

Quirks & Tips

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The Idea of Europe

“ ...market forces, not political majorities, will compel societies to reconfigure themselves... ”

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This week we return to Europe, as what is happening there is one of the most important questions of the day. It is every bit as critical to our long-term world economic future as the valuation of the Chinese currency or US trade deficits or Fed policy.

Let me set the stage with this note. I am not happy about and take no pleasure in what is happening in Europe. For a variety of reasons, I view it with some concern. A united Europe is simply better for the world at large, even recognizing the problems associated with unity. I recognize the polarities and difficulties. But I had always hoped (and still do), that somewhat like Massachusetts and Texas, or California and Alabama, a political union could emerge.

Even so, we cannot make investments based upon what we might wish the world to look like but upon what the facts are. And the facts suggest some problems. We will look at several of the more significant ones today.

The Idea of Europe

The United States, it is often said, is more of an idea than a place. It is an idea that has compelled millions of people from every nation to come and join in a grand experiment of human liberty and opportunity.

Europe, or at least the concept of a united Europe, is no less an idea. It is certainly not a country. Not yet, and maybe not ever. Composed of multiple countries with multiple languages and multiple currencies and a very diverse population who have many individual thoughts on what being European means, Europe is trying to find out what kind of an idea it is. Is it a continent with many countries or is it a country which spans a continent? And if it is a country, what will be the basic philosophies which drive it? What is the idea that will be Europe?

Let's start with a powerful quote from James Dale Davidson and Lord William Rees-Mogg in one of my all-time favorite books, *The Sovereign Individual*. You may want to read it twice, as it is quite profound. Remember that they presciently wrote it in 1997, but it is even more relevant today [emphasis mine]:

"In short, the future is likely to confound the expectations of those who have absorbed the civic myths of 20th-century industrial society. Among them are the illusions of social democracy that once thrilled and motivated the most gifted minds. They presuppose that societies evolve in whatever way governments wished them to - preferably in response to opinion polls of scrupulously counted votes. This was never as true as it seemed 50 years ago. Now it is an anachronism, as much an artifact of industrialism as a rusting smokestack. The civic myths reflect not only a mindset that sees society's problems as susceptible to engineering solutions; they also reflect a false confidence that resources and individuals will remain as vulnerable to political compulsion to the future as they have been in the 20th century. We doubt it. **Market forces, not political majorities, will compel societies to reconfigure themselves in ways that public opinion will neither comprehend nor welcome.**

"It will therefore be crucial that you see the world anew. That means looking from the outside in to reanalyze much that you have probably taken for granted. This will enable you to come to a new understanding. **If you fail to transcend conventional thinking at a time when conventional thinking is losing touch with reality, then you will be more likely to fall prey to an epidemic of disorientation that lies ahead.** Disorientation breeds mistakes that could threaten your business, your investments and your way of life."

There has been an idea among European intelligentsia for over 50 years that has been driving the unification movement. It was "... the illusions of social democracy that once thrilled and motivated the most gifted minds. They presuppose that societies evolve in whatever way governments wished them to." That idea is now on life support. Can a new idea emerge? Are Davidson and Rees-Mogg right? Will the realities of the markets, the realities of demographics and new technology and globalization force a new model? Or will Europe once again become a continent inhabited by a number of competing countries? **"Market forces, not political majorities, will compel societies to reconfigure themselves in ways that public opinion will neither comprehend nor welcome."**

The French Social Model?

Tony Blair and Jacques Chirac met a few weeks ago, and the conversations were, in diplomatic terms, frank. My friends at Bridport Investor Services (Lord Alex Bridport and Dr. Roy Damary), a monster bond house in Geneva and astute observer of all things European write:

"The stubbornness of European politicians in their deafness to the popular swell of anti-EU feeling is remarkable. The more they attempt to push ahead with referenda, the more the voters will revolt. Even Luxembourg might vote 'no!' The entire European project is now ready for a re-orientation: less centralization, more democracy, retained responsibility at national level, freedom of choice on the mix of social vs. free-market economy. It is obvious which opposing sides Blair and Chirac are on, but the wind is clearly in favor of the Blair vision.

"The 'All is well in la Belle France' of Villepin and Chirac can only survive so long. The role of Sarkozy is crucial. He is playing the game of pretending to agree with Villepin and saying that the 'acquis sociaux' [social entitlements - John] are to be protected, but the details of his comments point in a different direction (see <http://sarkozyblog.free.fr>). Our guess is that Sarkozy is more of a Gorbechev than a Thatcher. Rather than making a frontal attack, he will seek reform in France (taming of the public sector unions, proper pension financing, a return of the work ethic, etc.) by using the language of the old guard. For France's sake and Europe's, we hope so."

