Why The EU Is Doomed

By Alasdair Macleod via The Mises Institute, 19 September 2016

We are accustomed to looking at Europe's woes in a purely financial context. This is a mistake, because it **misses the real reasons why the EU will fail and not survive the next financial crisis**. We normally survive financial crises, thanks to the successful actions of central banks as lenders of last resort. However, the origins and construction of both the the euro and the EU itself could ensure the next financial crisis commences in the coming months, and **will exceed the capabilities of the ECB to save the system.**

It should be remembered that the European Union was originally a creation of US post-war foreign policy. The priority was to ensure there was a buffer against the march of Soviet communism, and to that end three elements of the policy towards Europe were established. First, there was the Marshall Plan, which from 1948 provided funds to help rebuild Europe's infrastructure. This was followed by the establishment of NATO in 1949, which ensured American and British troops had permanent bases in Germany. And lastly, a CIA sponsored organisation, the American Committee on United Europe was established to covertly promote European political union.

It was therefore **in no way a natural European development.** But in the post-war years the concept of political union, initially the European Coal and Steel Community, became fact in the Treaty of Paris in 1951 with six founding members: France, West Germany, Belgium, Luxembourg and Italy. The ECSC evolved into the EU of today, with an additional twenty-one member states, not including the UK which has now decided to leave.

With the original founders retaining their national characteristics, the EU resembles a political portmanteau, a piece of assembled furniture, each component retaining its original characteristics. ***After sixty-five years, a Frenchman is still a staunch French nationalist. Germans are characteristically German, and the Italians remain delightfully Italian. Belgium is often referred to as a non-country, and is still riven between Walloons and the Flemish.*** As an organisation, the EU lacks national identity and therefore political cohesion.

This is why the European Commission in Brussels has to go to great lengths to assert itself. But it has an insurmountable problem, and that is it has no democratic authority. The EU parliament was set up to be toothless, which is why it fools only the ignorant. With power still residing in a small cabal of nation states, national powerbrokers pay little more than lip-service to the Brussels bureaucracy.

The relationship between national leaders and the European Commission has been deliberately long-term, in the sense that loss of sovereignty is used to gradually subordinate other EU members into the Franco-German line. The driving logic has been to make the European region a protected trade area in Franco-German joint interests, and to protect them from free markets.

It was not easy to find the necessary compromise. Since the Second World War, France has been strongly protectionist over her own culture, insisting that the French only buy French goods. Germany's success was rooted in savings, which encouraged industrial investment, leading to strong exports. These two nations with a common border had, and still have, very different values, but they managed to conceive and set up the European Central Bank and the euro.

In Germany, the sound-money men in the Bundesbank lost out to industrial interests, which sought to profit from a weaker currency. This was actually in line with her political preferences, and it was the political class that controlled the relationship with France. In France the integrationists, politicians again, defeated the industrialists, who sought to insulate their home markets from German competition.

When a common currency was first mooted, two future problems were ignored. The first was how would the other states joining the euro adapt to the loss of their national currencies, and the second was how would the UK, with her Anglo-Saxon market-based culture adapt to a more European model. It wasn't long before the latter issue was met head-on, with the withdrawal of sterling from the Exchange Rate Mechanism, the forerunner of the euro, in September 1992.

The euro was eventually born at the turn of the century. The Franco-German compromise led to the appointment of a Frenchman, Jean-Claude Trichet, as the ECB's second president. **All was well, because the abandonment of national currencies and the gradual acceptance of the euro meant that states in the Eurozone were able to borrow more cheaply in euros than they ever could in their own national currencies.**

Bond risk was measured against German bunds, traditionally the lowest yielding bonds in Europe. It was not long before the spread between bunds and other Eurozone debt was commonly seen as a profitable opportunity, instead of a reflection of relative risk. European banks, insurance companies and pension funds all benefited from the substantial rise in the prices of bonds issued by peripheral EU members, and invested accordingly. In turn, these borrowers were only too willing to supply this demand by issuing enormous quantities of debt, in contravention of the Maastricht Treaty. Bank credit expanded as well, leaving the banking system highly geared.

