reform for half a century, according to two participants. As recriminations flew, Euclid Tsakalotos, the Greek finance minister, was oddly subdued.
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> The wrangling culminated when Wolfgang Schäuble, the German finance minister who has advocated a temporary Grexit, told off Mario Draghi, European Central Bank chairman. At one point, Mr Schäuble, feeling he was being patronised, fumed at the ECB head that he was "not an idiot". The comment was one too many for eurogroup chairman Jeroen Dijsselbloem, who adjourned the meeting until the following morning.
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> Failing to reach a full accord on Saturday, the eurogroup handed the baton on Sunday to the bloc's heads of state to begin their own an all-night session."

That meeting ended with Angela Merkel and Alexis Tsipras arguing for 14 hours and giving up. Donald Tusk, the president of the European Council (and former Polish Prime Minister), forced them to sit back down, saying, “Sorry, but there is no way you are leaving this room.”

Arguing over what form of humiliation

Essentially, they were arguing over what form of humiliation Greece would be forced to swallow.

For all intents and purposes, Greece had to surrender its sovereignty and is now a European protectorate. But in the end, a majority of the Greek parliament agreed that was better than holding hands and stepping off the cliff into the abyss. In the wake of all my reading this past week on the topic, and after a lengthy conversation with George Friedman of Stratfor, let me offer some thoughts.

Europe as a free trade zone essentially works. It is not perfect, as no free trade zone is, but it is far better than the alternative. However, the eurozone has been an utter disaster for most of its members. It has been a triumph for Germany.

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Germany now exports almost 50% of its GDP, with half of that to its fellow European Union members. Germany has prospered with a far weaker currency, the euro than it would have with its deutschmark. The southern members of the eurozone (including France) have suffered with a far stronger currency than they deserve.

George Friedman argues (quite aggressively) that the Germans were bluffing. The idea that Greece might lead the eurozone panics German leaders, since they know that if other members were also to leave, their export market share would begin to erode.

I agree with George that there is a two-speed Europe that is trying to make a single monetary policy work for dramatically different economies. If you were to split the eurozone into several different currency zones, the zone that contained Germany would soon see its currency appreciate, perhaps dramatically, against the currency of its southern peers.

A political vision, not an economic one

The vision of a European Union as something more than a trade zone is one for Euro-romanticists. It’s a political vision, not an economic one. And during the meetings in mid-July, the political reality crushed economic reality. No one really thinks that Greece can repay the debt it has incurred. Greece was once again forced to agree to a deal that will let it to borrow more money that it can’t pay in return for hobbling its economy even further.

Why would Greece do this? Especially after the people voted overwhelmingly not to take a deal that was somewhat better? Because if they simply walked away from the debt and returned to the drachma, then every Greek pension would have to be paid in drachmas. Grexit would almost immediately cut the lifestyle of every person on a pension in half. And whatever we may think about the situation in Greece, Greek pensions are not all that generous.

Greece has to import nearly all of its pharmaceuticals and medical supplies, all of its energy, and most of the bits and pieces needed to run its machinery and businesses. By contrast with Germany's, Greece's exports are less than 15% of its economy. Greece is already at the critical point in the medical arena, with most drug and medical companies already dealing with Greek hospitals on a pay-as-you-go basis. Hospitals are short of the basics such as sutures and bandages, not to mention life-saving drugs.

Things would eventually sort themselves out, but…

If Greece left the euro, Greek banks would immediately be completely destroyed. Business would grind to a halt, as there would be no way to roll out a new drachma overnight. There is no mechanism in place to do so. Things would eventually sort themselves out, but for the several months that the transition would require there would be a real humanitarian crisis in a developed country, a phenomenon unprecedented in post-World War II Europe.

Tsipras, with the political naïveté that only a new politician could muster, came into office thinking the Germans would blink because the threat of the eurozone breaking up would terrify them. He overplayed his hand. Now he is a dead politician walking. Relatively soon there will be a new Greek election. There is no way the Greek economy gets any better over the next few months, and voters will be looking for another option.

