Let us speak energy, debt & European…disunion

The European baby boomers had two strokes of luck: that of having grown up in a society of growth and plentiful employment and above all, that of having lived in a time of peace. The European Union may have its faults but it does have the virtue of having preserved the "*old continent*" from any conflict for almost 70 years, a first in history. For fifteen centuries, the Europe of Nations that certain demagogues are trying to reinvent tore itself apart at the slightest opportunity, leaving in its wake violence, ravages and desolation. Yet this generous European Union, invented by Jean Monnet and Robert Schumann, nurtured by Paul Henri Spaak and Konrad Adenauer, progressively consolidated first in economic (the Treaty of Rome in 1957, the Single European Act in 1986), then monetary, terms (Maastricht treaty of 1992) but built unfortunately on insufficient political foundations (Lisbon treaty of 2008), is suffering from profound disunion.

Any entrepreneur will tell you that without stable foundations no construction can withstand a natural disaster. What a trying situation it was for the European Union, whose foundations had not been consolidated, to be shaken by a financial earthquake for which it was totally unprepared. What an opportunity for the unscrupulous populist to fan the flames and resurrect the old nationalist demon. Europe was the perfect setting to play out this sinister individualist game in which, as is always the case, food for growth plays a central role. It is hard to understand why Norway (4 Mboe/day) has never wanted to join the EU and why the United Kingdom (1.7 Mboe/day) and Denmark (300 kboe/day) have still not accepted to join the Euro zone. Is it really a coincidence that the few European oil nations prefer to "*go it alone*" rather than work with the community?

An unexpected tsunami reveals the political disunion

It had all started with scenes of jubilation on that January 1, 2002 when, as soon as the twelve strokes of midnight had sounded, people withdrew their first Euros. Gone were the francs, the Deutschmarks, the lira and the pesetas. We Europeans were now going to live shoulder to shoulder in a common economic space with a "single, protective" currency. Thus the wealthy nations of the North sealed a stability pact with the markedly poorer Southern countries, each agreeing to control their deficit so that their debt did not spiral out of control[1]. For almost seven years everyone believed it would work and, if it is right to praise the courage of those who were behind the Euro, it is equally fair to deplore the flippancy with which the convergence criteria were applied, owing to a lack of political union.

It is important to note that, prior to the creation of the Euro, there was a marked disparity in wealth between the Union's main driving forces (Italy, Germany[2]) and the Southern European countries (Spain and, in particular, Greece and Portugal) who had not long joined the Union. In 2001 there was a 20% difference between the income of a Spaniard and an Italian and 40% between a German and a Portuguese citizen. As for debt, if the Maastricht criteria had really been applied, neither Italy nor Greece would have been authorized to enter the Euro zone in early 2002 (**Figure 1**). Yet the sovereign interest rates which, prior to the creation of the Euro, were a measure of the financial health of each of the member states, converged rapidly (**Figure 1**).

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[1] The Euro stability pact was ratified based on four criteria: (1) annual deficit less than 3% of the GDP (2) debt less than 60% of the GDP (3) inflation not in excess of 1.5% of the average rate of the three less inflationary States (4) a long-term interest rate that does not exceed 2% of the average rate of these same three States.

[2] Great Britain is not included in the analysis as it has not joined the Euro zone

