The end of an empire

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Economic growth derives from one of two sources. Either it comes from a rationalisation of talent, which we call Ricardian growth, or it comes from new inventions, which we call Schumpeterian growth. Of the two, Ricardian growth is easier to achieve. As barriers to trade, to the movement of people, or to the free flow of capital are dismantled, inefficiencies get squeezed out and growth can soar. Bearing this in mind, it is obvious that the primary engine of growth across Europe over the past few decades has been the constant drive towards unification. In fact, we would go as far as to argue that between 1980 and 2010, one of the most prominent macro-trends globally was the incessant growth of what we came to call the "European Empire". This search for empire took on many forms, from territorial expansion (mostly into Eastern Europe following the fall of the Berlin Wall), through efforts to establish common regulations for the telecom, financial, healthcare industries and other sectors, to the desire to forge an ever closer political union.

But building an empire is a costly business, which is why imperial projects always need their own currencies - no empire was ever built on someone else's dime. The dream of European Empire therefore gave birth to the economic fallacy of the euro. As long as the European Empire remained in expansion mode, the euro itself - even though loaded with internal contradictions - was a structurally strong currency. As each new country was absorbed into the Empire, more companies needed euros for working capital, more individuals saved in euros, and more central banks padded their reserves with the common currency.

For 30 years, the structural trend was towards increasing European integration, with Ricardian growth as a consequence.

It is now obvious, however, that the best the European Empire can hope for is to stall at its present borders. And even that seems to be beyond the capacity of Europe's current leaders. Consider the following:

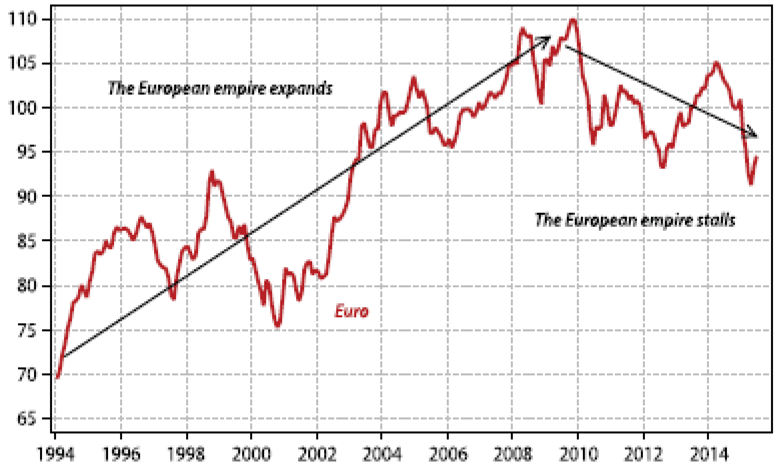
- **Territory** - If nothing else, the Ukraine conflict demonstrates that Russia has drawn a clear line beyond which it will not allow the European Empire to expand. In the absence of a political implosion in Russia, it is hard to see where Europe can expand territorially from here. Iceland? Not much of a prize (and the Icelanders have cooled to the idea). Turkey? With civil wars and ISIS on its borders, hardly a compelling proposition.
- **Politics** - The challenge of every empire has always been to keep its political institutions flexible enough to adapt to different cultures, yet solid enough to create a genuine union. The Greek debacle proves that Europe's leaders have failed this test.

Worse, a number of European leaders (Schauble, possibly Merkel, even Juncker?) now seem keener to embrace a Gaullist-style decolonisation process, getting rid of awkward imperial possessions as quickly as possible, than to adopt genuine political reforms in order to cure the Empire's peripheral ills.

- **Borders** - Surely the saddest sight in Europe this year has been the tens of thousands of African and Arab migrants risking their lives to reach the Empire's shores. Almost as sad has been the inability of European governments to agree a common policy to deal with this humanitarian tragedy. Instead, France and Austria have re-instated their borders with Italy and are refusing passage to dark-skinned individuals without papers, in contravention of the Schengen Agreement.
- **Vision** - Beneath the Greek, Ukraine, and Mediterranean refugee crises, the real problem undermining the foundations of the European project is the differing visions of what the European Empire should look like. No two nations offer similar visions - from the UK threatening Brexit, to the Germans who see in the EU the promise of European peace, to Poland which sees a guarantee against Russian interference. Even within nations, the idea of a European Empire is losing its appeal, as shown by the rise of the Dansk Folkeparti, the French Front National, the Five Star movement and the Northern League in Italy, UKIP, Podemos and others. There is no European leader strong enough, or inspiring enough, to unite his own country, let alone the broader continent, around a single binding vision.

So looking past all the debate about the sustainability of Greece's debt, and the consequences for global markets of another potential Lehman moment, perhaps we should simply acknowledge the Greek crisis for what it is - the death-knell for the European dream of empire. The growing European reality is the return of borders, of national preferences, and of opt-outs. At best, the European Empire has stalled. At worst, it will start to shrink in a way that will jeopardise Ricardian growth across the continent. All else being equal, this will mean slower growth in the use of the euro, which now has surely become a structurally weak currency (Figure 1). In the long run, people do not like to save in the structurally weak currency of a shrinking empire, a reality which means that European bonds are likely to underperform those of other, nonshrinking, empires - the US and China - for the foreseeable future.

Figure 1: Decline and fall?
BIS nominal effective exchange rate broad index



Sources: Gavekal data/Macrobond

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