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A Carrot for Europe

bergsicht

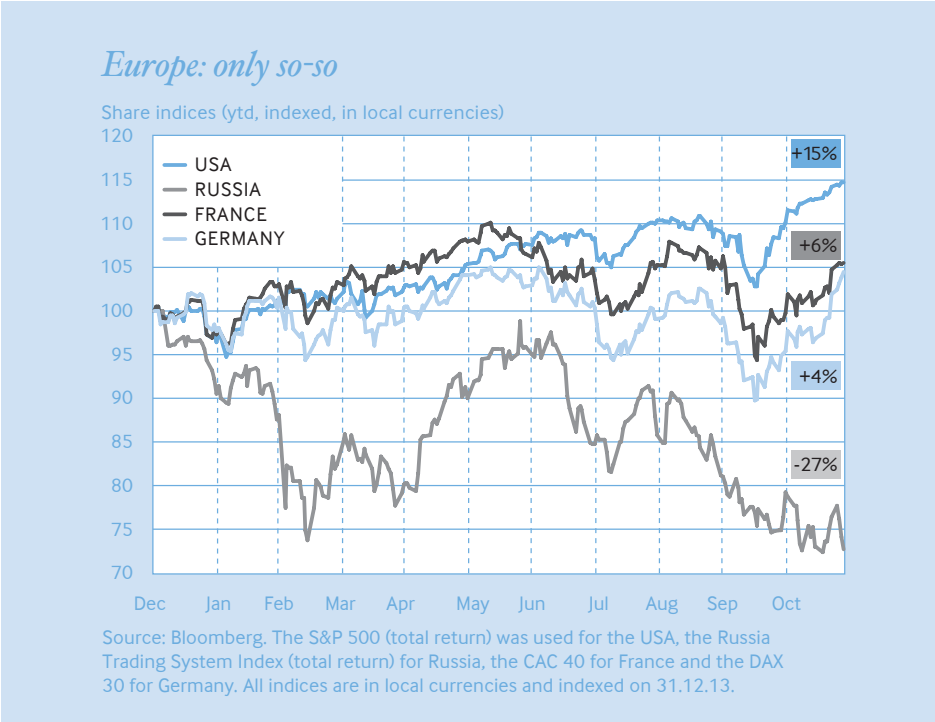
CHAPTER 1

New wine in old skins – or something more?

It might just work this time, and then everything will turn out better than expected. Indeed, there is a risk that it might even work out really well, which in the long run would be catastrophic. – This, in a nutshell, is our latest take on how things might be panning out in Europe. It has been a year since we last addressed the topic in our second edition of *bergsicht*, "Free(ze) Europe?", and we are revisiting it now. For one thing, it is right on the doorstep, both for us and for our readership, whose interests are bound up in Europe in all kinds of ways (the chronically anaemic economic growth of our neighbours Italy and France has been weighing heavily on investors' minds, for example); but also because any examination of developments in Europe represents a particular intellectual challenge. The financial and sovereign debt crisis has induced profound structural change in the European Union (EU), and the eurozone in its narrower sense. We are currently witnessing the emergence of new territories in the Old World – a notion that for cartographers, amongst whose ranks we count ourselves, is particularly intriguing.

The following remarks were prompted by the new European Commission (EC) President Juncker's unveiling on 26 November 2014 of an EU-backed investment vehicle called the European Fund for Strategic Investment (EFSI), which was trumpeted from the rooftops using every tool in the modern communications arsenal. Preliminary reactions to this initiative right at the beginning of his presidency have been something of a curate's egg. There was much rejoicing in the countries that are its logical target (Italy, Spain, Portugal, etc.), a muted reception in the rest of the EU, profound misgivings in economic circles and implacable opposition among the eurosceptic parties. Looking back at comparable plans from previous eras ("Lisbon 2000", "Horizon 2020" and the like), all of which have essentially petered out, one might be tempted to greet Juncker's initiative with a weary smile and a shrug of the shoulders. However, we believe that the state of play has a rather different complexion this time, as there has been a decisive shift in underlying circumstances in the wake of a hitherto successful stabilisation effort. This alone would justify more searching scrutiny.

