The Financial Crisis: Three Ways Out for Europe

Guy Verhofstadt

BertelsmannStiftung

The Financial Crisis: Three Ways Out for Europe

Guy Verhofstadt

Gütersloh, November 2008

Contact:

Joachim Fritz-Vannahme
Director
Programme Europe’s Future
Bertelsmann Stiftung
Phone +49 5241 81-81421
Fax +49 5241 81-681421
E-Mail joachim.vannahme@bertelsmann.de
www.bertelsmann-stiftung.de

ABSTRACT

Only days before the G20 meeting on the international financial system, Guy Verhofstadt – former Prime Minister of Belgium and a distinguished expert in all matters relating to international politics – offers his view on the current crisis and its consequences. In the following essay, he sets the international financial crisis in its historic context, depicts its far-reaching geopolitical corollaries and, above all, attends to the biggest challenge Europe ever faced: what should be the European Union's answer to the financial crisis?

For Guy Verhofstadt, this is not merely about emergency economic measures but rather a matter of structural reforms such as the development of a new and binding international financial framework. He stresses three fields on which Europe urgently needs to take action: Europe needs (1) a single financial regulator belonging to a global network operating according to identical rules and standards, (2) an institution clearing interbank loan requests and (3) a Eurozone economic government.

ABOUT THE AUTHOR:

Born in 1953 in Dendermonde (Belgium) Guy Verhofstadt began his political career in the Flemish liberal party in the 1970s. In 1985 he was elected into the Chamber of Deputies and became Deputy Prime Minister and Minister for Budget in the government of Wilfried Martens. After the federal elections in 1999, he was appointed Prime Minister of Belgium in July 1999 and stayed in office until March 2008.

2008 may well go down in history as a pivotal year: like 1989, when the Berlin Wall fell and the Iron Curtain was torn open; 1944-1945, when World War II ended, the United Nations was founded and the Bretton Woods Agreements signed, and when two new superpowers embarked on a fanatical race for supremacy; or 1919, 1815 or 1648 – the years, respectively, of the Treaty of Versailles, the Congress of Vienna and the Peace of Westphalia. All momentous events that marked the end of an era and at the same time heralded a new epoch in human history.

In the summer of 2008, three events occurred almost simultaneously that were both remarkable and far-reaching in their consequences, developments which – in my view – can be seen as portents (or perhaps consequences) of a new impending world order. In August, Russia invaded South Ossetia; this came as a surprise to everybody, not so much because it demonstrated Russia's continued hold over the Northern Caucasus, but mainly because it showed that Russia, after two decades of weakness and disintegration, was once again willing and able to throw its weight around militarily as well as operate an aggressive energy policy. The same month saw the opening of the Olympic Games in China, followed a few weeks later by the first successful spacewalk by a Chinese astronaut – two illustrations of the impressive comeback of this immense country as a great power, if only – for the time being – economically. I say "for the time being" quite deliberately, because it would be naïve to believe that China's rise will be confined to the economic sphere. An economic rise is inevitably followed by a political and military one. Then in September, with summer barely over, the full force of a financial crisis was unleashed.

Though it had been smouldering for months in the United States, it only became serious when numerous financial institutions were forced to admit that they held a raft of extremely high-risk credit products, which they had failed to cover properly. In consequence, banks fell prey to mutual suspicion and stopped lending to one another. Such interbank loans are vitally important for the financial sector, since they allow financial institutions to smooth out the peaks and troughs of their liabilities and so ensure that they have sufficient liquidity at all times. At the same time, the resulting accounting losses triggered unavoidable asset sales, which in turn led to a negative spiral of new losses and new sales. As a result, what began as a crisis in the US mortgage market ballooned into a global liquidity and solvency crisis on the financial markets and then into a stock-market crash and meltdown affecting all institutions (insurance companies, reinsurers, pension funds, hedge funds) and now also causing currency turmoil in many countries – turmoil that will hit developing countries particularly hard. However you look at it, a deep economic crisis in the form of a global recession now seems almost inevitable. Indeed, the first signs are already visible. Economic growth has come to a virtual standstill. Steel companies are closing down temporarily. Order books that until recently were filled several years in advance are now largely pared down to months. And unemployment is on the rise once again.

