Armistice Or Capitulation

Why did the euro first come about? Some will explain that it was to favor pan-European trade, tourism and a more efficient allocation of capital; even if in the times of Visa/Mastercard/Amex cards, and of easy currency-risk hedges through forwards, options and the like, such an explanation appears naïve at best. Others will explain that the euro was created as a “political project” to ensure the political integration that Europe’s people did not want; such an explanation appears to be extremely anti-democratic and a post-event rationalization. And then there is the likely real reason: the fact that the collapse of the Soviet Union massively destabilized the post-WWII European political order. The end of the Cold War suddenly raised the specter of a unified, economically-dominant Germany; or every French technocrats worst nightmare! And so, instead of having the DM of a re-unified Germany become the de-facto European reserve currency, French policymakers came up with a plan to harness German economic might for the benefits of a greater Europe, managed (it goes without saying) by French bureaucrats. Presented with a Faustian pact of sacrificing the DM in order to gain French support for a reunified Germany (let’s not forget de Charles Gaulle’s parting words that “I love Germany. I love Germany so much that I would rather there would always be two”), Helmut Kohl signed up for the euro, even though deep down he had to know that the unique currency could not work.

For let us go back to the early 1990s. At the time, free-market capitalism was riding triumphant (happy times!). The collapse of the USSR had just shown to anyone with eyes and half a brain that an economy managed by a technocracy rather than the market eventually hits the wall. And yet, against this backdrop, here were French eurocrats proposing an increased dose of technocracy, combined with the fixing of the two most important prices in an economic system: exchange rates and interest rates. Why would anyone in their right mind go along with such a plan?

At the time, I wrote (to my Cecogest clients) that this amounted to a “declaration of war” by civil servants, technocrats and politicians on to the markets. This is a view that I have held to this day, even using Churchill’s martial quip on WW1 French soldiers being “Lions Led By Donkeys” as the title of my first book, *Des lions menes par des anes* (the book’s main theme was that the euro was an unnecessary declaration of war on the market that France would eventually lose). In WW1 and WW2, France waited for Germany to bring the fight to France (thereby ensuring minimal room for error should things go badly). With the euro, French policymakers have now built a system from which there is conceivably no exit. So once again, France is fighting on its own turf, which severely cramps the room for maneuver and ensures that any mistake can rapidly become catastrophic. And unfortunately, by now, it is obvious to everyone that the war declared by the eurocrats on the market is not exactly going in their favor...
In a war, when one is taking a terrible beating, one usually has two options:

- **File for armistice.** This implies saying to the other guy: “You have won. What are your conditions to stop the bloodshed?” One then tries to get the best possible deal, and move on. Embarking on such a path is the right approach when a) the war cannot be won and b) the enemy is not attempting to destroy your entire country and way of life. So, for example, it made perfect sense for the Italians to surrender quickly to the Allies in 1943, for why keep fighting an unwinnable war against an America and Britain which had no true ill-intentions towards Italy?

- **Fight to the death** (usually of young men – not the death of the generals and policymakers who chose to fight the war!). The downside of this strategy is that a defeat implies that the country loses its sovereignty, its mode of government, its ability to fight in the future—it is, ultimately, a capitulation. Everything having been destroyed, this means reconstructing from scratch, usually under some sort of foreign pro-consul (McArthur in Japan comes to mind).

Now note that the euro is not the first declaration of war by technocrats against the market. As mentioned above, such a declaration of war was tried by communists in the Soviet Union and in China. The Russians—always excessive and always tragic—fought to the death (historically, the Russians have been world champions at fighting to the death). In the end, Russia had to capitulate and its great civilization has yet to recover; it is now under the yoke of a kleptocracy. Meanwhile, the Chinese, always more pragmatic and less romantic than the Russians, and having ensured that their borders would remain USA-free (North Korea, Vietnam, Laos, and Tibet), filed for an early cease-fire and have been thriving ever since. With each year that goes by, the technocracy in China retreats a little more and the markets advance a little more....

But back to Europe, where the eurocrats are now facing their Stalingrad, raising the question of whether policymakers will choose to file for an armistice, or adopt Hitler’s scorched-earth policies? This forces us to be precise about what an armistice, or a capitulation, in this very strange kind of war would look like. Below is an attempt to provide an outline for each.

### 1 - What an armistice would look like

An armistice has to start with a double realization. The first is that the euro in its current form does not work. The second is that the European project, usually called the common market, is what must be saved at all costs. This means that when we return to national currencies (the only solution), this return should be done in good order and with minimal acrimony. To get there, we probably need the following steps:

1) Transform the euro from being a common and unique currency, to simply being a common currency—i.e., countries would have the choice between using their domestic currency or the common one.