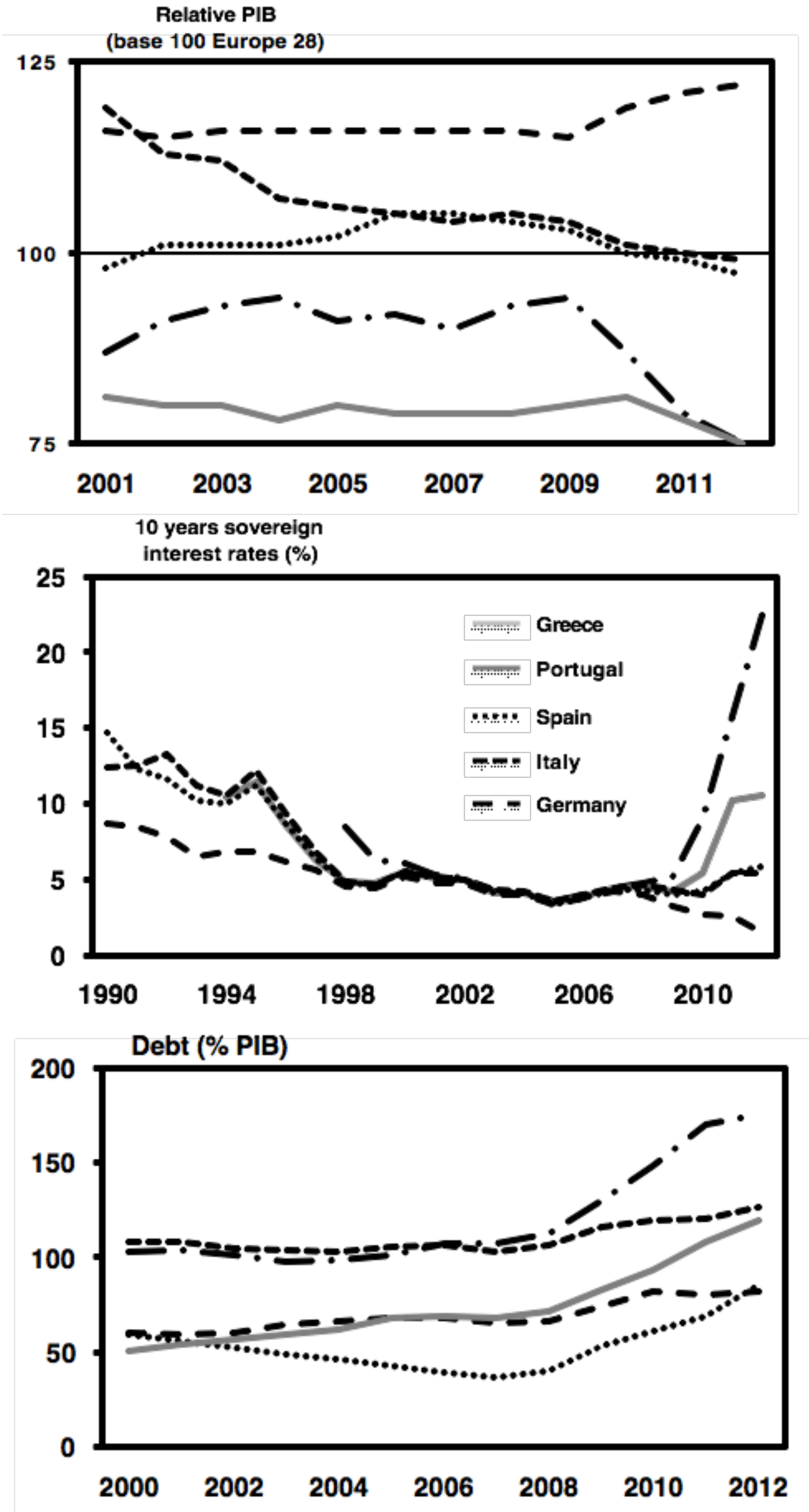

Figure 1 – History of GDP/per capita and debts of European countries[3]

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[3] http://epp.eurostat.ec.europa.eu/tgm/table.do?tab=table&init=1&plugin=1&language=fr&pcode=tec00114

History of European sovereign interest rates[4]