1. A New Age of Empires: The Return of Multipolarity

However, the effects of this crisis will extend beyond the economy. The economic downturn in the West, and particularly the United States, will undoubtedly also cast a shadow over the former's political dominance in the world. Not that this dominance will suddenly collapse: the power of the US, in particular, is too great and too multifaceted for that. Put another way, America's absolute power will remain huge into the near future, but its relative power will crumble, thereby shifting the balance of power. For whereas the weight of other nations and blocks (China, India, Russia, Brazil, etc.) is increasing that of the United States has quite clearly reached its peak. In short, the world that America's new President Barack Obama will face is fundamentally different from the one Bush Jr. inherited from Clinton eight years ago. And him being elected will accelerate this evolution. Not that one has to fear for some kind of isolationism. But the American leadership will be dissimilar. Whereas it took up a position of a dominant superpower under the Bush presidency by the war on terror and the wars in Iraq and Afghanistan, it will – under pressure of the circumstances- have to fix one's attention on the great imbalances at home (economic crisis, health care, climate) while also a less vigorous line in foreign policy can be expected. The hope awakened by Barack Obama being elected, is that the United States of America will evolve again from an arrogant superpower to a continent with opportunities for all, an example for the entire world of an open society where race and descent don't matter. Moral leadership would make way for the brutal quest for absolute dominance.

This will sign a more radical shift in global relations than we can appreciate today. It will herald the end, once and for all, of the short-lived unipolar world order in which we have existed since the implosion of the Soviet empire in 1989 – a world order dominated by a single power, the United States, and based on the global dissemination of a combination of two systems: the free market economy and political democracy. In fact, as early as 2001 the 9/11 attacks made it clear that the unipolar world order was not inevitably and that, contrary to the theories of Fukuyama, history would continue to run its course. It may have been somewhat presumptuous to suppose that the implosion of the Soviet empire would mark the start of a thousand years of Western or American dominance/hegemony. Indeed, 2008 would appear to be the beginning of a new – multipolar – world, a 'new age of empires'.

SUCH FUNDAMENTAL GEOPOLITICAL CHANGES ARE NOTHING NEW

Such fundamental changes in global politics are nothing new. We may even be witnessing a fifth major shift in the space of a century. When World War I broke out in 1914, Europe and much of the rest of the world was still living in the age of imperialism. A hundred years ago, most of Europe, almost the whole of Africa and large parts of Asia were still dominated by half a dozen European empires. Barely four years later, in 1918, four of Europe's six empires – the German, Austro-Hungarian, Russian and Turkish-Ottoman – had disappeared. Only the British and French were able to cling on a little longer, thanks to their colonies in Africa and Asia. That notwithstanding, the age of the European empires was over. The biggest winner, at least in the short term, was the nation state. In some parts of Europe, the nation state was rooted in age-old political traditions, but it was the disappearance of Europe's empires that allowed the European nation state to really take off in the 1920s. Unfortunately, the collapse of those empires and the huge power vacuum that developed in Europe left the way clear not only for the nation state but also for the most aggressive forms of ethnic nationalism – national socialism in Germany, fascism in Italy, national communism in Russia – which would drag the continent headlong into a Second World War. In many respects, the nation state, following the defeat of fascism and Nazism, survived the Second World War. But the price for this was paid to the real victors of that war: the new superpowers, the USA and USSR.

Between 1945 and 1989, the new superpowers were stronger than any state that had gone before, but for Europe this change ushered in an era of 'absence' from global politics. In fact, for 44 years Europe was split in two by an Iron Curtain that stretched "from Stettin in the Baltic to Trieste in the Adriatic". This was an era in which the USA and USSR, with their ever-threatening Cold War, instituted a bipolar world, not only in Europe but globally, and one that was even worse for the rest of the world than for Europe. What in Europe remained a Cold War, thanks to the nuclear arms race, elsewhere spawned numerous ‘Hot Wars’, from Korea and Vietnam in the Far East, across southern Asia and the Middle East to Africa and Latin America.