EU prime ministers and heads of state are to debate Juncker's proposal at their summit on 18 and 19 December 2014 and the EU parliament and Council of Ministers are to fast-track the legal paperwork for the bill's passage so that the new investment vehicle can begin taking effect from mid-2015. The Brussels eurocracy clearly means business. That "something must be done" – however reasonable or otherwise the wider consequences of such action might be – is obvious. The mournful refrain piped by the economic data has of late been taken up by the financial markets as well, with the performance of European share indices



limping along in the dust of the US market (+15%, ytd) and the trajectory of Germany's DAX (+4%, ytd) looking remarkably similar to that of France's CAC (+6%, ytd).

Understandably, there is a palpable feeling of unease and discontent in the air at present, and the question of whether a Brussels stimulus package can treat this torpor, and what the longer-term fallout of such an initiative might be, is of more than passing importance to all those who have invested a portion of their assets in European companies – a category into which the majority of *bergsicht* readers are likely to fall.

CHAPTER 2

One little sentence is all it takes

If we are to understand the potential impact of the proposed new EFSI vehicle, we need to place it in the context of the other entities created in the aftermath of the financial and sovereign debt crisis – the European Financial Stability Facility (EFSF), the European Stability Mechanism (ESM) and the European Banking Union – and explore their relationship with the European Central Bank (ECB). The EFSF, with its EUR 200 billion in capital guarantees, was created as a kind of stopgap to appease the markets at the height of the Greece crisis in 2010 and was replaced by the significantly more potent ESM in 2013. The Stability Mechanism has EUR 80 billion in paid-in capital along with committed callable capital of a further EUR 622 billion. With its capital guarantees in its back pocket, the fund finances itself via the capital markets. It has a first-class rating and the yield on its 10-year bonds is at least 2%. The funds acquired at such rock-bottom rates are then passed on to the target countries. The guarantors are the member states of the eurozone, i.e. Germany (with a 27% stake), France (20%), Italy (18%), Spain (12%), and so on. Those needing help are logically discounted as guarantors, which stacks the vehicle with an accelerating risk potential and disadvantages Germany – its most stable guarantor – disproportionately. A scenario in which Italy and France are forced to tap the fund at the same time, and thus drop out of the picture as guarantors, does not bear thinking about! But we shall come back to this.

Greece, Portugal and Ireland have had recourse to the EFSF, while the ESM has been accessed by Cyprus and indirectly – exclusively for the recapitalisation of its banking sector – by Spain, presumably to prevent the country from being disqualified as a fund guarantor. Such help comes with a programmatic *quid pro quo* from Brussels known in general parlance as an "austerity policy" – countries are made to cooperate with representatives of the International Monetary Fund and the ECB in implementing budgetary and economic reforms. In the case of Ireland, and seemingly also Portugal, such efforts have borne fruit; both countries have since been allowed to slip the reins of the "troika". The flow of funds between the capital markets and the target countries has been substantial, with total financial aid afforded by the EFSF and ESM now amounting to EUR 240 billion – capital that these states would otherwise have been able to raise only with difficulty, or at exorbitant prices. Taking the example of Greece's "solidarity payment" (lower financing costs for its outstanding debts), which he estimated at EUR 8.5 billion per annum, Klaus Regling, the ESM's Managing Director, suggested in a recent Zurich speech that the ESM had achieved even more than the Marshall Plan did after World War II.

By comparison with the EFSF and ESM, the European Banking Union seems to have a far more nebulous profile. While the most important banking institutions are notionally subject to European supervision (the "Single Supervisory Mechanism"), which is, in turn, beholden to the ECB, the resolution mechanism for ailing banks that was eventually settled on

required huge efforts and continues to leave many questions unanswered. Eight years have been allotted for the completion of a common resolution fund and, as the results of the stress tests to which the European banking system is periodically subjected are anything but reassuring, the only conclusion that can reasonably be drawn is that the goal of stabilising this sector has not yet been met.

Seen in the cold light of day, the same would apply to the ESM bailout fund. For one thing, it subsumes a dangerous mechanism that disadvantages its strongest guarantor, as has already been adumbrated. And then there is the fundamental question of the actual worth of guarantees given by guarantors who are already up to their ears in debt: Germany is in hock to the tune of 75% of GDP, France is at 95%, Italy 134% and so on. The only guarantors coming in under the 60% limit stipulated in the Maastricht Treaty are relatively minor players such as the Czech Republic, Latvia, Romania (!) and Sweden. Given all this, one would expect the markets to view the ESM as only marginally less rickety than the countries it is designed to service. But this is not the case.