I hope Alex and Roy are right. But if and when Sarkozy and/or his successors decide to confront French unions and the entitlements, it is not going to be pretty. To get an idea of what they will be facing, let's look at just the unions representing the French National Electric Company. There, the workers have negotiated a fantastic deal for themselves over the years. As if guaranteed lifetime employment and a 90% discount on their electric bills weren't enough, EDF contributes 1% of their revenue into a "social benefits council" which uses its half-billion dollar budget, vacations and other perks to control the 110,000 employees of EDF and apparently to support the Communist Party. Here's what the union members get:

- Guaranteed lifetime employment. This means that if your job goes away, you still go to work and do nothing and get paid. There are 5,000 people in this state, known as being "in the closet." Imagine 5% of your workforce being paid to do nothing.
- 90% discount on power bills
- Free health care
- Subsidized meals, housing, vacations, and cultural events.
- Option to work 32 hours per week for a 9% pay cut
- Retire with a pension up to 75% of what you made in the last year you worked.
- Early retirement

Those clever guys at Gave-Kal did a study a few years ago, and updated it last week. They first give us the economic rationales or criteria of a communist economic model. Then, they write:

"If we decide to apply the criteria outlined above to the French economy, we discover pretty quickly that quite a few sectors are operating partly or totally according to those rules. As we look at it, the French communist sectors are:

- The health system (hospitals, social security, pensions, etc...).
- The educational system.
- The public transportation system.
- General & Local Administrations.
- Energy & Waste Management.
- The postal system.
- The telecom system."

Then they show a graph which depicts the growth of the communist sectors versus the various capitalist sectors. What you find is:

"The first fact to emerge is that, **since 1978, the French communist economy has grown far more than the capitalist one.** On average, the communist sectors have grown by 2.8% per annum while the private sector has grown by 0.8% per annum."

That means the communist economy in France is slowly sucking the life blood out of the producing sectors. This process is confronting the demographics we discussed a few weeks ago. The two are headed for a collision, as the economic burdens of the promised benefits grow ever greater and the ability of a shrinking population and economy to pay for the benefits increases.

The unions are aggressive. The French government wanted to privatize just 50% of the electric company (EDF). Knowing that would eventually mean someone would actually be running a company for a profit and it would mean the loss of jobs and privilege, the unions went ballistic. They cut off the power to the prime minister's house and other such goings on. They got the government to back down. There are no

Thatchers or Reagans yet in France (although Bridport hopefully points to Sarkozy) to confront the unions, though they will one day have to show up, or the country will continue to slowly fade. I would add to Gave-Kal's list mentioned above the socialized agriculture of France. That, too, will have to go. (See more below.)

(In fairness, US subsidies to agriculture are just as political and just as costly, and they, too, will have to go when we confront our own future budget crises brought about by the promised benefits of Social Security and Medicare and an inability to pay for them without much higher taxes. Won't the future be fun?)

"Until then," Gave-Kal writes, "however, we are stuck with what Mr. Chirac calls "the French Social Model" (which is opposed to the despised Anglo-Saxon model). Although as Patrick Devedjian (an ex-government minister close to Sarkozy) put it: "the French model is not a model, since no-one wants to imitate it, it is not social since it leads to record unemployment and it is not French since it is founded on class struggle and a refusal of democracy"! He went on to add: "ask yourselves why the CGT, the communist party, [doesn't] want to see the model changed? Because it is their model! They are the authors of the so-called compromises, passed under the threat of strikes". The coming months in France will be hot!

"For the first time ever, more than one million French citizens are living abroad. The countries where Frenchmen have moved to in hordes (US, UK, Switzerland, Asia...) are indicative of what they are looking for. The new entrepreneurs are moving to the Anglo-Saxon world, to be able to create. The old entrepreneurs, who have been successful, are moving to Switzerland, to avoid the punitive French tax rates."

Young French entrepreneurs and those with ambition will increasingly vote with their feet. Typically quite well-educated, multi-lingual and capable of dealing in multiple cultures, they will seize the opportunity. This will of course, make it even more difficult for France to find the growth they need to pay for their promised expenses.

I should note this is a problem all over Europe. Young creative types are moving to places where there is more opportunity. My English partner (Absolute Return Partners in London) is an investment firm primarily composed of Scandinavians, they speak multiple languages fluently and are at home in a cosmopolitan Europe. Many others are going to Eastern Europe, where taxes and constricting rules are fewer and opportunities are greater. Ah, it is a brave new world.

