Free(ze) Europe?

bergsicht

CHAPTER 1

Playing for time – but to what end?

Things have never been simpler for investors. Success and failure hang by a single thread: continuation of the central banks' monetary policy. As long as currency guardians are doing everything in their power to shield the financial markets and the banking system from another bout of paralysis by injecting truckloads of liquidity, investors will be compensated, whatever they do. Welcome to "risk-free" risk-taking, the central banks' chosen method of buying time for the system.

In all too many cases, however, playing for time amounts to no more than putting off the inevitable – a mere stay of execution; and if one is not very careful indeed, the prospect of impending disaster can dilute or undermine the will to take meaningful action. Unlike the calm before the storm (which may often be unwittingly savoured to the full), such playing for time (i.e, the willing acceptance of a stay of execution – and/or any enjoyment elicited by the same) is often accompanied by a crippling sense of indifference or *sangfroid*. While we have no desire to be cast as the doom-monger among economic commentators, we are seriously concerned about the insouciance that has been induced by monetary policy. As if real-world conditions (and disparities) didn't exist! There are certainly plenty of reasons to rein in one's risk appetite – the prevailing economic environment invites comparison with the fine weather we are currently experiencing on the northerly slopes of the Alps: it, too, is determined by a single cause, the *Foehn* wind. And sooner or later, the *Foehn* will come to an abrupt end – almost invariably ushering in an icy blast of rain and snow.

One of the symptoms of the monocausality we are witnessing is that the otherwise routine oscillation between the relative attractiveness of the equity markets and the bond markets has been put on hold for the foreseeable future. Both markets are running in sync, as it were; they are expanding and contracting at the same time, and are "positively correlated". They simultaneously freeze in terror whenever Ben Bernanke wrinkles his brow (as if a rise in policy rates were not on the cards, given the completely asymmetric interest rate situation…), only to heave a general sigh of relief when, in the next breath, the all-clear is blown. As the central banks' ultra-loose monetary policy is ultimately a gigantic sticking plaster, any signs that western industrial nations are persisting in their chronic propensity for dragging their feet economically and structurally will continue to be interpreted positively by the markets. Any hint to the contrary, however – such as lower unemployment rates or a rally in commodity prices – immediately raises the fear that the central banks' beneficent intervention may be drawing to a close.

We maintain that such absurd antagonism cannot last. Indeed, we are convinced that, from a systemic and theoretical perspective, monocausal phases in extremely complex systems (such as economies and financial markets) are highly problematic. When considered the only relevant force, there is a real risk that such a single impulse, rather than buying time and re-establishing equilibrium, will push the system into a ruinous, distorting dynamic. Viewed dispassionately, the current – barely disputed – notion that the central banks (which enjoy an unchallenged monopoly in the monetary system) are also infallible in their assessments ("forward guidance"...) and actions is at best presumptuous and at worst, foolish. Equally, the belief that monetary policy's contribution to economic events might in some way be sufficient to justify the prevailing cult of monocausality seems downright naive. But things are what they are: the markets delight in extrapolating from the familiar. And they do this in the full knowledge that what appears to be a gain for the present may prove tricky, indeed catastrophic, further down the line. In short, "playing for time" is a high-risk strategy.

Given that the central banks are flooding the system with liquidity, it is no surprise that the financial markets are all pointing in one direction for now: with the notable exception of money/liquidity *per se*, assets across the board are set to appreciate. Price signals from the bond markets are no longer the result of market forces, i.e. of the independent behaviour of countless market participants, but of the "visible hand" of the central banks. The traditional view that central banks can only influence short-term interest rates has been a busted flush since the US Fed's unconventional "Operation Twist" at the very latest; and the idea that price signals from the bond markets offer reliable insight into an economy's performance has thus descended into farce. The equity markets are likewise unable to escape the gravitational pull of this kind of monetary policy: in the current environment, using equity market price trends to draw any conclusions about real-world conditions is guaranteed to lead up a blind alley.

This notwithstanding, comparisons of individual sectors or national markets remain a useful source of information as these sectors/markets are influenced in equal measure by the central banks' liquidity infusions. The superior performance of the US equity market versus its European counterparts over the last five years cannot be ignored, for example; there must be deeper-seated reasons for this. Here, at least, the central banks' mantra of insouciance seems not to have swept real-world circumstances under the carpet entirely. The European equity markets' distinctly modest showing has been preoccupying us of late, and we shall thus be devoting this *bergsicht* to certain aspects of Europe. After all, the continent is both our home base as investors and, in the absence of diversification, also our "home bias". It is the screen onto which we project our desires and fears – so a little cool analysis is probably no bad thing.

