The Other Side October 11, 2012

U.K. in Europe – or the 51st state?

I happened to be in London last month at the time of the 20th anniversary of the pound's humiliating exit from the exchange rate mechanism of the European Monetary System (which later evolved into a single currency). While reading the local papers, one got an impression that there was some not-to-well hidden glee at the problems of the euro zone. In their turn, many in Europe are blaming Anglo-Saxon finance capitalism for their woes. There are, of course, many other areas of friction between Britain and the rest of Europe:

⇒ Banking regulation. Britain is opposed to the European Banking Authority regulating all the banks in the European Union. It would veto any such idea in order to "*Save the City*" of London. (When The Economist published a cover story with that title, January 7, 2012, there was scathing criticism even from British readers of the magazine. One specimen: "*Yes, the City did once fulfill the function of efficiently allocating capital, but that stopped some ten to 20 years ago when the 'zero sum' game of financial speculation for the self-enrichment of the participants took over …. It has become a gigantic skimming machine/casino."*)

⇒ If austerity has been forced on some countries in the euro zone, as a condition of rescue, U.K. has adopted it voluntarily, and is facing a second recession. The fiscal deficit is likely to be more than budgeted and more social services are expected to be cut. Could Britain face years of stagnation like Japan – another great island nation close to a large continent?

⇒ There is pressure on the Prime Minister to veto the proposed BAE–EADS merger which would create an aerospace giant to compete with Boeing, because it will have more French/German influence.

⇒ Britain would like to restrict immigration rights within the EU.

The big question of course is whether Britain will continue to enjoy the "special relationship" with the U.S. if it loses influence in Europe. Culturally and ideologically is

Britain more comfortable as the 51st state of the U.S. of America than as a European nation?

But to come back to the continuing problems in the euro zone, the current flash points are whether Greece will get the next tranche of the loan before it runs out of money in November, and whether Spain will get the money to recapitalise its banks without the funding becoming a sovereign obligation. Greece is caught in a vicious circle – fiscal austerity leading to cuts in salaries and pensions, social services etc.; leading to continuing drops in economic output (23% in the last few years); the deficit target not being met; and hence demands for further austerity.

As for Spain, apart from sharp increase in unemployment and drop in economic activity thanks to austerity, its big problem is Germany. At one time it was thought that an agreement had been reached that the bank recapitalization funds would not be part of Spain's sovereign obligations. Germany, while agreeing in principle to a banking union within euro zone, has now taken a stand that recapitalization for "legacy assets" will have to be part of the sovereign obligations. Spain has other domestic political problems like greater regional autonomy as well. And, Greece, Spain and Portugal all continue to suffer severe social unrest, as strikes, riots and street demonstrations continue; and, withdrawal of deposits from domestic banks, is a clear indicator of capital flight, as "family silver" in the form of public assets continue to be sold. The "vulture funds" (private equity and hedge funds) are salivating.

In a way it is strange that Germany, with less than a century of nationhood (Bismarck unified the country only in 1871 and, more recently, east and west Germany were different countries from 1945 to 1990) should have veto power in the euro zone. As Jeremy Warner commented in The Daily Telegraph (September 13), "*Europe's problem with the single currency is but a reflection of a much deeper and older fault line at the heart of this troubled continent: Germany is both too big and economically dominant to be easily contained, but too small, tainted by history and politically alien, to be trusted with the controls.*"

The euro will survive – the real question is whether the euro zone will, even after last Monday's agreement on the European Stability Mechanism (successor to the European Financial Stability Facility) of € 500 bn, backed by a small called up, and a much larger uncalled capital, contributed by all the members. At some stage, will the weaker members, Greece in particular, find the political and social costs of austerity unbearable and prefer a messy exit? And, they may well find life post-euro far better. After all, the euro imposes all the rigidities of the Gold Standard and Britain's disastrous restoration of the prewar parity in 1925. It was forced to abandon it in 1931 – and that gave policy makers a lot more freedom, leading to economic recovery. Greece may well experience the same after exiting the euro – and become the zone's envy!

A.V.Rajwade
Email: avrajwade@gmail.com