Many see the potential for a political union as dead. I agree that it is quite unlikely, but let me outline some of the pressures, both good and bad, which might make a union possible, though one which will be different than envisioned only a few months ago.

The Possibility of German Reform?

Gerhard Schroeder in Germany has essentially thrown in the towel on trying to get reform through his own party. What meager reforms he has gotten has been with opposition support. The German economy is on the verge of recession (with 10% unemployment) and his own supporters are upset with him because he urges reform which means his base will have to cover their share of the cost. But his version is reform-lite.

He has called for elections this fall, essentially asking his own party to give him a vote of no confidence. The polls suggest it is quite possible that the conservative Christian Democratic Union (CDU) could win an

outright majority. They would have three years to put reforms in place and hopefully see them make a difference in the economy. The CDU would move Germany to a more free market model.

In the beginning, this would almost surely mean higher unemployment. But it might also force the European Central Bank to actually cut interest rates. Germany is the true linchpin of the European Union. The ECB would be forced, I think, to support a Germany that was making an effort to reform its economy.

However, the far more astute team at Stratfor has a less sanguine view (quoting from their June 2005 Global Perspective):

"The European Central Bank is focused on the needs of the three major economies - Germany, France and Italy. The rest of Europe is not only ignored, but is directly harmed by the inability of Germany and France in particular to impose economic discipline on themselves.

"It is now clear that economic discipline will not be coming anytime soon. Therefore, France and Germany will continue to drag down the rest of the eurozone. And so, for the first time, respectable voices - i.e., those deemed respectable by the European elite - are raising serious questions about the future of the euro. The issue is not really so much the future of the currency as the fact that, in May, the euro's future became a reasonable topic of conversation.

"As of May 2005, there is no Europe. There is France, Germany, Hungary, Ireland and so on. As sovereign countries, they have entered into a series of important economic agreements. But none of these countries have abandoned their sovereignty. Decisions on war and peace or lesser foreign policy issues remain in their hands, not in those of Brussels. It is unlikely that any broad consensus on any of these issues will be reached by all of Europe, and anyone basing their policies on what "Europe" will do will be as misguided as those basing policies on what "Asia" will do. These are geographic and to some extent cultural expressions. The idea of Europe has no geopolitical meaning."

The British Are Coming!

This time it is not the citizens of Boston but of Paris that are upset with the British. When the European Economic Union was formed the French negotiated significant agricultural subsidies for France called the EU Common Agricultural Policy or CAP. Margaret Thatcher dug her heels in and demanded a rebate of English taxes to equalize the CAP subsidies going to France. Chirac recently stated that it is time for England to give up her rebates. That rebate is currently around E4.6 billion (or \$5.7 billion). Blair is quite adamant that this is not something for the British to give up (quote): "...if people want a reconsideration of the rebate there has to be a reconsideration of the reasons for the rebate. This is not some special thing that has been given as a special privilege to Britain. This is a mechanism of correction for something that would otherwise be grossly unfair." (from the Gartman Letter)

"British Prime Minister Tony Blair said, 'We are prepared ... to recognize that the rebate is an anomaly that has to go, but it has to be in the context of the other anomaly being changed as well.'" (Stratfor)

What "anomaly" is he talking about? The extra French CAP subsidies. That is why the latest talks between Blair and Chirac were "frank." Chirac cannot be seen as giving in to the Anglo-Saxons on anything, especially something as important to France as agricultural subsidies.

Blair has now upped the ante by suggesting that the whole CAP program be scrapped. Listen to what his finance minister, Gordon Brown, (and possibly the next Prime Minister after Blair) said (quoting again from The Gartman Letter, in Dennis's own inimical style):

"In other words, but in rather more dignified language, Mr. Blair has just said "ugger off" and made it quite clear that even with the rebates as they are presently the UK is a larger net contributor of tax revenues to Brussels than is France, and is second only to Germany. Further, last evening, the Chancellor of the Exchequer, Mr. Brown, jumped directly into the debate when he took on the debate over the budget and the problems with the rebate due the UK and the Common Agricultural Policy. Mr. Brown said, rather sternly it appears, that the majority of any proposed pan-European budget should be spent on science and training instead of, as is the case presently, 55% being spent on agriculture and/or subsidies for the richest countries. To mollify France somewhat Mr. Brown said that a 'modern social dimension' should be incumbent in the budget, but that was left purposely vague and seemed like rhetoric rather than reality.