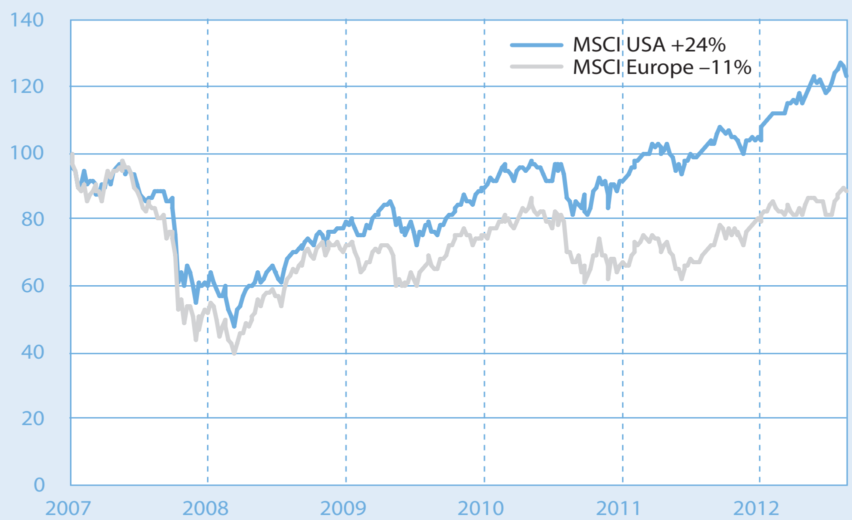
CHAPTER 2

On not seeing the wood for the trees, attaining salvation and the "one true Church"

The mere mention of the word "Europe" conjures up a host of notions – an established peace that has held for more than 60 years, the European Coal and Steel Community, EEC, EFTA, EU, the eastern enlargement of the EU 20 years ago, the European Court, Brussels, Strasbourg, the Paris-Berlin axis, London, Maastricht, MiFID, single market, ECU, the euro, ECB, regulation, Lisbon, subsidiarity, centralisation, bureaucracy, ministerial meetings, the democratic deficit, the eurozone, peripheral Europe, multi-speeds, migration, Lampedusa, the 2008/9 financial crisis, the banking crisis, the Greece crisis, Target2 balances, EFSF, ESM, fiscal union, banking union, transfer union, Cyprus, recession, unemployment, austerity, and so on. In recent years, we have had to acquire a whole new vocabulary to get a handle on our own continent. Most of the terms listed above are linked with worlds of greater or smaller dimensions, each with its own quirks and challenges, so there is no particular art to *muddying the waters when discussing Europe* or failing to see the wood for every kind of tree and foliage imaginable; stripping things back to the essentials, on the other hand, is a far harder task.

We shall nonetheless give it the old college try. Whether our fears turn out to have been unjustified and our desires are, to a degree at least, fulfilled (and, indeed, whether we decide to stay put physically and hold onto our positions as capital investors in Europe) will undoubtedly hinge on the

Europe is stagnating: why?
Comparison of US and European equity markets



Source: Bloomberg. Note: MSCI USA (NDDUUS) and MSCI Europe (NDDUE15) indexed from 31 December, 2007.

extent to which peaceful and prosperous co-existence continues to be possible on this continent. From our perspective – which, we concede, is heavily coloured by economic considerations – three major challenges, which we have formulated as questions, will shape the immediate and more distant future of the nations, peoples and individuals of Europe:

1. Given our globalised world, what can companies do to maintain and/or restore their *competitiveness*? What position should the European single market be adopting in a world based on specialisation and the division of labour?

2. What strategic options present themselves in light of the irresistible *rise in the population's life expectancy* and generally *low birth rates*? Has Europe prepared itself for shrinkage?

3. How can the various *liabilities* inherited from misallocations in the early years of the new millennium be restructured and – ultimately – unwound? Can trust, confidence and optimism for the future be regained?