In spite of the differences in revenues and debt the markets gave unconditional confidence to the new currency, considering Euroland as a united, responsible economic space that no longer saw the differences among the different States and what is more, indifferently lending them money at very low interest rates which could only increase their debt. That is, up until that gloomy Monday September 15, 2008 when a financial institution more than 150 years old collapsed, bringing an entire system down with it and paroxysmally causing the delicate monetary architecture, devoid of political foundations, to teeter for several months. In July 2007 the first tremors were felt in the United States with the advent of the subprime crisis when a great number of borrowers, often with very modest means, revealed that they were incapable of repaying their mortgages, which had been given without any guarantees[5]. These numerous failings forced banks to depreciate the value of their assets, causing the value of their own capital to fall by the same amount. To this cash-flow crisis was added a crisis of confidence in the banking system as the mortgage debts were often "*securitized*" in "*toxic*" financial products scattered across the continents. By summer 2008 banks were announcing losses of $500 billion. One of the most high-profile, Lehman Brothers, declared itself bankrupt on September 15, 2008. The result was the collapse of the entire banking system, causing the stock exchange to crash and very quickly, leading to a recession that affected the entire planet. To avoid a repeat of 1929 which, for two decades had buried the world economy and paved the way for nationalist dictatorships, as the governments stepped in to save their banks. The subprime crisis gradually became a public debt crisis and, as often happens, it was the weakest (the poorest and most severely in debt) who were the most affected. Greece, Portugal and to a lesser extent Italy and Spain, saw their debt rocket. Except for the purely financial considerations, what the crisis also revealed was a blatant lack of unity within Euroland. The most virtuous member states, such as Germany were initially reluctant to help the "class dunces" who, owing to poor management, "pork-barrel" politics and a lack of transparency, had let their debt spiral out of control. This kind of individualism was immediately reflected in the sovereign interest rates which began to diverge again. At the beginning of 2010 Germany borrowed at 2.5%, Portugal at 5.5% and Greece at 9%. This confirmed R. Mundell's economic model[6,7] which stipulated that a common currency is viable only if three criteria are met:

(1) economically integrated countries,
(2) economies that have similar reactions to economic crises,
(3) mechanisms able to rectify any discrepancies that may, or are likely to, exist.

There may have been a desire to fulfil these three criteria when the Euro was introduced but the political integration which was key to their application never followed. The treaty for the European Constitution signed by the Heads of State but rejected by referendum in France and in the Netherlands, was never enacted: a telling failure or one which was deliberately orchestrated?

An energy disunion by extension of the political disunion

In parallel with the sovereign debts crisis Europe's energy invoice rose sharply after the barrel prices rocketed from $30/bbl in 2000 to over $100/bbl in 2010, a historical high. These two events, when juxtaposed, contributed to slowing down European economic activity, the first giving rise to a reduction in investment and the second to an increase in

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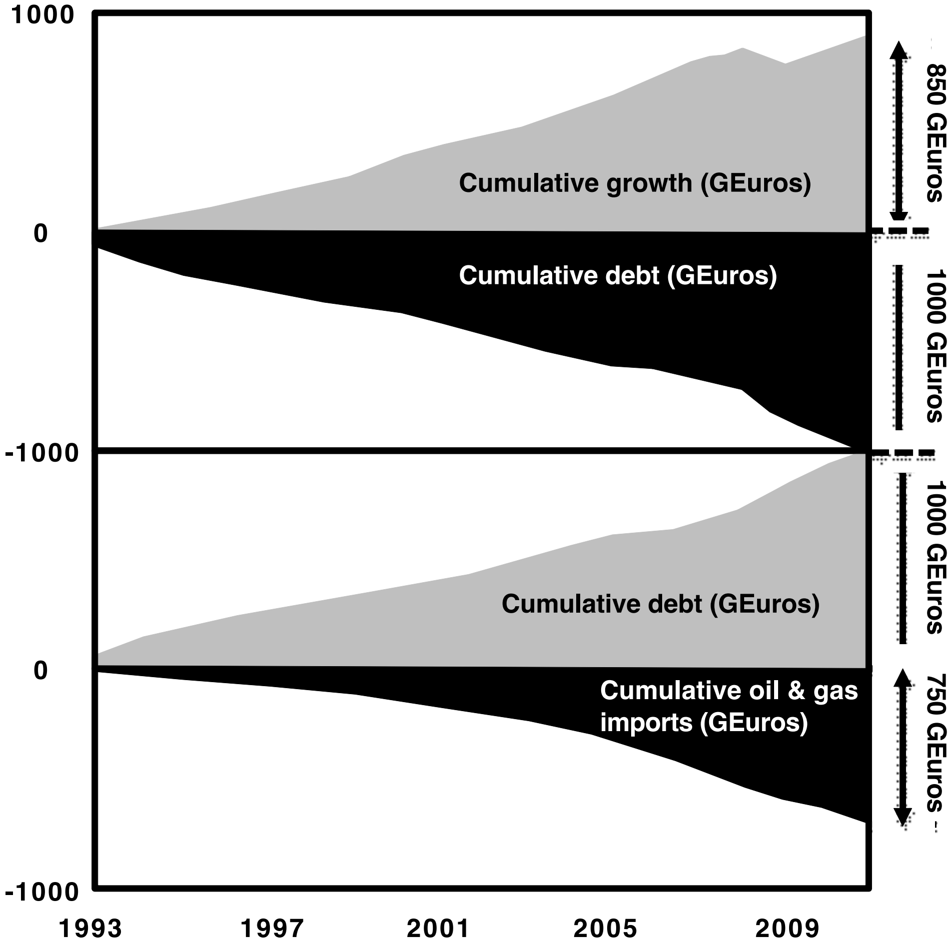
4 http://www.les-crises.fr/historique-des-taux-souverains

