SUPPLEMENT

The Collapse of the European Union

Overview

The EU currently faces so many crises–financial, political, and social–that it's difficult to identify any single problem that will serve to catalyze its ultimate demise. The current crisis du jour is the vast flood of immigrants arriving at its borders daily. This comes on top of the shaky banking structure that is resistant both to bail-outs and bail-ins, as well as the growing public distrust of the EU's political institutions. Taken together, this is a perfect storm of crises that will almost surely lead to a vastly changed EU over the next few years, if not its total unraveling. Here we examine the paths this collapse might take, using the tools of social mood and complexity overload presented in the White Paper as a case study of how to develop the X-Events Index for this event.

Social Mood and the EU

As discussed in the White Paper for this study, the simplest "sociometer" for measuring social mood is the stock market averages in the region under investigation. For the EU, the right index for this job is the Eurostoxx50, which averages the fifty largest corporations in Europe. Figure 1 below shows the index for the period 1987-2011. On the chart we see that "nice" things tended to take place when the social mood was positive, while rather less nice events were biased to occur when the mood was negative. Figure 2 zooms-in on the period 1998-2013 and shows that during this "bailout" period the current financial crisis in the EU started taking off. Since 2013, the Index has broken under 2700 twice and at the time of writing stood just over 2900. So in the past two years, the general trend is down and no one expects it to go anywhere other than further down over the coming year or two or three. In short, the social mood in Europe is negative and moving downward along with the Eurostoxx50 index.

The provisional conclusion we can draw from this trend is that the social mood favors collective events (like political economic trends) to unfold as they did in 2002 and during the Bailout era. In fact, it's likely that the Bailout era is still far from finished. A perusal of the headlines today confirms this general feeling, as the dominant themes focus on the downside of all the various crises noted above. So while these downbeat events are not guaranteed to take place over the next few years, it's definitely the way to bet.

Further confirmation of this forecast comes from the recent developments surrounding the UK "Brexit" referendum, which is definitely a negative social mood event for the EU.

Figure 1. The Eurostoxx50 Index, 1987-2011

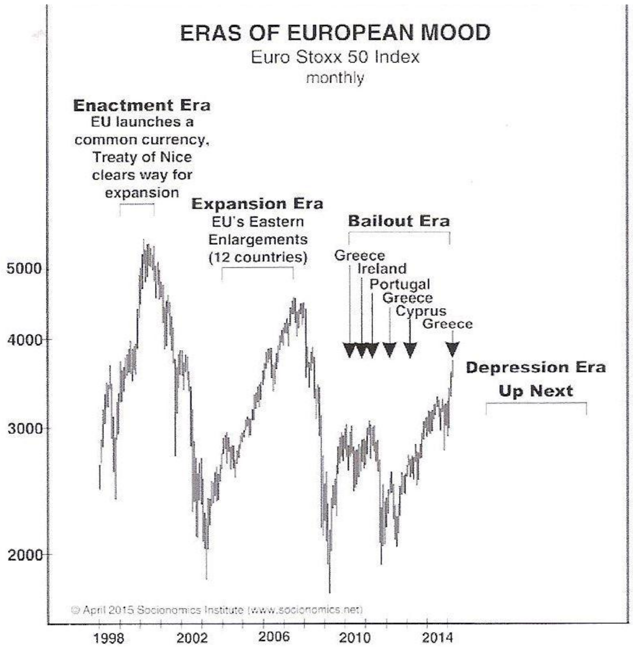

Figure 2. End of the EU Era

All of the major crises mentioned earlier–financial, political, social–are typical of the sort of things we can expect to see when people of Europe are fearing the future. What would move things in the opposite direction?

Basically, what happened around 2000 was that the positive mood that had been in place since about 1987 ended and the mood started moving into the long-term downward cycle that we are still in today. This change of trend is what we would term an X-event, a shift from one mood polarity to its opposite. Since this is a very long cycle, one measured in a decade or more, the shift doesn't happen overnight but takes years to unfold. And it has not ended yet. So for the next few years it's pretty safe to say Europeans will see further polarization in politics, further retreat behind national borders with respect to immigration and a continuation of the financial crisis among the member states.

