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When size sucks

"Sir, The mulish refusal of the EU negotiators to offer any kind of reciprocal compromises threatens to take us into Brexit extra time. But it occurs to me that it may simply be beyond them to do otherwise. Perhaps, conditioned by their legal systems, all more or less variants of the Napoleonic Code, Michel Barnier and his colleagues are simply unable to do more than recite rules; they may be quite incapable of searching for the right answer in the way of those brought up under the English Common Law. After all, the EU has consistently struggled to strike trade deals with other countries, most notably with those from the Anglosphere, who are blessed with a more supple Common Law heritage.

"An English lawyer put it to me this way. "In all my dealings with Europeans, I never once heard them ask if something was fair. Only whether it was correct."

"I fear that, in persisting with this whole process, we British may be wasting our time — and money."

- Gordon Bonnyman, Frant, E. Sussex, UK, in a letter to the *Financial Times*, 23 November 2017.

- You can listen to our latest 'State of the Markets' podcast with Paul Rodriguez here

(The following article was first published in *The Spectator* in March 2015.)

A couple of years ago, a bookseller sent me 'a little gem of a book', namely *The Making of the Euro* by Claudio Hils. This is a somewhat humourless coffee-table hardback which is only partially redeemed by one or two beautiful photographs of printing presses. It recounts the literal making of the euro, and it is all pure hubris. Take, for example, this introduction by Dr Jürgen Linden, lord mayor of the city of Aachen in Germany:

> The euro is being awarded the International Charlemagne Prize of Aachen for 2002. At first sight, this seems wholly inexplicable. A currency is to be awarded a prize intended to honour an individual's contribution to the unification of a continent? In actual fact — and this is something we have already noticed after only a few weeks — the unifying effects of the common currency in, for the time being, 12 countries have proved to be highly significant. The degree of acceptance of the euro has been surprisingly good wherever we look.

One doubts whether the euro will be up for many awards this year. Fears over a 'Grexit' seem to have distracted investors from the main event: the common currency is a deflationary neutron bomb slowly detonating across the economies of the eurozone. The euro is acting like an anti-Midas: whoever embraces it gets poorer.

All of this was forecastable. Among those who foresaw the threat of state gigantism in Europe was Leopold Kohr — an Austrian Jew who escaped Hitler's Germany just before the outbreak of the second world war. He was born in Oberndorf in central Austria, a village of just 2,000 souls, and Oberndorf's modest size would come to play a crucial role in his thinking. Kohr graduated in 1928 and went on to study at the London School of Economics alongside his fellow Austrian Friedrich von Hayek.

In September 1941 Kohr began writing his masterwork, *The Breakdown of Nations*. He argued that Europe, far from expanding, should be 'cantonised' back into the sort of small, autonomous regions that had existed in the past and still thrived in Switzerland, with a commitment to private property rights and local democracy. 'We have ridiculed the many little states,' wrote Kohr sadly. 'Now we are terrorised by their few successors.'

Kohr showed that there were natural limits to the growth of societies, and the complexity that becomes a feature of larger systems:

> Social problems have the unfortunate tendency to grow at a geometric ratio with the growth of an organism of which they are a part, while the ability of man to grow with them, if it can be extended at all, grows only at an arithmetic ratio.

As the European Union and its common currency bloc have grown ever larger, they have collided horribly with the logic of Kohr's thesis. Consider José Manuel Barroso's 2012 State of the Union address as President of the European Commission: 'Globalisation demands more European unity. More unity demands more integration. More integration demands more democracy.' But the words and concepts smeared together by Barroso have no real meaning beyond a perfunctory Orwellian doublespeak. Has an economically battered eurozone, beset by deflationary trauma throughout its periphery, really become more democratic since the launch of the single currency?

Another sceptic of the bulging state was the American physicist Professor Albert Bartlett, who died in 2013. He warned that the greatest failure of the human race was our inability to comprehend the power of the exponential function: how growth at a modest-looking but fixed percentage rate over time can lead to unimaginably huge escalation. He also warned that for any organism that reaches maturity, further growth equates to either obesity or cancer. The eurozone, according to this theory, is either bloated or diseased. It is clearly not healthy.

A debt-ridden world such as ours requires constant economic growth simply to service the debt. We have become addicted to growth. But we have also become addicted to debt. After the financial crisis, and the deepest recession since the second world war, expectations were high that the world's economies would pay down their debts. But as a recent study by the McKinsey Global Institute makes clear, nothing of the sort took place.

The very concept of austerity, so hated by the left, is mostly mythical. In fact, since 2007, global debt has grown by $57 trillion. (All figures relating to the size of accumulated government debts are eye-watering.) Far from contracting, global debt to GDP has risen by

17 per cent. If those debts were unpayable back in 2007, and they probably were, they are even more unpayable today.

This makes any analysis of the bond markets today frankly terrifying, because there are only three ways of dealing with a world clogged with too much debt. One is to generate sufficient economic growth to maintain debt service. In the eurozone, that prospect now looks wildly implausible. The second is to default. Since our global monetary system is based on debt, a default by any major player in the bond market will equate to Armageddon. The third and final option also happens to be the one to which desperate states have resorted throughout history. It is called inflation. The debt simply gets inflated away.

Conclusion: since the likely outcome for bond markets will be some combination of options two and three, choose your bond investments with extreme care. At the very least, check what your pension fund is exposed to. If it's bursting at the seams with UK government bonds offering pathetic yields, you may wish to diversify into other, higher-yielding assets.

And the eurozone finds itself in a pickle. The one thing that would ease the pressure on the periphery economies, beset by rising unemployment, stagnant growth and falling prices, is the one thing made impossible by membership of a currency union: competitive currency devaluation.

'Across Europe today economists are counting the movement of prices to clearing levels,' warns the financial historian and analyst Russell Napier —meaning not only the prices of some financial instruments and other assets, but also wage rates. 'What they obdurately refuse to count, or for that matter even to countenance, is the unwillingness of the peoples of Europe to surrender their sovereignty to a federal state as part of that process. That refusal is evidenced by the rise of Syriza, Podemos, Front National and others which make it clear that clearing prices within a federal state are not the future, whatever the numbers might say.'

Not only has the single currency forced a 'one size fits all' monetary policy — and now outright deflation — on the disparate states of the eurozone, it has also forced an increasingly disgruntled electorate into the arms of political extremists bearing dubious and dangerous promises of salvation from this process.

My bookseller friend bought the last remaining 200 copies of *The Making of the Euro* for one euro each. 'Not surprisingly it was remaindered,' he tells me,

> The difference is that books that don't sell find their way on to the remainder tables very quickly in the UK. In Europe it takes a little longer to own up to mistakes — especially state-sponsored ones.

Tim Price is co-manager of the VT Price Value Portfolio and author of 'Investing through the Looking Glass: a rational guide to irrational financial markets'. You can access a full archive of these weekly investment commentaries here.