I am anything but nostalgic for the supposed ‘stability’ of that bipolar world. We paid for that stability with a costly arms-race and the ever-present threat of nuclear war, heightened by the superpowers’ deliberate policy of mutual assured destruction if things went amiss. But they were also years in which we were unable, or unwilling, to do anything for our European ‘allies’ behind the Iron Curtain. Even during the Hungarian uprising of 1956 and the crushing of the Prague Spring in 1968, we stood by and declined to offer assistance. The price we paid for the stability of the Cold War was, in reality, intolerably high. Europe’s determination to bring the east of the continent into the EU in the 1990s can thus be interpreted as a compensation for our cowardly failure to act during the Cold War. Once the Cold War was over, we did what we ought to have done much earlier.

EUROPE IS NO GREAT POWER

Unfortunately, the bipolar world of the Cold War was not succeeded by a Europe that re-established itself on the world map. The European Union failed to develop any foreign and security policy worthy of the name. Japan plunged into an economic downward spiral. And countries like China and India took their first steps towards a free market economy. Nothing and nobody, in other words, could dispute – let alone challenge – the monopolistic omnipotence of the United States. Probably the most imposing aspect of American supremacy was its military might. In the past decade, US military expenditure has accounted for almost half of the entire world’s defence spending. The US defence effort is over double that of all EU Member States combined. When it comes to conducting military operations on the ground, the difference is much starker still. Military experts generally agree that the EU Member States combined have barely a tenth of the military capacity of the US. In the 12 years from 1989 to 2001, American leadership was not disputed by a single figure of state: until the terror attacks on New York and Washington, which marked at once a high point and a fundamental shift in European-US relations. Then, of course, we closed ranks with our American ally and went to Afghanistan to extirpate the roots of international terrorism, but we would not – at least, not all of us – follow the US into its war in Iraq. This was the first clear sign of a growing realisation that Europe wishes to assume its own responsibility on international political issues.

More than this nascent and shared (though admittedly not by all Europe’s political leaders) realisation, it is the events of the past few months and the financial crisis in particular that herald the arrival of the multipolar world. A monopolar order has clearly shown itself to be inefficient and undesirable. A new bipolar world, modelled on that of the Cold War era, is equally out of the question. Similarly, falling back on the nation state seems inappropriate given that the past few decades have shown us that no single state is big or rich enough on its own to meet the global challenges facing us all. Even grouped together at regional level, the nation state is too small. So whether we like it or not, we are, in a sense, seeing a return to the imperial, a new age of empires, an age led by a dozen regional powerhouses, in the sense of actual or potential political and economic global centres, spread out around the world. I realise that the term ‘empire’ has not had a good press, especially in nation states created when the one-time European empires came to an end. But let us not get embroiled in word games. What I understand by the term 'empire' is not the Prussia of the Hohenzollerns, the Dual Monarchy of the Habsburgs or the Russia of the Tsars, but rather a political and economic entity, potentially made up of many states and peoples, united by common structures and modern institutions, often nourished by diverse traditions and values and rooted in old and new civilisations. What counts in this new world order is the multiplicity of empires and civilisations, not the dominance of one. What matters is the political stability and economic growth that they can create at a regional level, not for one or other of them to rule the whole world. In a nutshell, this is not about nostalgia for a return to the European empires of old but rather the birth of new types of political organisations, established by open and free societies, competing with each other at a global level, building bridges rather than walls, but each retaining its regional roots and customs.

In other words: in today's world, the nation state is too small to influence global events any longer. The United Nations, on the other hand, is too big and too slow to be able to act effectively in rapidly changing times. In many respects, the new entities can bridge this divide between the few and the many since they can mobilise their regional strength at a sub-continental level and so – to echo the Charter of the United Nations – play a central role in tackling and solving regional and even global problems.

