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Understanding the Euro And the Chaos it is Unleashing in the World Economy

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There appears to be great confusion among not merely the public sector officials, but also among corporate and institutional Europe not to mention the rest of the world. Perhaps the most confusing aspect of the coming monetary changes in Europe is what will the single currency do? Will a single currency end currency speculation? Will a single currency lead to a single interest rate for Europe? Does a single currency mean Europe becomes one economy while retaining individual sovereignty? These were among a handful of questions that I encountered on my fall trip to visit our European clients. The most profound conclusion as I begin writing this piece while 60,000 feet in the air crossing back over the Atlantic, is just how many in Europe have absolutely no idea what a single currency is all about regardless if they oppose or support it.

To truly understand the implications of a single currency, we must begin with fact rather than mere opinion. In the postwar period, currency has become a badge of honor outside the United States. National pride has always been wrapped up in the European currencies as a standard form of measuring how far their nations have come since the devastation of World War II. This is also true in Asia. Because some sense of national pride is involved, politicians have often been judged by the value of their currency particularly against the dollar. If a nation's currency is suddenly devalued, politicians are attacked by their foes who paint this event as confirmation of their failure in government. Consequently, comments from Malaysia calling for currency trading to be banned is an example of a government enraged at being forced to allow its currency to devalue. The politicians see this as public and world confirmation of their own personal shortcomings in dealing with their economies.

We must understand that the old fixed exchange rate system of pre-1971 was also plagued by an age of "competitive devaluation" and cracks within the armor of the gold standard. Its ultimate demise was again wrongly blamed on speculation when in fact it was the political desire to spend at will while denying accountability and responsibility. Governments tried to hold the value of gold pegged at US$35 while allowing their money supplies to grow unchecked. The first sign of trouble came during the mid-1960s when private redemption of currency for gold was prohibited giving birth to a two-tier gold standard. Gold became a commodity that was traded on the London Metal Exchange. Governments agreed to uphold the old standard at $35 per ounce only between themselves allowing the private sector to trade separately on its own. The French, however, began an onslaught that would ultimately bring the entire house of cards down. The French began excessive redemptions of dollars for gold in an attempt to boost its gold supplies in hope of transforming France into the largest economy. Indeed, the French succeeded in forcing the entire gold standard to collapse because governments had printed far more paper currency than there was gold to go around. Instead of readjusting the value of gold to account for the huge growth in money supply between 1950 and 1970, politicians in all countries preferred to ignore the fact that the system designed at Bretton Woods could no longer be supported. Admitting the failure of Bretton Woods would have clearly highlighted the fact that politicians were indeed incapable of fiscal restraint.

When Britain was forced on "Black Wednesday" to leave the ERM and allow the pound to float, it was humiliating to the Conservative Party. While it is often said that this single collapse of the British pound cost every British citizen 20 pounds, it did so only because the government sought to reenter the ERM setting the value of the pound at the highest possible price for the three previous year period. Politicians chose the highest price for the pound as a symbol of how good a job they had done with the British economy. Unfortunately, while the economy in Britain had turned the corner, the pound was being priced too aggressively for the world economy.

Every currency collapse in the past 200 years has taken place NOT due to speculators, but due to politicians attempting to fix currencies based upon their personal careers rather than underlying economic considerations. The coming Euro is nothing different and given a transition period where each individual currency will co-exist along side the Euro until 2002, the opportunities for readjustments at the hand of capital markets could be endless.

Phase I of the European Monetary Union is a transition period. This means that each country will continue to maintain its own currency while attempting to pledge its link to the Euro. In other words, it is not much different than the gold standard where everyone tried to keep their currency fixed to gold. Some have argued that if currency speculators try to play around with the individual currencies, nobody will care since it is the Euro that will survive. Keep in mind one fact. Even Russia could not stop black markets and net capital movements despite torture, tanks and guns. If anyone believes that the currency speculators will be defeated by merely pegging the currencies to the Euro, you better take another close look.

There is only one way that speculation within Europe between one nation and another will be defeated. That exclusive secret weapon can only mean the full and unquestioned federalization of Europe. Even if the individual currencies dwindle and die between 1999 and 2002, net capital movement and speculation will merely take the form as it does within the United States – bonds and interest rates.

