EU – “adopt the brace position”

By Charles Gave, Chairman, Gavekal, August 3, 2016

In *A Study of History* the great Arnold Toynbee explained that the role of “elites” in any society is to handle challenges that allow the group to survive and move on to the next phase of their shared journey. If bad solutions are offered up then problems will intensify and pressure will arise for a change in the elite. This can happen in various ways: through elections in a best case scenario, a change of regime as with France’s forth Republic which failed to properly handle decolonization, a collapse in the political structure such as befell the Austrian empire at the end of WWI, or, most dramatically, the overthrow of a civilization as in South America with the arrival of the Spaniards or in Egypt when the Muslims took over.

In Europe, the main problem for a century or more was the internecine rivalry between Germany and France which led to three wars that became progressively more destructive. By the time Europe’s exhausted elites reached 1945, it was obvious that war was not going to solve anything and hence a new solution was tried in the shape of “political” Europe. The plan worked to such an extent that new challenges were spawned such as the handling of Germany's reunification, managing the effects of an aging population and integrating lots of immigrants from a genuinely different civilization.

New problems, old solutions

These *new* challenges required *new* solutions, and yet the elites responded with solutions used to handle the previous challenge, with the forced integration of Europe into a single political and economic construct. Unsurprisingly, the old solutions have not worked and indeed their application is making Europe’s various problems worse. The interesting thing is that members of the elite are starting to openly admit this:

- Mervyn King, the former governor of the Bank of England, wrote in his recent book *The End of Alchemy* that European leaders pushed for the adoption of the euro as a single currency knowing that it would cause an economic disaster in Southern Europe. The idea was that the impact of weakened economies would force national politicians to accept “reforms” imposed by Brussels. Put simply, Lord King argues that these elites consciously organized a huge decline in living standards in the expectation that it would undermine the legitimacy of local politicians. The problem is that most regular people (rightly) believe that their state is the best guarantor of their society being able to “live together”, which is the basic contract binding a nation.

- Last week the International Monetary Fund’s independent watchdog offered a scathing assessment of the agency’s handling of the eurozone crisis with the allegation that staffers willfully ignored fatal flaws in the euro project due to an emotional attachment. It became a totem of IMF thinking that in a common payment area, there could not be a solvency crisis. Moreover, the “solutions” imposed on Greece hurt the most vulnerable part of society, causing a collapse in living standards. In an indictment of the IMF’s competence, its assessments (forecasts) about the impact its policies would have on the Greek economy were shown to border on the ridiculous. To boot, the processes followed by IMF staff were shown to be unprofessional with decisions being taken without proper discussion and documentation.

Our “experts” (the brilliant men of Davos) have thus been shown to protect their own particular tribal interests, rather than the common good. These testimonies are part of a revelatory exercise in Europe which must accelerate a collapse in the legitimacy of both know-better technocrats and the trans-national institutions, which have been all over the European project since 2011 with such deleterious effects. As such, not only the IMF but the European Commission and the European Central Bank have all seen their credibility decimated.

The really worrying thing with these demonstrably incompetent institutions is their continued power grab without any proper authority. Such hubris has seen them break pretty much every agreed rule of national economic management that existed prior to the crisis (it seems a quaint detail now that the ECB was not supposed to buy government bonds) in a bid to sustain a project which is manifestly pushing European economies toward a disaster. So where does this leave us?

Historically, when an unelected “mafia” has seized control of the political domain, the two remedial options available to the citizenry have been elections, and failing that a revolution. As usual, the British moved first— through an election (England’s last revolution was in 1688). The Brits’ decision to break free should not have been that surprising, given that in the normal course of events the EU system had been rigged to stop the genius “elites” from being fired democratically.

Yet for all the significance of the Brexit vote, the UK is not part of the eurozone and so could leave without dooming the system. Italy, Greece, the Netherlands, Portugal and Finland, by contrast, are subjected to that straitjacket. And getting out of the euro implies exiting the EU. For this reason, the next exit (Italy looks like a prime candidate) is going to be far more momentous, with very clear investment implications.

The savings of the problematic countries will likely move to Frankfurt (in expectation of the deutschemark coming back), London or New York on the basis of a slightly revised Gresham’s law that bad currency will chase out the good ones. The result will be a big rise in German M1 and a banking crisis in the weak countries, with banks being bled dry of their deposits. The value of the pound and the US dollar can be expected to appreciate. Since it appears that Europe’s banking crisis is already under way, my advice would be to watch these variables very closely. If the pound and the dollar start to rise against the euro, it will probably mean that German M1 is rocketing upwards. And at that point the advice would be to adopt the brace position.