2) Countries choosing to once again print their own currency can then use this new money to pay civil servants, nationalize failing banks, etc.

3) Local government debt will have to be converted into the local currency, which will be allowed to float freely against the euro and other currencies.
Undeniably, quite a few participants in the financial systems in Euroland will go bankrupt, and will have to be nationalized. Just as undeniably, the standard of living of the local “rentiers” (bondholders, pensioners and civil servants) will take a massive beating. That is always what happens in devaluations. But is this avoidable given that, all too often, this standard of living has not been earned? It has only been promised by politicians who can no more deliver a standard of living then the French general staff could deliver a quick victory over the Germans in 1940?

Conversely, a lower, national, and economically rational currency will give local entrepreneurs the opportunity to invest for the future, and prosper. Furthermore, an undervalued currency, coupled with much lower interest rates would lead to a massive increase in the local growth rate which could go a long way towards solving the debt trap problem. In such a world, the German consumer would be a big winner, the German producer a big loser and the German financial system would have to be nationalized. Provided nobody went down the protectionist path, the euro could then be remembered as the nightmare it was. Europe, would once again rise from its own ashes and investors should want to own European equities above anything else.

2 - What a capitulation would look like

In this second scenario, the euro is maintained at all costs (trampling over treaties, constitutions, democracy, record high unemployment rates, social compacts that took decades to achieve, etc…) and Europe walks towards its unavoidable demise. The baby (the baby being the common market) is thrown out with the bath water. Left-wing and right-wing extremists gain prominence, not just in Greece but across the continent. There would be no transfers of wealth from rentiers to entrepreneurs; only a massive and general loss of wealth. First the entrepreneur would be killed off (which is what is happening now), then the rentiers would perish following the demise of the last entrepreneurs. In such a scenario, investors should want to own nothing in Europe, except perhaps (for those who have to), a small sample of European companies whose sales happen mostly elsewhere (see our list of European “export champions”), if only because these will likely go down a whole lot less than the rest. Maximizing one’s position in US$ cash is probably the best solution. One should also continue to avoid US or Asian companies with a significant portion of their sales in euroland. Incidentally, markets for the past two years have been pointing in precisely this direction (not an encouraging sign!).

This destruction of wealth brings us back to an old GaveKal favorite, namely Aftalion’s concept of “acceleration”. The French economist was the first to explain that, in most countries, incomes are distributed along a bell-shaped curve. The reason this matters is that the demand for certain goods, or services, can explode when the average income in a country moves past a “threshold” along this Gaussian distribution curve. For example, nobody buys a TV if the average income is less than, say, US$1,000 per annum. But when incomes move above this threshold, then everybody buys a TV. When the whole income distribution curve moves to the right, the number of people able to buy TVs rises much more strongly than the increase in the average income would itself suggest. This explains why, while 15 years ago only around 10,000 Chinese had ever
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When incomes shrink, the decline in purchasing power is even more exaggerated

It is time for a “peace for the brave”

been skiing, this past year, China’s icy and cold slopes witnessed some 5mn Chinese whizzing down slopes (ed. note: “whizzing” may be an exaggeration here—a better description may be “making their way down the mountain with varying levels of skills”).

However, as we saw in Asia in the late 1990s, the acceleration phenomenon works both ways. When incomes shrink, demand for goods and services on the right side of the curve can disappear overnight. Unfortunately, in either the capitulation or armistice scenario, the European rentier is due to take the mother of all beatings, with his standard of living going sharply down. Under an armistice, the loss of purchasing power will be sudden and climb back thereafter. Under the capitulation, the lower standard of living will likely prove permanent. But either way, in the immediate term, all European expenditures situated at the right side of the curve (luxury cars, financial products, tourism, second homes…) will register tremendous falls. Which means that in the capitulation scenario, one can only buy the producers of the goods which are totally revenue inelastic (utilities, staples…). In the case of an armistice, the exporters of the goods which are price elastic and revenue elastic for the non-Europeans should be favored.

3- Conclusion

One of the legendary moments in the history of the French Foreign Legion was the battle of Camerón in Mexico, where 65 legionnaires refused to surrender against 2,000+ Mexican soldiers (incidentally the Legion was sent by Napoleon III because Mexico had defaulted on its bonds). The French soldiers died on the (completely meaningless and strategically unimportant) spot they were defending.