2. A NEW INTERNATIONAL FINANCIAL FRAMEWORK

But we are at a breaking, or turning, point not only in terms of the international balance of power but also ideologically. If 1989 marked the decisive victory of the free market economy and capitalism, then 2008 looks likely to be the year in which we are forced to recognise that unbridled capitalism has its limits. In itself, this is not a particularly original observation and far from a new idea. Adam Smith in The Wealth of Nations warned of this explicitly. Consequently, the question is not so much whether we agree on the diagnosis but how we react to that diagnosis. What is the remedy? How should we respond intellectually to the crisis?

RESPONSES TO THE CURRENT CRISIS IMPLY RISKS

The initial reactions and measures taken to contain the financial crisis do not bode well. In any case, they are highly predictable. Just as happened in earlier financial crises, such as those of the interwar period, the dominant responses have been (economic) nationalism and collectivisation or a combination of the two. Whether or not they belong to a broader supranational federation, countries are intervening on a massive scale to save their own (national) assets. Moreover, they have no qualms about exploiting the situation to save some of their lost 'crown jewels'. In other words, national prestige is winning out over international cooperation and power. As an illustration of this, in recent weeks we have heard ever louder neo-nationalist rumblings and frenzied talk of victors and vanquished – for the entire world as if the European Union had never existed. The Netherlands cried victory after buying up Dutch Fortis and ABN-Amro. In Paris, there was jubilation at the 'victory' in the battle for Dexia. And many European heads of government roundly announced they would guarantee only the savings of their own citizens.

The form taken by these interventions is more or less identical in each country, namely massive injections of government money and in some cases even full-scale nationalisations to restore the failing solvency of banks and insurance companies. The only proverbial exceptions to this rule are

Lehman in the US and Fortis in Belgium, which were simply closed down or sold. The state, too, stepped in to solve another acute problem: the collapse of interbank loans. By attaching government guarantees to such loans, the hope is to eliminate growing mistrust between financial institutions and so ensure that their liquidity remains at the required level.

All these interventions are undoubtedly justifiable if the aim is to save the financial system from wholesale collapse in the short term. However, the danger is that the remedy could soon become worse than the evil it is intended to combat. As with any kind of state guarantee, injecting massive amounts of government cash into troubled banks or any other economic sector requires the utmost prudence. In this sense, it is comparable to medication: just as a painkiller such as morphine or methadone should only be taken in tiny doses, and over a very short period, so government injections or state guarantees should only be used in very limited measure. If not, they become a drug, an addiction that stifles and removes any incentive to effective, efficient management within the institutions concerned. Why should a bank bother to thoroughly scrutinise a loan request from a fellow bank if the state will bear the ultimate risk? Why should an insurance company manage its portfolio prudently if at the first sign of trouble the state will shoulder any uncovered liabilities? And what about the distortion of competition? The state makes little or no distinction between institutions that are insolvent and badly run and those that are solvent and well run. The state even ends up financing heavily capitalised banks that were initially in no trouble whatever and only came under pressure because their fellow banks and competitors at home and/or abroad benefited from government support. Here too, such emergency economic interventions may be appropriate in the short term, but they soon come to be overused, which only makes the situation worse.