The bond markets have effectively already acknowledged and priced in the stabilisation of Europe since the sovereign debt crisis, with risk premiums for outstanding debt sinking to the very low single digits, even for such hopeless cases as Greece. For all its debt, Italy's 10-year bonds are currently being traded at yields of little more than 2%. The reasons for such indulgence on the part of the markets (which, by the standards of the sovereign debt crisis, is nothing short of sensational) are not to be found in some markedly more generous reading of real conditions, however, but in the sole circumstance that there is an *ineffably powerful buyer* lurking in the wings. Markets believe that, in an emergency, this purchaser will step into the breach and buy up everything in order to save the system – by which we mean, the euro. We are referring to the ECB's so-called "Draghi put". What a difference one little sentence (" ... the ECB is ready to do whatever it takes to preserve the euro.") can make, if spoken by the right person with the right authority at the right time! At a conference on 26 July 2012 that had otherwise provided pretty slim pickings, Mario Draghi, the ECB president, chose to slip this billion-euro bombshell in almost as an afterthought.

CHAPTER 3

A unique constellation

Thanks to the monopoly on printing money it holds by state fiat, a central bank is in principle at liberty to act as it sees fit and can thus make unlimited assurances along the lines of "whatever it takes". The only restrictions here would be the credibility of the currency to the outside world – in other words, the exchange rate – and its domestic credibility, i.e. its purchasing power. Would be! Given the current set of circumstances, there is no question of an *exchange-rate problem*, nor any serious danger of *inflation*. Draghi – and with him the cream of the EU's economists – has understood the singularity of this constellation and the infinite latitude it allows the ECB, and, as a result, he is now exploiting it to the full. So what makes this constellation unique ?

Led by the US dollar, the currency of global monopoly, all the world's major currencies have for some time now been engaged in a kind of "race to the bottom" as far as interest rates are concerned. The only real alternative to the US dollar would be the euro. Draghi and the ECB have speculated – entirely correctly – that the US Fed is very far from wishing to raise USD interest rates, and that this creates an asymmetric situation. In such circumstances, the ECB would be able to counter any downward pressure that it regarded as extreme with entirely autonomous measures. Quite apart from the exceptional leeway that this allows, it should be noted that some further depreciation of the euro would actually be quite welcome from a trade perspective. As the markets are well aware of this, the question of the euro's credibility is moot and will continue to be so.

Inflationary pressure, on the other hand – in other words a loss of faith in the currency from within – will remain in abeyance because all the bellwethers of the real economy point towards goods and services getting cheaper rather than more expensive. We have expounded at length in previous editions of *bergsicht* on persistent overcapacity on the supply side of the world economy. In situations like these, the central banks are essentially free to do what they like. The amount of money in circulation has become an irrelevance and even a statement like "whatever it takes" (which of course has potentially significant consequences for the money supply) is, for the moment at least, of no import as far as inflation risk is concerned. All those economists who resolutely issued dire warnings of inflation in the face of an actual or intimated liquidity glut are yet to have the satisfaction of being proved right and are conspicuously falling silent. Their generally monetaristic mindset led them to presume that the velocity of money (v) would remain consistently high. However, as a result of the real changes outlined above, money in circulation has slowed dramatically and, as the money supply times the velocity of money equals the produced, traded or consumed volume of goods times the price level, their Cassandra-like prophecies will not be coming true any time soon.

If an institution is credible enough (or the personalities representing it are), it doesn't even need to act for the desired effects to be elicited – just as a properly equipped and well-trained army will, in an ideal situation, not actually have to go into combat because fear of its superiority will drive the enemy to

lay down its arms before fighting has even begun. Understanding the *power of dissuasion* is key to explaining why the ECB has never had to step up to the plate, and why its expanding balance sheet has been kept in relatively close check. By contrast, the Swiss National Bank (SNB) has found it much harder to maintain its minimum exchange rate of CHF 1.20 against the euro, which is technically comparable to the Draghi put; the central bank's credibility presumably suffered from the forced resignation of its chairman, Philipp Hildebrand, and/or the circumstances that led up to this move. The SNB's balance sheet has thus increased by 50% since the end of 2011.