"Then Mr. Brown really got into the meat of his subject, taking on Europe's proposed role in a modern, global-trading world. He said "Our task . . . is to move Europe from the old trade-bloc Europe to the new global Europe... [and] we do so under the banner of pro-European realism where Europe looks outward to the world, where Europe sees the US as partners not rivals, where Europe becomes more competitive, more enterprising.' We hope that Mr. Brown's vision can succeed, but thus far we and the markets have our very serious doubts."

France receives about one quarter of the CAP subsidies, with nowhere near that percentage of farmers. Most of "New Europe" gets almost nothing. The CAP does not mean all that much to Germany. Indeed, the German opposition leader, Wolfgang Erhardt, has spoken favorably of reform. And it is quite possible that under a conservative government Erhardt could be the foreign minister.

We are not talking about small sums here. The CAP is E55 billion (or around \$65 billion). There are calls from other European quarters to see that money directed to programs that would enhance Europe's markets and technological capabilities.

Let's go back to a portion of the original quote from James Dale Davidson and Lord William Rees-Mogg:

"In short, the future is likely to confound the expectations of those who have absorbed the civic myths of 20th-century industrial society. Among them are the illusions of social democracy that once thrilled and motivated the most gifted minds....**Market forces, not political majorities, will compel societies to reconfigure themselves in ways that public opinion will neither comprehend nor welcome. As they do, the naive view that history is what people wish it to be will prove wildly misleading.**"

The European intelligentsia has 50 years invested in the idea of a United Europe. They will not easily give up on that dream, which has seen more than a few setbacks, although admittedly none as severe as the recent ones. Could a Blair and a more conservative Germany in concert with many other "New" European nations develop a Union with a more "Anglo-Saxon" economic model at its base? When confronted with a fait accompli, could a Sarkozy led France get a few concessions so he can sell it at home?

Would the intelligentsia, who are almost viscerally opposed to such an idea, go along with it in order to get their #1 objective, a Unified Europe? My bet is they will, rather than lose their dream. If they do in fact get it, they will immediately work to make changes, but that is another battle for another day.

Their old vision is now dead. Only a new vision based upon real reforms can have a hope to succeed. If you ask me to bet, I think in the end Stratfor is right. There is no longer a Europe. For there to be a Union, a New Idea will have to emerge. **"Market forces, not political majorities, will compel societies to reconfigure themselves in ways that public opinion will neither comprehend nor welcome."**

The idea of Europe is on the bonfire. Will we see a phoenix of a New European Idea arise from the flames, or just find the cold, gray ashes of socialism in the morning? All of this will happen in slow motion. I see no cataclysmic event. It will indeed be a Muddle Through World in Europe as they will be forced to make the difficult adjustments to their systems because of the economic reality of the market.

Austin, Paris, London and moving!

I finish this week's letter on Thursday night, as tomorrow I drive with seven kids and a daughter-in-law to Austin to spend the weekend at Gary and Debi Halbert's home on Lake Travis. Great food (Gary's department), fantastic wines (my department), jet skis, lake swimming, lots of laughter, late night conversations and the best of times with family and great friends. Life doesn't get much better. I feel so good I may even break down and buy a French Bordeaux, just to show my solidarity with the French. We all do what we can.

My family has been going to Gary's every summer for more than a decade, and it is one of my (our) best family memories, except for that skiing accident. Gary is Mr. Ski Jock, and was convinced he could get this klutz up on skis. After falling a time or two, I was determined to get up and so put a white-knuckle death grip on the ski rope handle. I was not going to let go. Bad idea. I fell backward and my legs went over the handle, jack-knifing me with the rope between my leg and my knees around my head. When the ski ropes gets tangled between your legs as you go down it can be painful! I couldn't wear anything remotely tight for a week.

The rope drug me fairly deep into the water, because when Gary turned the boat around to pick me up, my life jacket shot up about ten feet out of the water like a Polaris missile. The force of being dragged deep through the water pulled it off. I (finally) floated to the surface and Gary and friend lifted me into the boat. I checked and found no missing, only somewhat worse for the wear, important body parts. But I did walk funny for a week or so.

Speaking of Europe, I will be taking the family to Paris, then on to Bill Bonner's chateau at Ouzilly in southern France and then on to London. My London based partners will be arranging a small get together for clients and those who are interested. Alas, my accountant says that will not make the whole trip a write-off.

It is going to be a very busy week, but it's a good time to be alive. I hope you are having half the fun I am.

Your can't believe he is having so much fun when he is so far behind analyst,



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