How will these trends manifest themselves in specific events? This is really impossible to say since as we saw earlier in the White Paper specific events depend on the random trigger that sets them off. But we can offer a few speculations.

The negative mood of the population could easily manifest itself by other EU member states following England's lead and holding referendums about their membership in the EU. We may also see greater activity among independence movements, with areas like Catalonia and the Basque regions in Spain, along with the Corsicans in France and the French and Flemish halves in Belgium all moving toward some form of independence. In short, the trend will be toward events that would be labeled "rejecting" and "localizing", rather than "welcoming" and "globalizing", exactly what the mandarins in Brussels least want. But, in fact, it doesn't matter what they want; what counts today is what the disaffected populations in the EU countries want and that is a lot less Brussels and a lot more local control over their finances and their lives.

Now let's turn to consideration of the complexity gaps generating the EU crises.

Complexity Gaps and the EU

The simplest way to see the complexities that are undoing the EU is to consider each of the three major crises from the standpoint of the two systems driving the crisis and their respective complexities. Along the way, we will note also the ultimate resolution of the complexity mismatch if the competing systems do not voluntarily reduce the complexity gap by negotiation and compromise.

Economic Crisis: Think of the Eurozone member countries as a system in interaction with the rest of the global economy. If the countries were not in the Eurozone, they would have many options at their disposal to address changing economic times. They could, for instance, manage the supply of their own currencies, raise or lower interest rates, impose trade tariffs and the like. In short, they would have high complexity as measured by the degrees of economic freedom they have at their disposal to act. This level of complexity would then be more or less at the same level as that of non-Eurozone economic powers.

Instead the complexity level of the Eurozone countries is severely constrained, since no country can act unilaterally but must act in unison as per the dictates of the European Central Bank. So a complexity gap arises between a high-complexity system (the world) and a low-complexity one (the Eurozone member states). Loans from the wealthier Eurozone countries and efforts by the ECB to bridge this complexity gap will almost surely end up falling into the category labeled "good money after bad," leading to human nature's default solution for such a problem, which in this case will be the X-event of a collapse of the Euro. Here it's no pun to call it a "default" solution.

Could the complexity gap have been bridged without a collapse of the Euro? Maybe. But only if the EU had taken a politically unpopular, but necessary, short-term "hit" when the debt crisis first arose instead of trying to buy their way out of a problem that money cannot solve. For example, implementing much more stringent regulatory procedures for vetting the finances of candidate member countries, or even slowing down the entire process for admission of new members, would have been painful and unpopular in the short-run, but would certainly have helped prevent the current crisis. Presumably, this "the faster, the better" policy was put in place to try to make the EU as big as possible as quickly as possible so that it would be "too big to fail." What an irony! That policy is now looking a lot more like The Problem than any kind of solution.

Even the policy of rapid expansion might have worked if it had been accompanied by the recognition that "one-size-fits-all" financial policies, while looking good in principle, almost always fail miserably in practice. Different cultures call for different approaches to almost everything, and to imagine that financial policies that work for a country like Germany could/should apply equally well to a country such as Greece or Portugal is only to invite a disaster.

Of course, it's much too late in the day for actions of this sort now. The graveyard of history is littered with the corpses of ideologies that crashed into the brick wall of reality. The big question at the moment is whether the EU itself will end up in that graveyard of experiments in social engineering, an experiment that had to be done, but which seems likely now to be seen ultimately as a kind of noble failure.

Political Crisis: The Brexit referendum in June 2016 offers a perfect example of the complexity gap that is emerging in almost every EU country. The Brexit case is a struggle between a national political system anchored in a parliamentary supremacy, and a supra-national technocracy in Brussels that requires pooling of national sovereignty so as to achieve a European federal union. Basically, the British voting public was the low complexity system in this dance, seeing Brussels as becoming ever more complex over the past couple of decades.