This fear is warranted with respect to the recent creation of ‘sovereign funds’. However honourable their objectives may be (namely to safeguard Europe’s strategic interests in the face of a possible impending wave of takeovers by foreign sovereign wealth funds), the reality is usually less noble, certainly when it comes to ‘national’ funds. In any case, the argument for setting up such funds seems decidedly specious. When American or European companies invest in or take over a Russian, Chinese or Indian enterprise, this is hailed as an example of internationalisation and globalisation. When the reverse happens, it is labelled a threat to our independence. In fact, what we are seeing is a repeat of the reaction that decades ago greeted the arrival of Japanese companies on Western markets. Then too, the air was thick with warnings about the ‘yellow peril’; then too there was resistance. Moreover, we have to ask ourselves whose financial assets have remained largely or wholly untouched by the current stock-market crisis and therefore who can muster the financial resources to finance the large-scale takeovers we fear so much. Over the past few weeks, China, Russia and India have had the opportunity to buy up the entire Western financial sector. Aside from an injection by Russian investors into the Icelandic banking system, there have been few signs of any such move. The assets lost in recent months by the Russian oligarchs and the Arab royal families are, believe it or not, even more spectacular than the massive losses sustained by our own so-called institutional investors. Once again, the arguments used to justify the creation of sovereign funds are often fallacious. The real reason tends to be that those concerned see the financial crisis as a perfect pretext for implementing a protectionist national industrial policy in all but name, where once there was little support for such a course.

WHERE IS EUROPE?

However, there is a very real danger that all these government interventions (state guarantees, capital injections, sovereign funds) will jeopardise a country's financial future. After all, such massive interventions will simply mean extra debts for future generations. How, we may wonder, will countries with high public debt and no significant pension reserves manage to cope with the costs of population ageing? And even for those without towering debts, do such operations not constitute an unacceptable mortgaging of the future? Take Ireland, for example: it has only a modest public debt, but it is guaranteeing all bank deposits to the tune of €400 billion. Quite apart from the problems that move this has caused in other countries, with the outflow of funds to Irish banks, this amount is equal to twice Ireland's current GDP, six times its annual government revenue and no less than eight times its current public debt. And where does this leave EU competition law? What about the Growth and Stability Pact? It hardly need be said that exceptional times call for exceptional measures, but can any Member State simply decide of its own accord to ditch the acquis? In short, where has Europe been in recent weeks and days? Why the deafening silence from the Berlaymont?

But if neither a retreat behind national borders nor a series of collectivisations or nationalisations is desirable, then the question remains: what, ultimately, is the right remedy to adopt? It is no coincidence that the current financial crisis is taking place in an age of rapid globalisation, affecting the economy in general and the financial markets in particular. When a crisis hits the US mortgage market for one reason or another, this has global repercussions since hundreds of banks, insurance companies and pension funds all around the world have direct or indirect interests in that market. This is itself a result of increasing securitisation, which has led, for example, to loan contracts being negotiated between banks and borrowers that would previously not have been negotiated or not have been considered viable. Inevitably in such a situation, a lack of oversight or a lax approach in one country can have negative consequences for the whole world. However, the conclusion we should definitely not draw from this would be to point the finger at the phenomenon of globalisation itself then retreat behind our own national borders. Globalisation has gone beyond the stage where it can be held back. On the contrary, the conclusion must be this: the economy may well be globalised, but oversight of the economy is not. It has remained fragmentary and national in nature. Political control of the global economy is (virtually) non-existent.

In Europe, the introduction of the Euro is proof enough that the answer to the global financial crisis lies not so much in emergency economic measures but rather in structural reforms such as the development of a new and binding international financial framework. Without the Euro, 10 or so European currencies would now be under immense pressure, like the Brazilian Real and the Icelandic and Danish Krona. The fact that they are not is down to the Euro. We should learn from this success and establish large-scale – in other words, cross-border – policy and oversight mechanisms in many other areas of economic and financial life. At the very least, a sound – and consequently uniform – system of financial and prudential oversight should be set up in every currency zone as a counterpart to the monetary authority(ies). Binding agreements on this should be concluded between the various currency zones within a newly established international framework, so that the world economy has a single system of global supervision, or at least a single global network of supervisors – a network that rigorously applies an identical set of rules. However, these international rules will also need to be new in various respects. The national segmentation of regulation is certainly not the only cause of the current situation: what little international regulation there is has also been found seriously wanting. For instance, the international Basel regulations led to risks being underestimated and many being classed off-balance-sheet, while the current international accounting rules (IFRS) are unsuitable, as they are too pro-cyclical and tend to encourage, rather than check, a downward spiral of falling prices and forced sales. It will also be necessary to establish quality rules and quality control for all types of newly traded financial products – a form of 'product safety', as it were.