You may have noticed that, unlike most commentators, we regard the euro/the euro crisis not as a fundamental challenge for our continent but rather as a (significant and real-world!) secondary variable that may exacerbate problems or ease their solutions, as the case may be. Similarly, while we believe the many and various institutional questions to be eminently important in shaping background conditions (indeed, the old questions regarding concentrations of power remain unresolved and have been compounded by new ones), neither a specific currency system nor a particular power constellation, nor yet their attendant institutions, can be considered a goal *per se* in the sense of "peaceful and prosperous co-existence". One of the key problems with current debates and *démarches* within Europe is precisely the tendency to conflate ends with the means that point the way to success (or indeed do not) – and this is why institutions like the EU or the euro are suddenly described as "non-optional" instead of being qualified as what they in fact are: political projects with all their disadvantages and potential advantages. One might compare this mindset with the Church's view of salvation in days of yore; but let's not forget that the absolutisation of the former ("non-optional", especially for the clergy) at the expense of the latter was the spark that lit the fuse of the Reformation, one of Europe's greatest upheavals, 500 years ago…

CHAPTER 3

Axiomatic diversity

In the following observations, we shall refrain from the all too common phenomenological approach that purports to draw conclusions from bald "facts" – many such asseverations are borderline racist and thus not only reprehensible as such but also useless when it comes to formulating economically correct or consistent statements. It is unproductive, for example, to bemoan the Greeks' alleged disinclination to hard work and thence to conclude that they would be incapable of hauling themselves up by the bootstraps from their miserable predicament. The Italians are often dismissed wholesale as hopelessly Mafia-infiltrated and disloyal to their own tax authorities. But even if we admit that there may be a grain of truth in such observations, is anyone seriously suggesting that this imputed behaviour is a function of Italians' origins, of their DNA?! Spaniards are said to be especially proud people; but is it possible to build a model that will solve the real estate crisis based on such a "fact"? Any such prejudices or sweeping generalisations should be treated with the utmost scepticism, given Europe's exceptional diversity. In the end, neither the Teutonic *Geiz ist Geil* attitude ("look after the pennies…") nor the northern work ethic nor the southern disposition towards the *dolce vita* are of relevance – what really count are underlying conditions, the availability or absence of incentives for value creation, whatever the latitude or longitude. And let's not forget that, while people were still tending sheep and goats across hill and dale in large portions of Europe, Venice was a wealthy Mediterranean city state and Naples an economically vibrant kingdom.

While it clearly makes sense to refrain from attributing certain behaviours to ethnicities, it is important not to close one's eyes to the differences that patently exist across the continent of Europe – and which in certain quarters are very pronounced indeed. There is *no question of homogeneity*, so it is fairly ludicrous to wheel out average figures or aggregated values. Given the differences from country to country, neither the average productivity *per capita* nor the total GDP of the eurozone has any particular informative value; geographical groupings or the clustering of certain phenomena are of far greater interest. There is, for instance, a clear "value creation cluster" bounded by Baden-Württemberg and Bavaria to the north, Austria and Switzerland in the middle and northern Italy to the south; the Benelux and Scandinavian countries form a second such cluster. The "wasteland" of France, a once-proud industrial nation, and the all-too-apparent ground that the former East Germany still has to cover if it wishes to catch up are equally striking.

It is simply not the case that more homogeneity is being created by the array of EU initiatives and the *zeitgeist* that impels them. A glance at a map of gross value added in Europe over the last 25 years confirms that there was only one short period in which certain areas – namely those areas that experienced a real estate boom until 2008 – took a noticeably more positive turn. Since then, many regions' economic performance has slipped back to pre-euro levels, or lower still. If anything, the harmonisation drive within the EU has created centrifugal momentum, augmenting the differences between regions and countries. Once again, France cuts a sorry figure, with only Paris, the capital, standing out with more or less positive figures. The growing economic and structural disparities between those longstanding confederates France and Germany must surely give pause for thought?

Similar geographical observations can be made in respect of unemployment numbers or gross value added *per capita*; great gulfs invariably open up between the various regions. We find the map of Germany particularly striking, especially when it comes to the unemployment situation. What looks like a north-south divide within the EU ("the further south you go, the more out of work you are") is inverted in Germany. There is a south-north divide, with zero or minimal unemployment in Bavaria and Baden-Württemberg, far greater problems north of the Neckar (including former high-employment zones like the Rhineland and the Ruhr), and the same old gloomy story in East Germany. Incidentally, this picture throws into sharp relief quite how inadequate a single currency is when it comes to fostering homogenous growth – the currency that had been in use in West Germany since World War II was adopted by a reunited Germany, a country whose two halves have now had a common currency for some 23 years. It is clearly other, very different, factors that beget or forestall prosperity. Those arguing along tribal lines will cite the Alemannic work ethic – and yet that would exclude the denizens of Bavaria. Might the nutritional value of their beer explain their outsize productivity?