Now scale down the nation-Brussels struggle to the country level, and we find again the same mismatch. Voters in virtually every EU country have lost faith in their politicians, seeing the national government as a local Brussels surrogate. So again, the national government is the high complexity system, the populace being the low complexity component. That low complexity shows up in a movement from centrist politicians and the status quo to fringe candidates, populists, the far right and far left, all of whom promise a return to a simpler, more leisurely bygone era. In particular, all of these different parties that have gained power are Eurosceptics, leading to the forecast of big trouble in maintaining an overall European federal union. A strong indicator of this move to the periphery politically-speaking can be seen in the huge increase in unemployment during the last fifteen years, especially in the southern countries of the EU. Figure 3 shows this movement.

Now let's consider the question of social complexity within the framework of the current immigration crisis in Europe.

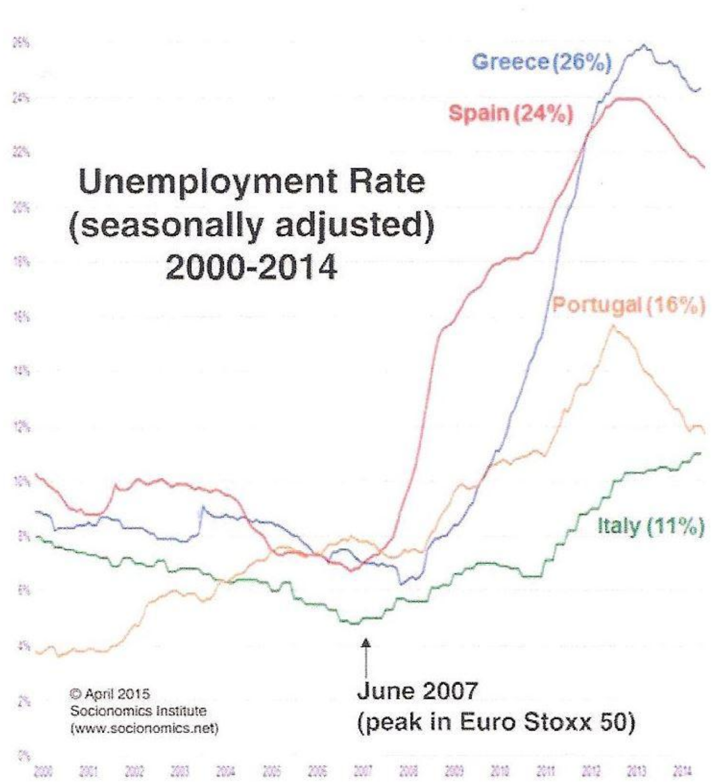

Figure 3. EU Unemployment in Southern EU Countries

Social Crisis: The dominant social crisis in Europe today is how to handle the massive influx of immigrants and refugees arriving on the EU doorstep every single day. In 2015 alone, over 1.3 million appeared asking to settle in the EU from the Middle East, South Asia and Africa. This compares with 280,000 immigrants in 2014 and does not count those who got into the EU undetected. The countries most affected on a per capita basis are Hungary, Sweden and Austria, while the least were Croatia, Slovakia and Romania. The overall EU average was 260 immigrants per 100,000 population.

The initial EU response was confused and passive. There were really no administrative tools to deal with this massive increase in the flow of people, and so the EU countries began arguing with each other about how to handle it while the migrants and smugglers continued their actions. This all reflects the fact that the EU is now facing the consequences of its failure to put in place a coherent, comprehensive migration strategy at the time of the establishment of the Schengen free-travel zone.