Though I have little sympathy for radical socialists like Tsipras, I will admit to feeling sorry for him. He was in a no-win situation. Greek voters do not want to leave the euro, but they don't want to have to deal with the realities of austerity that is European- (read German-) imposed.

Economic reality after exit would be ugly

If Tsipras and Syriza actually took Greece out of the euro, there would be a massive voter backlash, because the economic reality on the ground for the year after exit would be quite ugly. No politician who wants to get reelected wants to inflict that kind of pain.

Merkel and team knew Tsipras would have to cave at the end of the day. It is not that Angela Merkel is mean-spirited or wants to make the Greeks suffer. She has her own political realities to contend with. The odd thing is, the majority of German voters think they are the victims. They were innocents who goodheartedly lent Greece money, and now Greece doesn't want to pay them back.

There was a fascinating op-ed in the *New York Times* last week by Jacob Soll, a professor of history and accounting at the University of Southern California and the author of *The Reckoning: Financial Accountability and the Rise and Fall of Nations.* He talks about speaking at a conference in Germany where they were debating the Greek situation. I'm going to quote a little bit more than I usually do from someone else's essay, because he conveys a serious point really well. He has spent much of the day listening to German economists before he rises to speak and debate on a panel.

> …but to hear it from these economists, Germany played no real part in the Greek tragedy. They handed over their money and watched as the Greeks destroyed themselves over the past four years. Now the Greeks deserved what was coming to them.
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> When I pointed out that the Germans had played a major role in this situation, helping at the very least by insisting on austerity and unsustainable debt over the last three years, doing little to improve accounting standards, and now effectively imposing devastating capital controls, Mr. Enderlein and Mr. Fuest scoffed. When I mentioned that many saw austerity as a new version of the 1919 Versailles Treaty that would bring in a future "chaotic and unreliable" government in Greece – the very kind that Mr. Enderlein warned about in an essay in *The Guardian* – they countered that they were furious about being compared to Nazis and terrorists.
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> When I noted that no matter how badly the Greeks had handled their economy, German demands and the possible chaos of a Grexit risked political populism, unrest and social misery, they were unmoved. Debtors who default, they explained, would simply have to suffer, no matter how rough and even unfair the terms of the loans. There were those who handled their economies well, and took their suffering silently, like Finland and Latvia, they said. In contrast, a country like Greece, where many people don't pay their taxes, did not seem to merit empathy. It reminded me that in German, debt, "schuld," also means moral fault or blame.
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> **The Greeks were robbing the Germans**
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> When the panel split up, German attendees circled me to explain how the Greeks were robbing the Germans. They did not want to be victims anymore. While I certainly accepted their economic points and, indeed, the point that European Union member countries owe Germany so much money that more defaults could sink Germany, it was hard, in Munich at least, to see the Germans as true victims.
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> Here lies a major cultural disconnect, and also a risk for the Germans. For it seems that their sense of victimization has made them lose their cool, both in negotiations and in their economic assessments. If the Germans are going to lead Europe, they can't do it as victims.

Admittedly, conferences tend to attract a focused group of attendees and are generally not representative of a population at large; however, the reaction he got is in line with the opinion polls I see coming out of Germany and other northern-tier European countries.

Merkel will not remain popular if she is seen to be caving in to the Greeks. And so she dug in her heels. But at the end of the day she finally had to agree to lend the Greeks more money in order to maintain the appearance of a united Europe.

Germany dictated essentially unconditional surrender terms

But the agreement with Greece undermined, if not destroyed, the concept of European unity. Germany clearly dictated what were essentially unconditional surrender terms to Greece. One can be sympathetic to the German position that the Greeks have been profligate, don't pay their taxes, need significant reforms, and on and on. But that doesn't take away from the fact that the Germans who lent the money have benefitted from the system. The reality is that the Greeks owe something approaching one-half trillion euros to the rest of Europe. The Germans are going have to pick up about €200 billion of that, give or take.