3. THE EUROPEAN ANSWER

To get an idea of how this new framework would function, the best starting point is European policy. In addition to an independently operating European Central Bank, the Eurozone urgently requires three reforms (or new institutions):

- A single European financial regulator belonging to a global network of regulators, all bound by the same rules and standards.

- An institution (possibly a division of the ECB) whose tasks would include issuing clearances for interbank loan requests; in any case, this seems a more sensible solution for restoring confidence between banks and guaranteeing market liquidity than issuing massive state guarantees or setting up a 'European intervention fund', which is tantamount to Europeanising/collectivising the cost of nationalisations.

- Finally, a Eurozone government responsible for pursuing a policy of socio-economic convergence; convergence, as opposed to harmonisation, entails establishing parameters within which the economies of the different EU or Eurozone Member States must develop in order to achieve, together, a more integrated and more competitive European economy; a major step in his direction was taken recently with the holding (in October this year) of the first Eurozone summit.

The last of these recommendations is an acknowledgement of the fact that the financial crisis will inevitably bring with it a general economic slowdown over the next few years. This may well herald the definitive rise of countries like China, Brazil and India. In 2007, China was already 4th in the world GDP rankings, with Brazil, Russia and India occupying 10th, 11th and 12th places respectively. By 2050, China is expected to be number one, with a GDP around twice that of the United States. India will be 3rd, Brazil 4th and Russia 6th. This will force Western economies to make drastic changes in the economic sphere, but not by jumping on the regulation bandwagon (however indispensable regulation may be for the financial markets). Quite the opposite. Paradoxically, increased regulation in the financial sphere will need to be combined with increased liberalisation in the field of general economic policy. In this connection, it is worrying to note that the need for budget balance is now being called into question with the same ease as the need for nationalisation is being defended. Yet to suppose that the recession can be beaten by deficit spending is no less of an illusion. The misgivings of savers and consumers will only be overcome by tackling the causes of the financial crisis itself in a credible, that is to say drastic, manner, and not by artificially injecting purchasing power into households' purses. Under the present circumstances, those households will simply save more, rather than spend more. Moreover, deficit spending is not even an option in countries with a high level of pubic debt and/or a lack of pension reserves.

Nobody can now be in any doubt that the world is at a turning point. The financial crisis is acting as a sort of ‘particle accelerator’, speeding us on our way to a new multipolar society. This is abundantly clear in the economic sphere, but politically and militarily too great powers in the making are beginning to sit up and make their presence felt. Russia and China particularly, but India as well, let no opportunity pass to show the world that they are a force to be reckoned with. The question is, though, whether Europe will be able, or willing, to play a part in this multipolar concert. ‘Able’ it most certainly should be, but ‘willing’ is another matter. Europe continues to suffer from cold feet. While the financial crisis triggered a string of national interventions from individual Member States, the EU’s reaction was – with the exception of the Euro summit – largely confined to a number of well-meaning conclusions. Yet the way ahead for Europe is only too clear. If it wishes to play a role in tomorrow’s multipolar world and survive the ‘new age of empires’, its only option is to take a bold and decisive new step in the integration process. Seen in this light, the current financial crisis is not a disaster but rather a golden opportunity for the future. What is needed now is for our political leaders to overcome their cold feet and take the plunge.

Address | Contact

Bertelsmann Stiftung
Carl-Bertelsmann-Straße 256
33311 Gütersloh
Phone +49 5241 81-0
Fax +49 5241 81-81999

Joachim Fritz-Vannahme
Director
Programme Europe's Future
Bertelsmann Stiftung
Phone +49 5241 81-81421
Fax +49 5241 81-681421
E-Mail joachim.vannahme@bertelsmann.de

www.bertelsmann-stiftung.de

BertelsmannStiftung