Almost a century later, the French general staff, in a bid to bring the fight to the elusive Viet-Minh, decided to place all of France’s better battalions (Legion, Paras, Colonials, Mountain Infantry…), in the remote hills of North Tonkin, close to Yunnan and Laos. Within a few weeks, General Giap’s troops had managed to drag up artillery through the jungle, and on top of the hills surrounding Dien Bien Phu. By the time the first canon shells landed in the valley below, it was obvious that the outcome would not be a happy one for France. Turning to the General de Castries (who was in charge of the camp), Marcel Bigeard (a legendary French officer) said “we can’t do Cameron with 15,000 guys”. But yet, that is pretty much what the French battalions ended up doing; fighting until they ran out of ammunition and able men and (to the troops’ credit), never raising the white flag; simply fighting until they were over-run. But this also means that only three out of ten Frenchmen (including the actor Alain Delon and the movie director Pierre Schoendoerffer) involved in the battle ended up coming home (in pretty bad shape).

A few years after Indochina, France found itself mired in another colonial war, this time in Algeria. After a few years of misery, de Gaulle had the political and physical courage (he was nearly assassinated several times for it, see The Day of The Jackal) to ask for “la paix des braves”. So is Europe confronting its own Dien Bien Phu, a very visible, and avoidable, disaster which unfolds simply because no-one has the political courage to ask for terms? Or will Europe come up with a leader of de Gaulle’s stature, ready to look the truth in the face, take the difficult decisions, and move on?
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Italy, or England, are the two countries most likely, in my reckoning, to bring about an armistice.

The easiest conclusion is that Europe today does not have a de Gaulle. In fact, all of Europe’s policymakers cut about the same figure as the French IVth republic politicians did against the tall man, with little credibility, few principles and even less vision. This means that if Europe is to ask for an armistice, the request will likely not come from one of the eurozone’s major powers. Instead, looking back through history, I would venture that an armistice will come from either one of two places:

Italy: At the risk of sounding tart, I would say that Italy has a decent track record of switching sides as historical tides turn. Perhaps because, as Northern Italians themselves never fail to highlight, “Garibaldi never managed to unite Italy… though he did manage to divide Africa”. Indeed, it seems that most Italians feel a much stronger bond to their families, cities, or regions then they do to their country. Dying needlessly for a country with whom one’s bond is somewhat tenuous has rarely been a top priority. Thus, in World War 1, Italy started off as a neutral, but as it became clear that Austria-Hungary would likely not survive the war, Italy joined the Allies for its share of the spoils. In WW2, Italy started off on one side, and then very rightly switched in 1943. So will the end of the euro prove that the “third time’s a charm”? We have long argued (see Divorce Italian Style) that Italy would end up being Europe’s soft underbelly. After all, with Italy now entering into its fourth recession in a decade, we could be approaching the time when Italians start to wonder what is so great about the Euro?

England: I was heartened to see London mayor Boris Johnson argue on TV that “an end with horror beats horrors without end.” To my knowledge, this is the first senior, non-extremist, European politician to visibly take such a stance on ending the euro. Now how long until the conservative back-benchers force the current government to admit as much? Incidentally, each time Europe has attempted to recreate the Roman Empire (see Was the Demise of the Soviet Union a Negative Event?), the United Kingdom was the force that brought the continent back to its senses. Will the same thing happen again? Some British Members of the European Parliament (e.g., Daniel Hannan, Nigel Farage…) are using their bully pulpit to fight the good fight. Over time, and as the facts on the ground keep proving that their dire warnings were on the money, they may start to convince men and women of good faith (for there must be some, even in the European Parliament!). MPs from Poland, Sweden, Czech, Hungary and elsewhere could start to realize that France and Germany have led Europe for the last 50 years, and are thus now responsible for the current mess. The time has come for the UK (but also Sweden, Denmark, Poland, Czech Republic and, who knows, even Italy?) to step in and replace the current leadership in euroland….

We are now at the stage whereby to save the Europe that everybody likes, the euro needs to be killed. The only question is whether Europe can find within its ranks the political will to go through the act, and whether our current crop of meddling leaders can, like Pontius Pilate, accept that the euro’s fate is out of their hands.

To stay with the religious analogy, in his theory of the just war, St Thomas of Aquinas stressed that wars should only be undertaken if success was a likely outcome. If failure was a foregone conclusion, then war was just a
wasteful spilling of blood. With this in mind, knowing what we now know, who can still believe that the euro can be made to work? Is this really the hill on which we want to sacrifice an entire generation of European entrepreneurs? Yes, taking down the euro will be painful. But is there another solution at this stage other than to ask for terms and move on? As John Kerry asked about the Vietnam War: “how do you tell a man he is going to die for a mistake?” How dare European policymakers tell the population to continue suffering for their mistake, just so that they do not lose face. This crisis of the euro is rapidly evolving from being the single most important economic decision of my generation, to being the single most important moral decision of my generation.