If Merkel had to deal with a €200 billion loss, her popularity would plunge. And there would be the risk that other countries would decide – perhaps on an emotional basis but decide nonetheless – that they would walk away from their debts owed to Germany as well. Germany is on the hook for multiple trillions of euros, just as I wrote some five years ago. The longer they keep lending money, not just to Greece but to the rest of Europe, the bigger the debt grows. What money are they lending, you ask? They are lending as part of their commitment to the European Central Bank and eurozone banking system and various European financial mechanisms. All that money is one day going to have to be accounted for, or the ECB is simply going to have to print a vast amount of money or guarantee an even larger pool to absorb all the debt.

Give up fiscal sovereignty

A fiscal union in Europe will require that nation-states will have to give up their fiscal sovereignty. Try sliding that past voters. You might get a significant number of smaller countries to do that, but can you really imagine France doing it? Seriously? Marine Le Pen is getting 40%-plus of the prospective vote today. Try getting the French to agree to give up to Brussels their ability to control their own budget and see how large her poll numbers get.

My friend Eddy Markus and the rest of his team at ECR Research offered a good summation of where this leaves Europe. (I always make a point of getting Eddy to take me to lunch or dinner when I'm in Amsterdam. He has a way of getting the best tables with the most scenic views in really good restaurants – an excellent talent for an economist to have.) The bold print is from me.

For the moment, Greece may have been saved from the abyss, but the underlying weaknesses of the Eurozone and the EU remain in place. Still, **we do not think Europe will disintegrate for the foreseeable future.** After all, the EU project is of eminent importance to the European leaders. It has boosted economic growth, there is an extremely low chance of war breaking out between the EU countries, former communist countries are functioning as democracies, and Europe counts for something around the world. This is not forgotten, and the EU leaders will not easily abandon the project.

On the other hand, the Eurozone and the EU are no longer a byword for unity, prosperity, democracy, solidarity, and mutual respect. In essence**, the project should be revamped to stop the rot, but this is unlikely to happen**. After all, visionary leaders are lacking, and the sprawling structure of the EU is **incredibly complex** and often rigid. Reforms are years in the making.

The most likely outcome is that **the Eurozone and the EU will continue to muddle on**. At the same time, there is a constant threat of disintegration and waning global influence. Europe also needs to **narrow the gap between the economic viewpoints in the North and the South of the continent.** Not to mention the rise of populism and the problems arising from Germany's ascendant dominance. Such a climate does not seem to be conducive to euro strength.

A geopolitical analysis of Europe's future underpins our economists' opinion that the euro will have a hard time holding its own against the dollar in the medium to long term.

Don't Bring a Knife to a Gunfight

For the next few years and maybe for the remainder of the decade, Europe will indeed continue to muddle on. The European Central Bank will try to paper over whatever problems they have. Greece will again go critical, if not next year, then the year after. If Schäuble is still around, he will again say that the Greeks have to figure out their own financing; and we will have another endless round of meetings with a lot of shouting and finger-pointing as they try to kick the can down the road one more time. That will continue to happen until one country or another finally reaches the endpoint and says, "We are out of here."

But when it happens, it won't be a last-minute surprise. Greece taught a lesson to all those who might someday want to leave the euro. If you want to exit, then you have to plan for it. Waiting to the last minute is an absolute, utter, complete, total, (insert your own adjectives and expletives) disaster.

If Tsipras had wanted to do more than bluff, he should have started contacting currency printers about printing his new currency. He should have been making real plans to exit. He should have told the voters that he was prepared to walk away from the euro. Of course, he could not have gotten elected if he had done that.

So he walked into a poker game holding a pair of deuces and tried to bluff his way through. I know the rules of poker, and I have a lot of friends who play poker at a serious level, but I would have a snowball's chance in Hades of walking into the World Series of Poker and not being blown out of the room. I might get lucky for a few rounds, but luck is not how you win that tournament. And you certainly don't prevail by trying to bluff your way through. Germany knew that at the end of the day Tsipras was bluffing. And they held all the cards.

Tsipras broke the first rule of politics: don't bring a knife to a gunfight. This time, politics crushed economics. But my long-term bet is that economics wins. At some point some country is going to break from the herd, and we will once again see a multicurrency Europe. Or somehow countries will agree to give up their fiscal sovereignty, which means their own pensions and benefits will be at risk. Either way, it's going to be a tough time to be a European politician.