The control mechanism for this explosion in borrowing was meant to be the Exchange Stability and Growth Pact, agreed in Maastricht in 1993. This laid down five rules, of which two concern us. Member states were bound to keep their national budget deficits to a maximum of 3% of GDP, and national government debt was limited to 60% of GDP. Neither Germany nor France qualified on the debt criteria, without rigging their national accounts, and the only reason that deficits came within the Pact was a mixture of dodgy accounting and fortuitous timing of the economic cycle. The control mechanism was never enforced.

So from the outset, no nation had any sense of responsibility towards the new currency. The rules were ignored and the euro became a gravy-chain for all member governments, spectacularly brought to public attention by the failure of Greece.

The Eurozone's banking system, incorporating the national central banks and the ECB, bound together in a bizarre settlement system called TARGET, became the means for member nations to buy German goods on credit. Very good for Germany, you may say, but the problem was that the credit was supplied by Germany herself. It is the same as lending money to the buyer of your business in a rigged transaction. This flaw in the system's construction is now a rumbling volcano ready to blow at any moment.

The Germans want their money back, or at least don't want to write it off. The debtors cannot pay, and need to borrow more money just to survive. Neither side wishes to face reality. It started with Ireland, then Cyprus, followed by Greece and Portugal. These are the smaller creditors, which Germany, led by its Finance Minister Wolfgang Schäuble, managed to crush into debtor submission and are now economic zombies. ***The real problem comes with Italy, which is also failing and has a debt-to-GDP ratio estimated to be over 133% and rising. If Italy goes, it will be followed by Spain and France.*** Herr Schäuble cannot force these major creditors into line so easily, because at this stage the whole Eurozone banking system will be in deep trouble, as will the German government itself. German savers are also becoming acutely aware that they will pick up the bill.

The first line of defense, as always, will be for the ECB as lender of last resort to keep the banks afloat. The only way it can do this is to accelerate the printing of euros and to monopolise Eurozone debt markets. Whether or not the ECB can hold the currency with all these liabilities on board its own balance sheet, and for how long, remains to be seen.
For the moment, the euro stands there like a Goliath, seemingly invincible. It represents the anti-free-market European establishment, which no one has dared to challenge. This surely is the underlying reason the ECB can impose negative interest rates and get away with it. But serious cracks are appearing. First we had Brexit, likely to be followed by other small states wanting out. **The Italian banking crisis is almost certain to come to a head soon, and an Italian referendum on the constitution next month is also an important hurdle to be overcome.** The politicians are in panic mode, reassuring everyone there is nothing wrong more integration and a new army won't cure.

Meanwhile, the overbearing attitude of the European Commission and the refugee crisis are undermining public support for the status quo. Angela Merkel, hitherto regarded as invincible, has lost her public support in Germany. Marine Le Pen, leader of the Front National and who wants France to leave the EU, led the opinion polls recently for France's next President, due to be elected next year. The strongmen of Europe are on the back foot.

All the elements for a mighty political and economic smash are now there. Whether or not it will be the trigger for, or itself be triggered by external events remains to be seen. Either way, the Eurozone's crisis time-line now appears to be measured in months.

The market effect, besides being a severe shock to all markets, is likely to be two-fold. Firstly, international flows will sell down the euro in favour of the dollar. Given the euro's weighting in the dollar index, this will be a major disruption for all currency markets. Secondly, Eurozone residents with bank deposits are likely to increasingly seek refuge in physical gold, as signs of their currency's impending collapse emerge, because there is nowhere else for them to go.

Whichever way one looks at it, it is increasingly difficult to accept any other outcome than a complete collapse of this ill-found political construction, originally promoted in US interests by a CIA-sponsored organisation. The euro, being dependent on political cohesion instead of original market demand, will simply cease to be money, somewhat rapidly.