Be that as it may. In the face of much scepticism, the credibility of the ECB has to this day proved itself remarkably resilient and capable of riding out bad weather. An assertion like "whatever it takes" thus acquires far broader and infinitely more serious *implicit power* than any concrete market intervention by a central bank ever could. On the back of the Draghi put, the markets are not only *de facto* assuming that no European country can ever go broke again, but also that the financing of other kinds of outstanding debt will be guaranteed – *whatever that takes*, be it because the commercial banks can submit debt certificates to the ECB via their central bank, because the ESM will have access to fresh money via a similar mechanism, or because the ECB is directly buying up bonds on the open market. There is no other explanation for the crassly depressed risk premiums for shaky debtor countries and the ongoing undercapitalisation of banks. The Banking Union – contrary to its original purpose of enabling the orderly wind-up of zombie banks – is now effectively synonymous with a blanket guarantee from the ECB. The "too big to fail" label originally applied to commercial banks on a national level has now morphed into a "too big to fail" on the meta-level of the eurozone and/or EU. The indirect bailout of Spanish banks by the ESM has certainly played its part in this.

The story of the *stabilisation* of the eurosystem by the ECB and Draghi, its president – with the aid of the EFSF, ESM and Banking Union institutions – is one of *success*. On the markets, success is often a self-fulfilling prophecy, so this stability may well be sustained even when the extraordinary conditions under which the ECB is operating (i.e. the absence of competing currencies and inflationary pressure) normalise. The EU and the eurozone would then have pulled themselves out of the mire by their own bootstraps, so to speak.

The flipside is that this success is just the reason why the "big spring clean" of sovereign debt has not come to pass, indeed, that the structural problems (in Italy and France, for example) have if anything become more acute. We shall come back to this point again when we look at current economic data. Despite – or indeed precisely because of – the unmistakable success of the Draghi put and the implicit blanket guarantee arising from it in the eurozone, one might of course take the long view and in a still, small voice wonder just how much tautology a system can stand. A central bank is, after all, ultimately part of the same national wealth in which the all-too-apparent debt levels of the banks and states were created. Shifting debt from one pocket to the other (ECB) or, as it were, sewing a new pair of trousers altogether (ESM), doesn't actually make one's obligations disappear. Or does it? Then at least we'd have discovered how to spin straw into gold ... On a more serious note: is it possible to imagine an economic or socio-political configuration in which, for systemic reasons, the pyramid of guarantees from individual countries and the ECB's blanket guarantee, representing its totality, collapses under its own weight? Let's not forget that the Draghi put is dependent on what we have called a "unique constellation", the exogenous *fait accompli* of plain sailing as far as exchange rates and inflation are concerned. Endogenous developments could cause the wind to change in the blink of an eye.

CHAPTER 4

Waning vitality

That Europe has not got its house properly in order, despite successful stabilisation, is abundantly clear from the economic data. While base effects occasionally conspire to provide the countries on Europe's southern fringe with positive growth figures (which those media generally inclined to gloss over things then immediately and dutifully trumpet as another success for European economic and monetary policy and proof of a major trend shift), we should not forget that in such cases we are scraping the bottom of the barrel. Italy's real per capita gross domestic product (GDP) is currently close to where it was at the end of the 1990s. Extensive de-industrialisation has been taking place in Switzerland's southerly and westerly neighbours over the last fifteen years and the only sector that has genuinely been able to expand is the state.

Things are looking even worse for *unemployment*, which is plaguing young job-seekers in particular. There is every reason to suspect that entire cohorts of the population will never so much as sniff a workplace their entire working lives. Even the birth rate seems stultified under such circumstances; (Southern) Europe's young adults are neither in jobs nor yet – ahem! – on the job. This places the already precarious inter-generational contract under further pressure and it is fundamentally impossible to imagine how a defined-benefit pension system is to be financed in the future given these inauspicious parameters. A superabundance of the superannuated is facing a generation of jobseekers cut down by youth unemployment, and this means that the demographic

problems already dogging Europe are only going to get worse. Mountains of implicit, pension-related liabilities are piling up on top of the sovereign debt already outlined, to create a summit several times higher than each country's GDP. The prospect of drawing a greatly reduced pension, or no pension at all, is a distinctly *depressing* one.