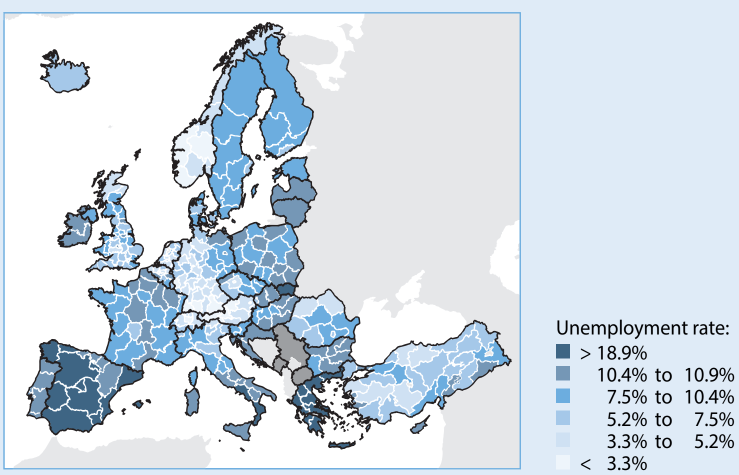
But joking aside – if diversity, rather than uniformity, prevails even in Germany, with the same economic policy resulting in vastly divergent outcomes; and if, when viewed in the cold light of day, even vast reservoirs of structural aid – of the kind that were undoubtedly tapped for the former DDR and cheerfully continue to flow – achieve precious little, then the "success stories" surrounding the common European economic, monetary and fiscal policy that have been piling up of late should be taken with a generous pinch of salt. Homogeneity, were it even desirable, is clearly not easily conjured up by artificial means; a rise in unit labour costs in Germany – even as they slumped in the ailing countries of Italy, Spain and Portugal – was recently hailed as a triumph of the common economic policy, for example. As if the concerted erosion of those countries' competitiveness by the introduction of the euro had not taken place! Such success as is celebrated, if there is any at all, redounds to the credit of the "Church" (i.e. of the absolutised institutions), but does not advance "salvation" (i.e. the common weal) one jot – and probably does nothing at all for peaceful co-existence, either.

If "axiomatically divergent" conditions obtain on one and the same continent – a continent across which national borders no longer represent any genuine obstacle to freedom of movement – you might be forgiven for thinking that any imbalances could be corrected though internal migration, at least. It is a feature of the United States, for example, that regional economic downturns are quickly offset by movements to flourishing areas. The US's fairly uniform culture (neither shopping malls nor private dwellings nor dietary habits differ substantially from sea to shining sea) makes internal migration much easier, of course, as does the common language, whose general intelligibility is a rule proved only by the exception of Texans.

A glance at migration figures within the EU suggests lower levels of *wanderlust* among Europeans. According to Eurostat, the EU's statistics body, some 34.3 million foreigners were identified as residing in EU member states in 2012, of which 20.7 million were from non-EU countries such as Turkey, Albania or Morocco and 13.6 million were from other EU nations. Measured against a total population of around 500 million inhabitants, that means inter-EU migration stands at 2.5%. Bearing in mind the sacrosanct status of "free movement of people", this figure is incredibly low; Europeans are clearly a *sedentary bunch*. This is especially true of the core countries such as Germany, France, Italy and even Spain. The only country to see a veritable exodus after the EU's eastern enlargement was Poland; most headed for Germany and the Anglo-Saxon countries. The number of Romanians in Italy and Spain is also noteworthy, but even so: overall migration within the EU is minimal, especially between the major *blocs* of Germany, the UK and France. Not even the euro crisis and the resulting divergence in growth rates has brought about any material change, and the Great Trek of unemployed Greeks and Spaniards to Bavaria and Baden-Württemberg has yet to materialise.

Is more internal migration desirable? In the greater scheme of things (i.e. in the context of the stated aim of ensuring peaceful and prosperous co-existence), not necessarily. However, if you assume that a homogeneous monetary, economic and fiscal policy is

A patchwork continent
Unemployment rates in Europe



Source: Eurostat. Note: certain overlaps can be observed between the representation of unemployment rates and gross value added. The chart shows data for 2012.

a *sine qua non* for achieving this superordinate objective, then absolutely – besides capital allocation and transfer payments, labour mobility is one of the few mechanisms for ironing out disparities in the real economy. That cultural, religious and familial identities are the toads beneath this particular harrow is by the by in such circumstances; and if one can market such Procrustean proclivities as a passion for multiculturalism, so much the better.

CHAPTER 4

Competitive – but how?

It is easy to dismiss acceptance of the diversity we have described and/or the way it is irrefutably baked into this continent as eurosceptic heresy; "churches" have a long track record of denying manifest facts – it took the Vatican quite a while to accept that the Sun does not orbit the Earth, for example. In our opinion, such diversity is a European fact – a fact that we see not as a problem but as an opportunity, perhaps even the only true opportunity on an Earth that is getting flatter by the minute, and we would like to examine this in greater detail against the entreaty made earlier, that Europe must maintain and/or restore its competitiveness.