5 The causes of this crisis are in part attributed to the Federal Reserve Bank which, in 2003 and 2004, practiced low key interest rates, encouraging banks to lend to borrowers who were barely solvent.

6 http://www.lemonde.fr/economie/article/2005/05/23/robert-mundell-et-la-zone-monetaire-optimale_652784_3234.html

7 http://jourdan.ens.fr/~laffargue/teaching/Macroeconomie_du_developpement/Chapitre3a.doc

production costs, which in turn led to a decrease in consumption. It is estimated that in 2011 and 2012 the price of the barrel stunted European growth by 0.6-0.8%[8].
Over the last decade, for example, France has felt its energy invoice impose a strain on its commercial balance[9], whose deficit is perfectly linked to the price of the barrel. The fact that the figures for the growth in GDP (850 billion Euros of total growth between 1993 and 2010), of the increase in debt (1,000 billion Euros) and the cost of oil and gas imports (an invoice totaling some 750 billion Euros) are becoming closer to one another, clearly shows that debt in developed countries is, for the same social system, the sum of the cost of energy and the repayment of the debt (**Figure 2**). During the golden sixties, developed countries built their growth (and consequently their social system), by taking advantage of "*a food for growth*" which was virtually free. The first oil crisis brutally shattered this "*guaranteed income*" and obliged the self-same countries to go into debt to import energy at great cost, while continuing to finance social systems that go far beyond their actual means - a downward spiral in which European politicians are inevitably caught up, whatever their political bent.



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[8] http://www.insee.fr/fr/ffc/iana/iana7/iana7.pdf