How are we to picture the frame of mind at the heart of all this growth dysfunctionality? Let's try: demographically driven fear – across several generations – of getting old, fear of structural change, fear of losing your job, fear of marrying and having children, fear of starting your own company, fear of your own colleagues, fear of investments, fear of the Kafka-esque regulator poking his nose into every aspect of banking and insurance business, fear of the tax authorities and their inquisitive inspectors, fear of global competition, rage at the steps taken by the troika. The frustrating thing about it is that much – though not all – could have been avoided with better policies. Interest rates (which have been at record lows for years now) are also not really helping on either the demand or the supply side. Fear, anxiety and discontent are clearly not directly related to the cost of money or capital, indeed quite the opposite: low-interest-rate policies – "financial repression" – are used to squeeze out any joy a saver might derive from his capital. He saves out of fear of the future, not from the joy of delayed consumption or with a view to some costly future project; he would far rather crawl back into bed and pull the duvet over his head. Anyone who would theoretically be in a position to invest is preferring not to bother, despite ultra-low interest rates. He fears that any return on his investment will only diminish over time as there is a negative fiscal relationship between his private earnings and the ever-increasing mountain of sovereign debt. Unease is all around.

Here and there, although fortunately for the moment still a good way from where the real action is, this unease is expressing itself in political unrest. The NZZ recently reported at length on the Spanish "Podemos" protest movement that may threaten the delicate balance of power between the conservatives and socialists in this young democracy and bring to a head the challenges already besetting a country faced with Catalan thirst for secession. Podemos recruits from just those strata of society that are most affected by the sovereign debt crisis; but the most proximate cause for concern is the group's ideology, which can only be described as social fascism. If we think in scenarios for a moment and countenance the possibility of things turning really nasty, the mobilisation of discontents on Europe's periphery is definitely one of those wild cards whose worst manifestation would be a riot on the streets of rather less peripheral France. It can't be entirely ruled out.

Disagreeably enough, even *Germany* – the poster child nation – has now suffered an *economic knock-back*. Eurostat forecasts just 0.1% growth for Q3 of 2014, which would translate to a little more than 1% over the year as a whole. By contrast, the USA is currently growing at about 2.5% and the UK at 3%. It is still difficult to tell whether this sag is related to the generally undervalued trade links between Germany and Russia and/or the sanctions applied because of the Ukraine crisis, or a curbing of exports to the Far East, but one thing is clear: if Germany's economy really did start to wobble, it would be devastating for the entire eurozone. The credibility of many institutional arrangements in the EU, not least those of the ECB, is ultimately predicated on the stability of the German economy.