Looking at this situation from the complexity gap point of view, we can cast it as the interaction of two very different systems: The EU and the migrants. At present the EU has very low complexity as it can take very few actions, basically either take the migrants in or try to close the borders. On the other hand, the migrants can in principle knock on the door of any one of the 28 EU member states. This is a huge gap that is creating enormous tension between the two systems, a stress that has already shown itself in the numerous cases of violence in Munich, Nice, and other major cities throughout the EU. To get an idea of how the migrant crisis has changed Europe, the map below in Figure 4 shows the share of immigrants in each EU country as a percentage change from 2015 to 2016.

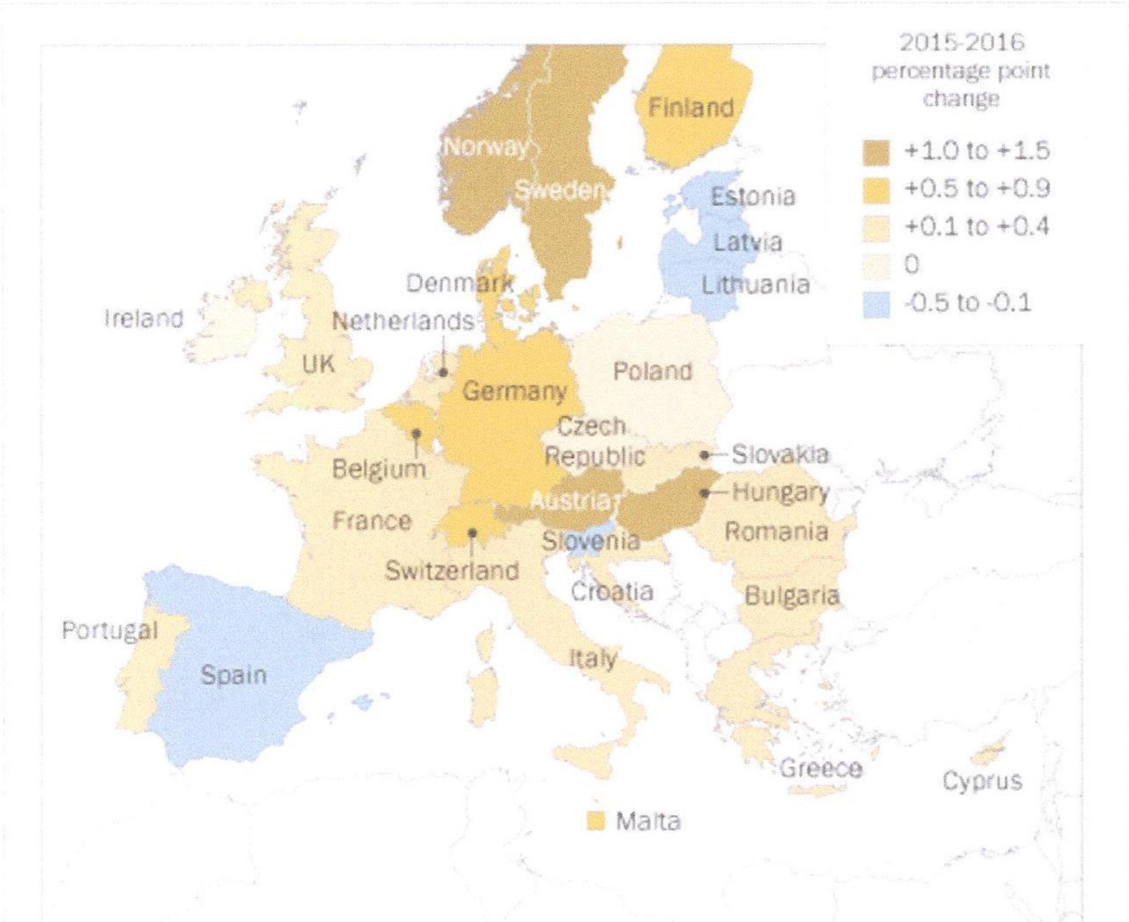

Figure 4. Population Change in EU as Percentage of Migrants, 2015-2016

At this point one might ask, What can be done? Brunson McKinley, former Director General of the International Organization for Migration notes that as the flow of migrants slows in the upcoming winter, the EU needs to use this period of reduced flow to begin working on many different fronts to manage this crisis. Diplomatic efforts to end the war in Syria is high on this list, as is reinforcing the maritime borders of the frontline EU states. But most importantly, the EU needs to undertake the construction of a comprehensive, coordinated migration policy taking into account economic, humanitarian security and political factors. This means that new EU institutions will have to be created to manage the migration, which will entail transfer of sovereignty from individual EU states. Needless to say, this is a development that many states will resist. The point here is that solving this social crisis involves raising migration to a foreign policy matter, not leaving it solely as an issue for law enforcement agencies.

Will that actually occur? Right now it's anybody's guess. But the history books are not optimistic. If the books are correct, then the EU as we know it today will surely implode. To complete this short survey of the travails the EU is facing, let's look at a few scenarios for the end of the Eurozone.

Possible Eurozone Endgames

In times like today, many pundits argue that the future of the Eurozone rests primarily with its strongest member states, Germany and, to a lesser degree, France. The most likely way the Eurozone could fall would be if Germany saw the collapse of the Eurozone as being in its best interests. In short, the fundamental question is whether Germany would gain more by remaining in the Eurozone and, in essence, bankrolling it, or would Germany's interest be best served by leaving? There are at least three major scenarios that might play out if Germany decided for the latter course of action by leaving the Eurozone. Each one of these paths constitutes its own special type of X-event.