There is no doubt that the competitive landscape in which western industrialised nations operate has changed dramatically over the last 25 years in the wake of globalisation; new providers, wielding ever longer lists of qualifications, have been popping out of the woodwork continuously, and will continue to do so. In some fields, such as consumer electronics and textiles, only highly specialised firms from the western industrialised nations can stand the pace – and most of these only manage to keep up by farming out their actual manufacturing to emerging countries. Things look a little more promising in other industrial sectors (mechanical engineering and equipment construction, for example), even if here too, manufacturers from countries like Turkey and China are breathing down the necks of western providers. Competition is slightly less acute wherever industrial output includes a sizeable service component.

High unit labour costs are generally trotted out as the principal reason for western providers' losing so much ground; prosperity in our latitudes – thank goodness! – translates into a thicker pay packet for workers and better social security, although these benefits inevitably also drive up the average cost of labour per unit of output produced. But this is only part of the story; without the disastrous, hyper-centralised single currency, unit labour costs would have remained in fairly competitive territory in Italy and Portugal, indeed even in France. Now the sick men of Europe, these countries would otherwise have been able to reduce their unit labour costs and/or boost their exports by devaluing their currency. Admittedly, had the EU nations retained their independent monetary systems, they would have had to do without the "blessings" of the single currency – the elimination of country risk premiums and generally lower interest rates (complete with a real-estate boom) – and some of them would have remained vulnerable in the face of perennial inflation issues. By the same token, however, there would have been less leeway for taking on additional sovereign debt. Given the current situation in certain places we could mention, there are people who would doubtless be only too happy to turn back the clock of European history. The economic gains achieved by removing the information and transaction costs associated with numerous national currencies may have been overstated.

It is interesting to note – and this relativises the significance of unit labour costs considerably – that Germany is able to throw its weight around as the "world champion exporter" despite its generous pay packets. Success on the global markets is clearly also not monocausally linked with one particular element on the cost side; instead, it arises from the interplay of a host of favourable conditions, expertise, distinctive qualities, speed, flexibility and sanctity of contract that is decisive. How, for example, do German cars manage to see off the opposition from Korea, Japan and, more recently, China as well, while French car manufacturers would have long since bitten the dust without relentless state subsidies? Audis, BMWs, Mercedes and Volkswagens are not exactly cheap, and the prices are to some extent a reflection of high German unit labour costs. German cars are evidently a good deal better – not just technically, but across the board, i.e. in the way what they have to offer is valued by the market; this also includes soft factors such as design, brand-building, the creation of an image in the mind of the purchaser, etc.

This is intended neither as a paean of praise to Germany nor a side-swipe at France – we wish instead to make clear where Europe as a whole might have a chance of holding its own against global competition. Cost leadership? Probably only in exceptional cases; there are sure to be producers around the world whose unit cost levels will be far lower than European norms for some considerable time to come. The only way out of this is to focus on *uniqueness*: only those with unmatched technical quality and technological innovation, unparalleled services, punctuality, reliability, agility and connectivity will be competitive. The last point in particular should not be underestimated. Market success is very rarely defined by a unique, lone producer; it is a function of "clusters". A cluster can be thought of as a many-sided matrix in which new real-world opportunities are constantly being created for clients, service providers, employees, suppliers, investors and other stakeholders.

There used to be a textile/silk cluster in Como and a cluster of shoe manufacturers in Le Marche, and there is still a cluster of *parfumiers* in the South of France. The German car cluster has enjoyed particular success, as we have mentioned, as has precision engineering in the Black Forest (and the Swiss canton of Jura). Europe is in fact a patchwork of successful clusters – but time is running out for this successful model. The cocktail of economic policies prescribed following the euro/debt crisis threatens to definitively stifle and starve out industry and the middle classes in Italy, Spain, France and elsewhere. Even as the economy declines, the currency is being propped up, taxation is being raised (or new taxes are even being introduced) and fiscal activity is being choked off. Where the state is indeed placing orders, it is becoming a truly delinquent debtor. Commercial and industrial value and expertise are steadily going to waste: France, once a dignified industrial nation, lost on average a third of its industrial value added to other sectors between 1999 and 2010. Economic horror stories are similarly emerging from Italy, many of which are unfortunately all too plausible: since the Monti administration, the deadlock that had so propitiously existed for decades between the (largely impotent) world of politics and a highly successful private sector has been destabilised to the point that investment has dried up almost completely. Entrepreneurial types are emigrating and the rest of the land is sinking into depression.