CHAPTER 5

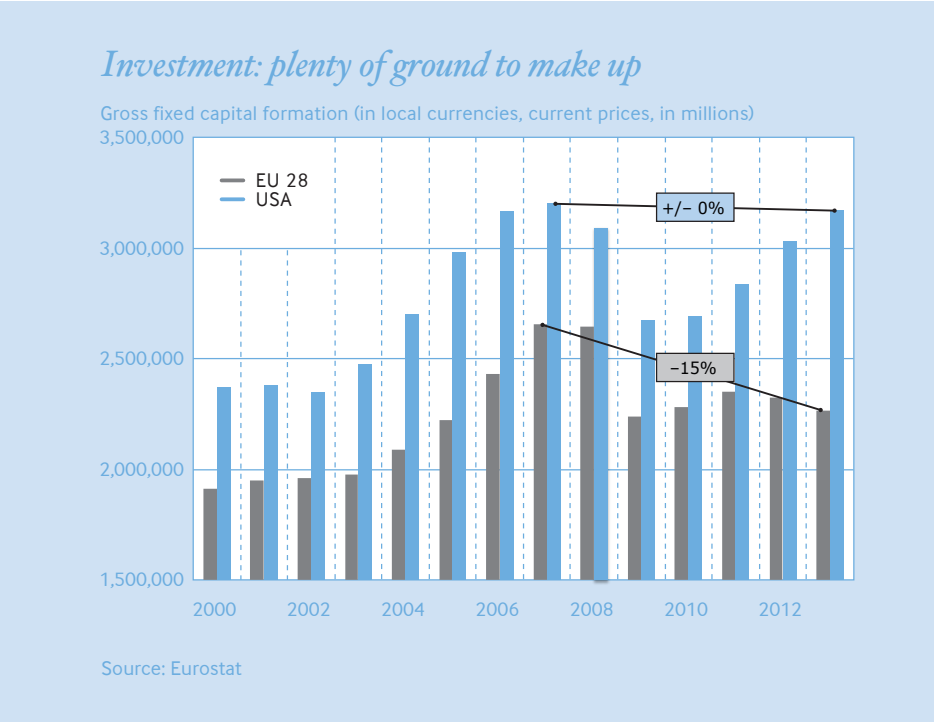
The dream of Silicon Valley

In a climate like this, it is hardly surprising that Jean-Claude Juncker has decided to take the bull by the horns. As the Commission knows, in simple terms GDP is calculated using the following variables: government "production" (G), consumption (C), net exports (NX) and *investments* (I). Attempts have been made since 2012 to get a handle on G in the less stable countries, which in the first instance is having a negative effect on GDP. It is clearly difficult to influence consumption, unless you resort to distributing money by helicopter. Increasing net exports is tricky because the euro continues to ride too high for the peripheral member states. Competitiveness has yet to be restored, despite internal devaluation, and in some sectors the industrial base may simply no longer exist. Even Germany is finding the next chapter in this otherwise striking success story an uphill struggle.

So all we are left with is variable I, investments. This is what the EFSI initiative is addressing. What do President Juncker and the EU Commission have in mind? They wish to set up a fund that will provide a total of EUR 315 billion for investment projects over three years. The fund's guarantor is to be the European Investment Bank (EIB), which is already pursuing a similar mission with a balance sheet total of some EUR 500 billion. The EFSI will first be issued with EUR 5 billion of paid-in capital from the EIB, and this equity capital is then to be boosted with an EU guarantee of EUR 16 billion to make EUR 21 billion. Juncker is assuming that the EIB's AAA rating will ensure that there is no obstacle to leveraging this initial capital fifteen times over with financing from the capital market; this is how he arrives at his desired figure of EUR 315 billion.

With its "own management structure", this capital will be deployed between 2015 and 2018 by an "independent investment committee" in line with "agreed investment guidelines" where private initiatives have failed to gain sufficient traction. The EIB is

to provide a team of dedicated staff to ensure that the pipeline is filled with suitable projects. In practice, the process is likely to work as follows: selected – that is, approved – projects will initially be financed by leveraging the fund's guarantee three times (subordinated debt); then, with this risk buffer in place, leverage will be increased to five times ("normal" debt). Technically, the EFSI is a *special purpose vehicle* with a cascading liability structure of the kind many will recall from the Great Financial Crisis in the USA. The vehicle is intended to bask in the reflected glory of the EIB's AAA rating.



From the macro-economic data, the EC has identified in certain countries in particular a disjunction of up to 75% between current and pre-crisis investment activity. A total EU-wide decline in investment equivalent to EUR 430 billion (or 15%) may be assumed from 2007 to the present day, while GDP and consumption have returned to pre-crisis levels over the same period. The corresponding figures for the USA look completely different – the ground lost in the 2008/09 slump has since been virtually made up. To relativise this a little, it is worth noting that the 2007 investment activity figures selected for comparison purposes factor in the property boom in countries such as Spain and Portugal. The drop in investment in machinery and technical equipment is considerably less dramatic, but it is nonetheless undeniable.

If things go to plan for President Juncker and the EC, the EFSI investment programme's EUR 315 billion will precipitate exclusively private, follow-on investments in the order of several hundred billion euros. The Commission is hoping that this plan will add nigh on 1% to EU GDP and give a fillip of more than a million new jobs to the labour market or, to put it another way, reduce unemployment by about 3%. *Nota bene*: each newly created job will thus cost EUR 100,000.

Juncker's plan is relatively open-ended as far as the financing methods envisaged for projects are concerned, with mention made of "gaps in the market", "new clients", "new projects" and new "distribution modalities". The plan promises complete transparency in the pipeline of the EFSI's potential investment targets and this is intended to encourage others to follow suit. *Potential investments* include "strategic infrastructure" in the energy and digital sectors, transport infrastructure, labour-intensive SME ventures, sustainable projects in the environmental arena and innovation through research and development. Everything must conform to EU guidelines, add economic value and be achievable within the next three years. Member states are invited to do their bit with financial and practical contributions to the initiative. As a sweetener, state investment in the EFSI will be regarded as neutral under the Maastricht criteria.