***Total Collapse*:** In this future, the Eurozone would revert back to what it was before the euro was introduced. This would require the European Central Bank to return its gold to member states of the Eurozone in proportion to their initial contribution. The myriad former national currencies—deutsche mark, lire, franc, Finn mark, and others—would be brought back to life and cross-values set to their levels at the time the euro was introduced.

In this scenario, the US dollar reserves built by the states will replace their euro reserves. Confidence in almost all currencies would disappear, as people and countries would desperately seek hard assets like gold. It's safe to say that currency markets would be chaotic, probably with a strong initial move into the US dollar—but only until the smoke cleared away and business returned to something approximating normalcy.

***Partial Collapse*:** It's more likely that the Eurozone will not totally collapse, at least initially, but will simply shrink by kicking out weak member countries from southern Europe. These southern countries—Spain, Greece, Portugal, Italy—would have to go back to their original currencies, which would take place in conjunction with imposition of currency controls to prevent flight capital from moving to the still-extant euro.

The outcast countries would suffer years of poverty, but maybe not worse than what they will suffer by remaining in the Eurozone. The "new euro" would suddenly become the currency du jour, as the indebtedness of the remaining Eurozone countries would decline dramatically.

***Unilateral Withdrawal*:** This is an extreme scenario in which the strongest member of the Eurozone decides it's had enough and sees that its national interest rests in flying solo. If this were to happen, the euro would be devastated to the advantage of the US dollar, which would remain the global reserve currency—but still fall slowly against other major currencies like the Japanese yen and Chinese yuan.

These sorts of scenarios can be put together for all three major crises the EU faces today. But we hasten to point out that the most common image of a failing Europe is that of something falling apart, unraveling, crumbling away or even evaporating into thin air. This picture is very misleading. While the EU itself may cease to count as an institution of global importance, like the League of Nations, some of the EU institutions will go on, probably surviving in a state of atrophy.

As noted by the policy analysts John Gillingham and Marian Tupy, "In this reduced state of importance, we are likely to see the international responsibilities taken on by the EU to be given over to other international organizations like the WTO, WHO and others.

Secondly, a post-EU settlement will most likely require large-scale diplomatic efforts like the one in San Francisco setting up the UN and the one in Bretton Woods that created the framework for the post-World War II international monetary system. Such a gathering may well be very helpful to global cooperation. So even while there is a lot of bad news for the EU, that news may well lead to good news for the world as a whole."

So there is no compelling reason to conclude that the eclipse of the EU implies the decline of Europe.

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