[9] http://lekiosque.finances.gouv.fr/Appchiffre/Etudes/Thematiques/A2012.pdf

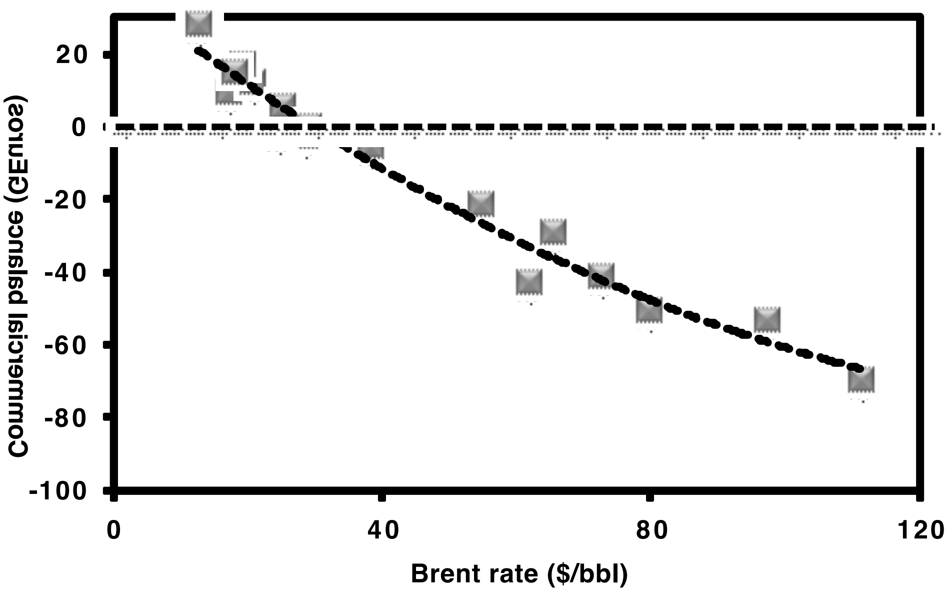

Figure 2 – Growth, debt and oil and gas imports[10] (above)
Commercial balance in France and the Brent price[11] (below)

As for the Maastricht criteria, each country, on the pretext of an age-old heritage, continued to build its own strategy without any real desire to consolidate a common energy policy (**Figure 3**). Between pulling away from nuclear energy, the revival of coal and a possible inroad into shale oil and gas, environmental concerns and promises of low-cost energy vied with one another until it was almost farcical. While Germany withdrew from nuclear energy to give some guarantees to the powerful ecological lobbies but began to import coal again in massive quantities (+10% between 2009 and 2012) and the French President definitively closed the "*shale gas*" file to the extent of excluding any exploratory phase[12], the British government adopted "*the most favorable tax rates in the world to encourage the development of unconventional hydrocarbons on its territory*"[13].

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10 Sources: Energy Funds Advisors

11 Source: customs (estimated FOB data)

12 F. Hollande (2013) "As long as I am President there will be no exploration of shale gas in France" http://www.lexpress.fr/actualite/politique/14-juillet-hollande-a-t-il-rassure-sa-gauche_1266505.html#rrVeDtXey3yijipL.99

13 Le Figaro 14/08/2013 INTERNATIONAL " Cameron takes a stance concerning shale gas"

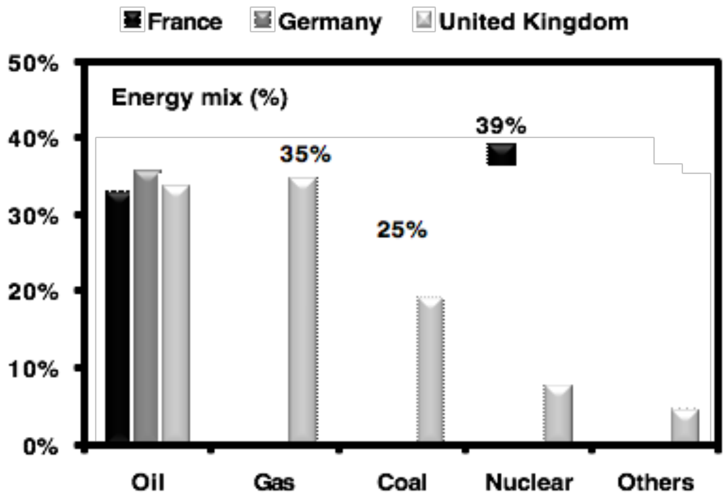

Figure 3 – European primary energy mixes in 2012[14]

If Europe wants to move back towards sustainable growth it must reduce its energy expenses, even if only slightly. But this aim is not really compatible with the discordant energy policies that send out contradictory messages to the general public. On this issue Europe needs to have a calm, responsible and coordinated debate based on objective data. The decision as to whether it is the right time to exploit unconventional hydrocarbons is based on a great unknown - the actual state of the resources themselves.

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