According to Juncker, the main advantage of the investment initiative is the fact that no claim for new funds from the EU budget will have to be submitted. Half the guarantees for the EUR 16 billion that make up part of the fund's core capital are being drawn down from pre-existing programmes such as Horizon 2020, while the rest is subsumed within the ordinary annual budget totalling EUR 180 billion. He maintains the initiative is merely an attempt to use suitable institutions and modest financial means to galvanise the private sector and re-energise flagging investor confidence.

CHAPTER 6

It might just work!

As with its predecessors, this plan soon attracted fundamental criticism from various quarters. Leading the charge were accusations of *technocratic naivety*: Why on earth should experts from ivory towers in Brussels, Frankfurt or Luxembourg be better placed to judge a profitable investment than those already getting their hands dirty in the local economy? Followed by: If it's so easy to kick off an investment

boom, why hasn't anybody tried it yet (and succeeded ... !)? Is it really for want of a quasi-equity risk buffer that projects are not being financed? Or is it because of a lack – for whatever reason – of those whose job it is to provide this risk buffer, in other words, of entrepreneurs? Is there really any guarantee that, despite all the regulations from Brussels and any amount of highly professional controlling, the funds will not be ploughed into utterly superfluous real estate (again)? And so on.

As justified as these criticisms may be, we can't just let matters lie. In the following, we shall attempt to place the investment initiative within the larger context of the EU and its operation since the financial crisis and thus incorporate what we have learnt from the EFSF, the ESM and the Draghi put. Were the EFSI initiative a stand-alone undertaking, a shrug of the shoulders would suffice, but, given the (to many surprising) success of the combination of a seemingly independent EU institution and the ECB's *de facto* blanket guarantee, something more than a superficial judgment is required. We suspect that the EU wishes to emulate with growth-generating instruments what it has achieved with the EFSF and ESM stabilisation vehicles.

To our mind, there is no doubt that the EFSI – if passed by the relevant chambers – will slip under the same implicit blanket guarantee of the Draghi put as the two preceding stabilisation vehicles. The choice of the extremely high multiplier of 15 is an indirect indication of this. In our post-financial-crisis world, no commercial bank would dare to finance such high risk – and this, and nothing else, is what it is – with such high leverage; every bank capital requirement in the book – Basel II or III – would prohibit such risk-taking. Now, one might well argue that, thanks to the fund's cascading liability structure, only the EUR 16 billion from the EU and/or the EUR 5 billion from the EIB is ultimately at risk and that this is a drop in the ocean when viewed against the total volume of the EU budget and the EIB's balance sheet. But that's exactly what people said about American CDOs pre-2007. In certain economic or market constellations, all of the risks can be triggered more or less instantaneously. Or, to put it another way, the planned fund is a vehicle intrinsically freighted with risk. If the debt securities it issues are graced with the same *privileges* as those of the ESM, however, there is nothing to stand in the way of the EFSI's success on the capital market. Thanks to the Draghi put, the carry trade merry-go-round can carry on spinning here as before.

Or, to put it yet another way: without the Draghi put, Juncker's investment initiative would be dead in the water. But the reverse might also be true: the EFSI is rendered realisable thanks to the Draghi put, and if the model is sound, you can be certain it will be followed by further initiatives – EFXX, EFXY, EFXZ, etc. Herein lies the true significance of the investment initiative. The EU is beginning to adapt and expand its governance via this vehicle and other structures. The stabilisation mechanisms and the new investment funds are bricks to be held together by the extremely rugged mortar of the ECB, and further bricks may follow. What this might mean over the longer term, however, merits further analysis.

CHAPTER 7

Déjà vu – in the Middle Ages

The carrot and the stick are two tried-and-trusted methods of leading people – and nations. The Maastricht Treaty's sanction mechanism was too feeble a stick to maintain, or indeed restore, financial discipline within the eurozone, principally because the powers-that-be who might be wielding it were the first to kick over the traces, but also because a currency union with the widest possible base, to be established as soon as possible, was desirable for political reasons, and so members were let in who from the outset were clearly not up to snuff. The sovereign debt crisis made it painfully apparent that it wasn't going to work without something like a fiscal union. However, fiscal union was hardly going to be achieved in a routine fashion, i.e. by amending EU treaties. Thanks to the financial and subsequent sovereign debt crisis, the circle could be squared with a much more "softly, softly" approach – the recipient countries would be offered financial aid in return for accepting financial discipline. This involved substantial power devolving from the countries affected towards Brussels and, in some cases, it went as far as the appointment of veritable *satraps* with quasi-governmental authority. The stick worked and the EU managed to step over its own shadow (obviate its inherent weakness in asserting its will among its member states).