It is ABSOLUTELY IMPOSSIBLE for Europe to impose a single interest rate upon the whole membership of states. As long as some sovereign rights reside with the individual nations of Europe there will be differences in credit risk as there is today between all 50 states within the US. Therefore, even if the single currency succeeds, speculation will be shifted from currencies to the bond markets. The socialistic dreams of Europe that paint a utopia where everyone will enjoy the same interest rate and stability simply cannot materialize as has been the case throughout the past. If capital perceives that the French are going in their separate direction from that of Germany, France will find it cannot sell its bonds at the same rate as Germany. France will be forced to sell its bonds at a discount such as 98 to Germany's 100. In effect, Europe will be no different in 2002 than it is today. All that will be saved is mere currency costs of transactions within Europe but not external to Europe. In order to deliver the dreams of European politicians as related to the people, only a federalized Europe with dictatorial powers over domestic policy in each nation can deliver. If this is the ultimate true goal, then devolution in Britain has come at the precise wrong time.

A close examination of the United States economy reveals that its success is due to a standard uniform code of law throughout all 50 states. Federal taxes are the same in Texas as they are in Hawaii or New York. Who is taxed in the social code is also the same in all states. The issue of inheritance taxes, retirement customs, pensions and the general rule of law are uniform. In order for Europe to succeed in this ultimate quest, Westminster must be reduced to a parish council subservient to Brussels as every state is to Washington in the US.

What is frightening for Europe is that there seems to be a political drive with its spin-doctors who deflect any and all serious investigation. If the goals are to produce a single economy with federalized powers or somehow a loose economic co-operation zone with a figure-head with about as much teeth as the United Nations when it comes to enforcing.

What does appear to be clear is that at least short-term interest rates will be federalized. This will not end speculation, but could promote excessive speculation in the bond markets. If France is not following the same economic agenda, then it may find that if short-term rates cannot differ throughout Europe, then it will be forced into shifting its national debt into long-term funding where the market will dictate the interest rates – not Brussels.

The single currency cannot produce utopia without pain unless everyone is on drugs. Each nation must meet the criteria of the whole and be willing to send its own economy into deep recession for the good of the whole. If Europe cannot meet the criteria today without playing all sorts of games with its numbers, are we to take Europe seriously in the future?

There does not appear to be a political will to tell the truth. Kohl ignored all the experts who warned that German unification would cost far more than he was telling the German people. Kohl feared that if the people knew the truth about the cost, they might vote against unification. Perhaps there was a risk. The point is we will never know if there even was a risk that the German people might have turned down unification. This same tactic is now being used with regard to EMU. The promises being made simply cannot take place without a full-scale federalization of Europe. Anything shy of that will merely transform currency speculation into bond speculation assuming the Euro is successful.

From a historical perspective, it was the revolution in the United States that finally forged the bonds of brotherhood within the 13 colonies. Previously, each competed against the other and even tried to block free trade. If Europe is to one day emerge as a new federalized state, it may need to go through the pains of severe economic hardship before individual states are willing to give true control over their economic and political social goals to a new federal government.

The winds of change are subtle yet continual. Tony Blair is up for the head of the EC in 1998. His recent verbal slips stating that if Britain wanted to join the first wave of the Euro in 1999, it would need to make up its mind in early 1998. Some have not panicked just yet arguing that a referendum would need to be called before Blair could take Britain headfirst into the Euro. However, keep in mind that Tony's role model is Bill Clinton who motto is "never tell the truth until you are served with a subpoena and then stall." Tony does not have to call a referendum simply to go in on the first wave. Sources tell me that he only promised a referendum before the abandonment of the pound. Tony wants to be President of Europe. He is up for the slot in 1998 and he wants to lead Europe into the millennium. A referendum in Britain may not be necessary until 2002. The argument is that Tony view 1999-2002 as a trial run and his political spin-doctors are preparing scenarios along those lines. If they think they can sell the Euro and are assured of victory, then Tony may call for a referendum even by March 1998 while his popularity is still soaring. If not, then look for the trial run argument to emerge pushing the referendum off until 2002. Germany desperately needs Britain as a counter-balance against the new ultra-(far-out)-left in France. Kohl is using Tony Blair's personal career desires to be head of Europe and maybe its first President to entice the UK into EMU. After all, Tony cannot become head of the EC in 1998 if Britain is not in EMU.

