MV Capital Management Weekly Market Flash

The Euro Standard

June 26, 2015

"These arguments are not arguments against the gold standard as such. That is a separate discussion which I shall not touch here. They are arguments against having restored gold in conditions which required a substantial readjustment of all our money values".
– John Maynard Keynes, *The Economic Consequences of Mr. Churchill* (1925).

In Search of Lost Time

For decades it was the most solid measurable quantity in the world of global finance: £3.17s.9d per oz. of 11/12 fine gold. From 1870 to 1914 that calculation was the price of entry into the privileged club of nations favored to trade their goods and services across borders in the most globalized economy the world had witnessed to then. Being a member in good standing of this club meant subsuming all other economic and monetary decisions to the only one that mattered: maintaining full convertibility of the national currency into gold at that sterling-denominated value. The price of anything else – other commodities, labor wages – could and did fluctuate by wild amounts as economic fortunes waxed and waned. But gold and currency exchange rates stayed fixed.

World War I smashed Europe's existing order, and with it the classical prewar gold standard. For monetary policymakers dealing with the Continent's postwar chaos, nothing was seen as more urgent than restoring gold's primacy to bring back order and harmony. In 1925 Britain, led by then-Chancellor of the Exchequer Winston Churchill, made the fateful decision to restore gold at the prewar convertibility rate. That decision – as Keynes' prescient remarks in the aftermath of the decision foretold – would weaken Britain's export competitiveness and compromise its economic position generally for the remainder of the decade, with fateful consequences indeed.

The decision to return to prewar gold was a result of blinkered thinking; British policymakers were unable to comprehend the uselessness of the old system in a vastly different world. Sometimes the status quo is worth fighting for, but other times it is better to move on and let the chips fall where they will. As we resignedly read through the latest "developments" in the endless saga of Greece's negotiations with its creditors, we are hopeful that the consequences of 1925 are figuring into this generation of policymakers' thought process.

Athens Says "La-la-la-la-la"

That last statement is not meant to be glib, or to disparage the attempt to fight for the integrity of the single currency Eurozone. To paraphrase Keynes, we see this not as an argument about the euro standard as such. It is an argument about the terms under which the standard should be maintained. From reading the tea leaves in the communiqués over the past several days, this is exactly the argument that is causing the negotiations to drag on as long as they are. Indications are that at least a handful of negotiators are already more focused on the practical problem of managing fallout from a "Grexit" than they are about incremental concessions to narrow the still-considerable gulf between the two sides.

For their part, the Greeks' hardline stance on pension cuts and tax increases seems to reflect similar considerations over whether, in the end, they are prepared to subjugate every other economic consideration to the rules of the euro standard club. Whether or not this weekend produces some kind of patch-up fix that releases the next €7.2 billion tranche of bailout funding, so as to avoid imminent default, the economic fortunes of Greece are set to remain miserable for a long time to come. One can argue that these fortunes would turn much, much worse upon leaving the euro and returning to a wildly devalued drachma. Greece's financial policymakers would have to choose from a set of highly unappealing policy choices. At least, though, the choices would be theirs and not those of Brussels or Berlin.

The gold standard may have lasted for longer than it did if policymakers had been more willing to adapt the system's old rigidities to changing conditions – for example, to allow for greater use of banknotes alongside gold to meet reserve requirements, as argued during the Genoa Conference of 1922. Likewise, we believe the euro standard has a better chance of surviving if it can adapt and evolve. If a "Grexit" were to force the Eurozone to take another sober look at its own hard choices – for example the urgently needed reforms to streamline its fractious banking system – the result could be net-positive.

Clearly some of those at the negotiating table are leaning towards this train of thought. We'll see where it shakes out over the weekend – and just to repeat what we have stated in previous commentaries, if talks collapse and beget market turmoil in the short term, we are prepared to stay put, look for buying opportunities and keep our eyes on the longer game.

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