There is a link between the diversity of Europe and its conspicuous capability to create, design and brand. Diversity is ultimately a culturally determined phenomenon, imbued with *terroir*, local conditions, the root circumstances of civil society. A Europe that puts its shirt on uniformity rather than diversity is depriving itself of one of the few true comparative advantages over competitors with significantly more collectivist backgrounds.

CHAPTER 5

Unsolved demographic problems

However, even if we assume that the eurozone can somehow find a way out of bottom gear, and the countries on the periphery of the continent in particular are able to extricate themselves from the predicament in which they are currently mired, the next big problem is lurking just around the corner: the demographic challenge. Life expectancy in Europe continues to grow by about 2 months every year, with the latest figures placing it at around 83 for women and 77 for men. The reproduction rate is somewhere between 1.3 and 1.7 children per woman in most countries, with only the UK and France currently making it back to the 2 mark; overall, Europeans are not reproducing enough to replace themselves, however.

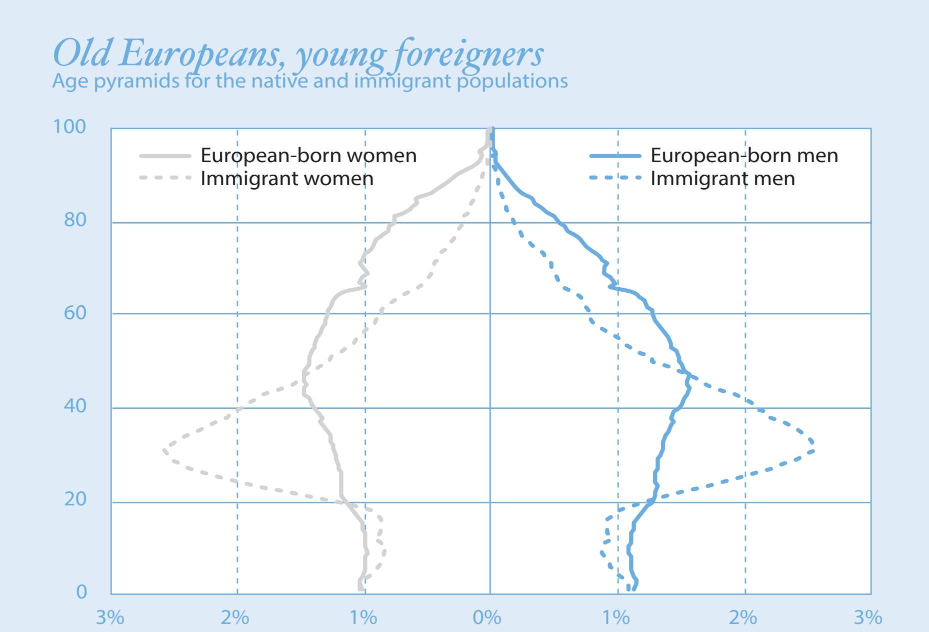
We do not intend to rehash the entire pension funding problem here. Suffice it to say that, in the absence of significantly greater diversity across the entire continent, an ever-larger proportion of the population is going to be getting old over the coming ten to thirty years. This is by no means a bad thing, but it will have structural consequences – in the hospital and nursing sector, for example. Furthermore, the total population will shrink; it will need less spaghetti, fewer clothes, and fewer schools. This is one of the reasons we are concerned about Europe's competitiveness on the global stage. As demand from the internal market is set to decline in the foreseeable future, exports will become increasingly crucial.

The age structure could be influenced and the shrinking process halted by means of immigration – but with a total population of some 500 million residents, it would probably take an influx of around 50 million people, all young and eager to reproduce, to have any significant effect on the state of play. Things are unlikely to pan out this way, however, especially as fewer and fewer of the geographically closest candidates, the Turks, wish to emigrate – economic conditions in their homeland are improving all the time (we shall draw a discreet veil here over the whole thorny question of Europeans' readiness to accept them). Given all these factors, the "immigration" option does not seem terribly realistic.