These revelations are already starting to move and shake capital. The British economy is in serious danger of imploding. Britain attracted vast amounts of capital from the continent and around the world because it had the best of both – in the EC but out of the Euro. Over 2,000 companies from Germany alone opened offices in the UK as a hedge against the uncertainty of EMU. Japanese investment into

Europe was all attracted to the UK for the very same reasons in addition to the significant lower tax rates. If Mr. Blair is going to take Britain into the Euro, capital will flee Britain as it appears it is now starting to do since it has become public knowledge that Tony is looking at joining as early as 1999. Even our computer model now warns that a year-end closing BELOW $1.58 could signal a 10-year bear market is underway going into 2002-2003 before its completion.

What EMU is all about is something very basic. It is the last gasp for a dying system of socialism. Russia collapsed; China also was forced into a more capitalistic system. Europe must break the cord with socialism and adopt a true free market system. EMU is the last attempt to hold onto a system that has made Europe the worst economic growth center in the western world. Its unemployment on a good day is double that of the US on a bad day. Failing to simply set the economy free from the heavy-handed control of government will raise the risk of total collapse. Europe simply cannot maintain an inefficient economic system that continually amasses debt at the expense of the future. Unfunded social programs cannot be maintained. No government can force capital to buy its debt not even at the point of a gun. The lack of capital broke the back of Russia and China. In the end, EMU must embrace SERIOUS economic reforms that go beyond merely the monetary reform issues and into the realm of a fiscal union. Perhaps it will be the birth of the EMU that will finally reveal that fiscal responsibility is as important as monetary union.

EMU will NOT bring utopia to Europe. EMU will not bring a single interest rate across the continent. If each nation retains the right to issue its debt in Euros at will, the system will collapse as surely as it did in the United States pre-1792. When the US became a federalized body, each state gave up its monetary authority to Washington. The Constitution specifically prohibited the states from issuing money on their own and that power was given to the federal government. Can you image the US if each state had the authority to issue more dollars at will? Such a system collapsed before as surely EMU will collapse within Europe. Ironically, it may be the collapse of the EMU that finally leads to true economic reform throughout Europe. Either Europe federalizes and imposes uniformity or it collapses back into a confused state of tribal self-interests.

These very basic issues concerning Europe will continue to force capital to move short-term as confusion rises to the surface between those who simply believe in fairy tales and those who ask the hard questions. Volatility will continue to rise spreading from the FX markets into stocks and bonds as well. Speculators will prosper. Capital will suffer and pull away preferring to hoard its assets in an atmosphere of certainty. But the wage earner will endure the worst for it cannot place his labor offshore nor can he hoard his labor in fear of volatility, political uncertainty and devaluation. In that atmosphere, political change is born.

It is this very uncertainty over the Euro that is driving the dollar higher. The first casualty has been South East Asia where governments have tried to maintain a currency peg to the US dollar. But the dollar is being driven higher by a flight of international capital while Asia has been experiencing a net capital outflow. Asia fails to understand that the attack upon their currencies is nothing personal. It is merely that their currencies had become grossly overvalued given the US dollar’s rise due. The rising US dollar has destabilized the Asian markets due in part to EMU and threat of the Euro combined with an economic depression in Japan. This cocktail of international confusion and chaos is tearing the global economy apart causing capital to lack its very basic requirement – some sense of certainty. The end result is an explosion in volatility over the period just ahead turning the global economy upside-down and driving it to the brink of sheer and utter chaos.

We do not live in a world where capital can be forced to invest against its will. We do not live in a world where the marketplace can be artificially dictated to by politicians. While there will be a major thrust to insure that EMU and the Euro succeed, we must realize that if the Euro succeeds, then Europe may fail. The Euro will NOT erase all the sins of the world. It will not redeem mankind from the savages of speculation. It will not even transform politicians into benevolent saints. It could merely prove to be a Band-Aid when what Europe needs most is stitches to binds its deeply rooting historical wounds.