The EFSI investment initiative is the second act in establishing coherent governance – it's time for the carrot. The EFSI is designed such that it pays to keep on the best possible terms with EU head office in order to enjoy the benefits of risk capital. These good terms subsume (but are not limited to): local representation for lobbying, mastering the requisite meta-language (including all those catchy abbreviations!), imbibing the necessary political correctness (every project must have a sustainability component) and loyalty to the system that we all have to thank for the blanket guarantee in the first place. A key point here is that all existing structures (such as the member states and regions) are circumvented in both the application process and the financing, resulting in a clear power shift towards the centre.

In both the EFSF and ESM stability mechanisms and the proposed EFSI, the EU is setting great store by the "independence" of institutions and committees. This may nominally be true, although it is hard to imagine that people might not occasionally

bump into one another in the narrow confines of the Brussels-Frankfurt-Luxembourg triangle; and, given the blanket ECB guarantee we have posited for this vehicle, there can be no question of it in practice. One thing is quite certain, however: such "independent" bodies are also largely untrammelled by democratic control. They are no more and no less than the essentially self-appointing oligarchic constructs of elite technocrats.

We feel the structure of EU governance betrays interesting traces of a model that held sway over this continent for many years: that of *feudal fealty*. In the Middle Ages, it was kings and dukes who provided their nobles with land and underwrote a kind of "blanket guarantee" of safety and security. Military service, personal attendance and tribute were to be rendered in return. Anything that happened in the Empire on a subordinate level was by direct fiat of the rulers and/or had its corresponding roots at their court. Carrot and stick were as much a necessity in the Empire as well, and it is an essential element of European history – and of its tragedy – that loyalty was often disregarded, even abused, by both sides, and that even a "blanket guarantee" could crumble from time to time.

Without wishing to be overly hasty in our judgment, we think we are entitled to suggest that such a despotic state and social model, with all its technocratic trappings, is a far cry from what is practised on the other side of the Atlantic, for example. Capitalism is a bottom-up business, but what is gathering momentum in the EU is a top-down model, state capitalism behind the fig leaf of sophisticated financial vehicles. A new meta-structure is being deployed above the existing – and hitherto, still relatively federal – structure of member states and the more or less democratic entities of the EU Parliament, Commission and Council of Ministers. At its heart is the ECB, which is pulling the strings and ensuring loyalty and coherence through financing vehicles. And as such financial aid is more than capable of penetrating deep into the capillaries of SMEs and universities, Brussels can ultimately count on the fealty of its vassals. However much the peasantry may groan under the yoke (as it is audibly doing at the moment), the elites – in particular the intellectual-political cadres that are virtually never productive – will do everything to ensure that the gravy train they are riding never runs dry.

It is another question entirely, of course, to what extent this emerging technocratic and authoritarian approach will be able to hold its own in the cut and thrust of the global economy. The world is drifting apart, as we speculated about six months ago when we suggested we might yet see something like a tectonic plate of free market economics and capitalism comprising the western industrialised nations. Subsequent observation and analysis move us to conclude that Europe is likely to develop differently from the USA, the United Kingdom (!), Canada, Australia and several of the BRIC states, in that it will be considerably more *dirigiste* and authoritarian in future. This mentality is widespread on the Continent, both in Cartesian, mercantile France and in Germany, which in many respects has undergone an intellectual reverse takeover with the former GDR.

What over the short term might sound great, even desirable – "something is finally happening"; "at last, Brussels is doing something"; armour is being provided for the Achilles heel of European recovery "without state funding"; indeed, thanks to a major injection of liquidity, this or that share index might even head north – proves, on closer inspection, to be another step along a path that bodes ill for competitiveness, personal responsibility, entrepreneurship and autonomy. *Cause à suivre*.

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