It will not be possible to maintain, in the envisaged form, the much-vaunted "inter-generational contract", a product of the late 19th century, when the population pyramid and life expectancy still had an entirely different aspect (such that any requirement for the active generation to finance its elderly compatriots remained very limited). In certain cases, implicit debt arising from the promised pension provision is several times national debt and represents multiple years of output in the respective economies. Implicit debt turns into explicit debt (i.e. debt that must be disclosed and entered in the national accounts) at the latest when outflows exceed inflows. Despite the questionable non-inclusion of this item in the national accounts, we feel sure that the additional burden on state finances caused by implicit debt is exerting an anticipatory effect; for one thing, as a drag factor on citizens ("I'll never get everything back anyway!"), and perhaps also, soon enough, through a downgrading of state finances by the financial markets. One thing seems clear: the inter-generational contract in a given economy is strongly dependent on the success – that is to say, the productivity – of the active population of that economy.

This leaves capital cover. Two-thirds of EU member states have no pension systems with capital cover. The more capital that exists and is diversified into other economies, the more you can do without the inter-generational contract, even with a shrinking population of young people; the younger generation of capital-recipient countries would be working for the old people of all Europe, as it were. Diversified capital cover is a kind of cross-border inter-generational contract. Europe still has a long way to go. With the exception of the Netherlands, parts of Scandinavia, the UK and (since the Riester reforms), increasingly, Germany, a collectivist and self-referential – and thus distinctly dubious – approach to the problem prevails.

This leaves capital cover of a different kind: human capital – families. These should not be underestimated, whatever the divorce rates might be. In Italy and Spain, it is currently families that are bearing the brunt of enormously high youth unemployment: *nonna* (or *abuela*!) does the cooking and washing, and sons and daughters are staying at home longer than was usual up to a few years ago. The *family* is the ultimate decentralised social security



Source: Eurostat. Note: each demographic group is represented as a percentage. Foreigners make up no more than 7% of the total population of the EU.

mechanism, acting as a longstop when all the high-level, collective safety nets have broken. The family may be about to make its big *comeback* in Europe – given the lack of retirement savings and the difficulty of honouring collective inter-generational contracts, there is little other choice but for parents to look after grandparents, and grandparents to look after great-grandparents. Sociologists call this the "verticalisation" of the family.

Let us be under no illusions, however – a demographic spectre is haunting Europe; less tangible than the sovereign debt crisis, perhaps, but at least as worrying. The challenges of an ageing and declining population have cast a paralysing pall over proceedings, nipping any hopeful visions of an upswing – a "new day" for Europe – in the bud.

CHAPTER 6

Inherited problems – stabilisation vs. rehabilitation

The most spirited stand against European diversity is being taken in dealing with the inherited burden of the financial, banking and euro crisis, i.e. the mountains of debt created by misallocations in the peripheral countries of the eurozone and on the balance sheets of certain (all too numerous and important) banks. The eurozone's top brass have consistently gone to every imaginable (and increasingly unimaginable) length to collectivise specific and regionally contained problems in an effort to gain leverage over the entire community of states.

Back in the spring of 2010, Jean-Claude Juncker put the cost of fixing the "Greece problem" at EUR 45 billion. This was doubtless intended to put lipstick on the pig at the time… and yet we think a strategy that isolated the source of the fire combined with a "bail-in" forcing all creditors to bear a portion of the burden (i.e. the kind of strategy that was deployed, albeit relatively heavy-handedly, in Cyprus this year) would have prevented the subsequent wave of trouble involving Ireland, Portugal, Spain, etc. from ever occurring. The scrabble to establish the "correct" risk premiums for heavily indebted states would never even have come to pass without the ongoing (and for a long time, implausible) plethora of bail-out packages and guarantees: instead, things would have speedily found their level and the struggle for lower risk premiums concomitant with lower interest rates to refinance sovereign debt could have been left to the individual member states.

The alternative, collectivising route was chosen instead, however. Little by little, new structures, initially christened the EFSF ("European Financial Stability Facility") with a guarantee fund of EUR 200 billion, were erected in the eurozone in the wake of the euro crisis; the ESM ("European Stability Mechanism", with paid-in capital of EUR 80 billion and an all-euro-member guarantee fund of EUR 700 billion, has been in place since February 2013. So far, the two interlinking mechanisms have given the member states Greece, Ireland, Portugal, Spain and Cyprus – and their respective creditors – a total hand-up of EUR 213 billion in cash and EUR 437 billion in pledged assistance. Terms are dictated to the countries seeking help via the vehicle.

The ESM is operated via a sophisticated structure built on modern principles of governance. Its highest executive body is a "Board of Governors" consisting of the finance ministers of the eurozone countries, whose voting rights are weighted in alignment with their particular state's contribution to the ECB (which in turn determines the level of the ESM's guarantee). A unanimous vote is required for certain decisions (e.g. the initial bail-out for a country) and a qualified majority of 80% for others. The Board of Governors elects a "Board of Directors" to take care of operational matters, and this in turn selects a "Managing Director". Thanks to the crisis, the eurozone is now the proud possessor of its first political organ. Should the euro – and thus the eurozone – survive as such, there is every chance that the ESM will become the core of the inner sanctum of the EU; in essence, the guarantees tendered are nothing more than transfer payments from stronger to weaker member states and the conditions they impose are part and parcel of financial equalisation. It is conceivable that the ESM will become the principal mechanism in the eurozone's transition to integrated monetary, economic and fiscal union. To a certain extent, it resembles the "Directory" after the French Revolution: largely self-appointed, undemocratic and doggedly devoted to a chimera-like goal, whatever the cost.

One might even go so far as to suggest that the crisis was a welcome development for the centralist thinkers within the EU (is there any other kind?), as it offered a convenient excuse to transfer much of what had previously been the preserve of the individual member states to Brussels. Certain circles in German politics still have their problems with the delegation of authority that this entails, but even constitutional judges would rather fall into line than preside over a system collapse. From an economic perspective, the ESM would not have achieved its current crucial position if the guarantee structure had not been propped up with a special commitment from the ECB and/or its President, Mario Draghi. The statement that the ECB was "ready to do whatever it takes" to preserve stability in the eurozone presented the ESM with a kind of blank cheque – and, given the weight of such a statement from the mouth of a central banker, this blank cheque need never even be cashed.

Draghi's announcement calmed the financial markets and (with very few exceptions) silenced the critics of the whole bail-out manoeuvre. While time has certainly been gained through the ESM's and ECB's efforts, we are nonetheless of the opinion that they have done nothing to alleviate the underlying hopelessness of this kind of debt management. On the contrary: the ESM and ECB are cementing not only the "system", but also the misallocations and inherited burdens mentioned earlier. The entire edifice is an exercise in stabilisation rather than genuine rehabilitation.

CHAPTER 7

Europe at the crossroads

The key questions are: how much failure will it take for the EU to rethink its approach, and how much time do its institutions have left to grasp the nettle? We reckon that the EU's frenetic activity has bought it about two years – three, at most. Europe urgently needs to weigh up a Plan B to expunge its financial burdens. Obliging the taxpayer to shoulder the debt has already been tried out, as has (selective) involvement of creditors; in the case of Cyprus, the strategy of expropriating non-participating creditors of non-participating third-party Cypriot banks was a new departure – it is astonishing what exotic blooms may be brought to blossom at a meeting under the green fingers of a council of ministers (or the ESM's "Board of Governors"). The worm in the bud of all previous attempts at solving the problem is that they have led further and further away from the individual responsibility of the debtors and have rendered swift resolution well-nigh impossible.

One option that has never been seriously entertained hitherto is debt-equity swaps. Whenever the subject of sovereign debt is raised, the presumption – in the absence of any relevant entry in the national accounts – is invariably that there are no assets on the other side of the ledger to balance the heaps of liabilities. Why are the oil and gas deposits in the Aegean never mentioned? Why not consider leasing the Acropolis to a tourism company on a temporary basis? Why are they so hesitant about putting (air)ports on the table? No one is suggesting they would have to cede the island of Lesbos to Turkey in perpetuity... There is more scope for granting licenses and conveyancing sovereign real estate than is commonly assumed. The estimated value of the fossil fuel reserves beneath the Mediterranean mentioned above lies somewhere between EUR 100 and EUR 400 billion. Such projects needn't be on such a spectacular scale, however – we are convinced that a deal could even be made over garbage disposal in Naples, if it could be properly organised. After all, the Mafia has been running the service for goodness knows how long and, in a time when the state purse is feeling the pinch, there is no reason why the paradigm shouldn't shift.

Europe must *clean up its act*, and fast – it cannot afford to lose any more of its industrial base. Unemployment figures have to be brought down pronto, or else Europe's jobless young people risk turning into a "lost generation". Europe must find a way back to greater joy and hope. But how? While we concede that the picture is complex, one thing is clear to us: our chances of reaching these sunlit uplands are greatest if we switch our focus from increasingly futile harmonisation drives to acknowledging and accepting diversity. The *euro* project involves extremely high *opportunity costs* but yields minimal benefit – we would do well to turn our attention to genuinely worthwhile enterprises and reduce any further steps along this dead-end road to a face-saving minimum.

Then – and only then – would investors have a solid rationale for "staying in Europe", with no reason to weight the patchwork quilt of Europe's member states lower than other corners of the globe when planning their asset allocations. All hope is not yet lost for our continent.

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