

EUROPE'S CRISIS MANAGEMENT: MISSED OPPORTUNITIES

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The financial crisis that affected the global economy in 2008 and 2009 originated from the USA, but it affected most economies, including of course the European Union. The 27 member countries were hit hard: Capital exporters like Germany had considerable direct exposure to sub-prime lending in the US, whilst Eastern European economies like Hungary were suffering from the deteriorating conditions on credit markets and the inability of borrowers to roll over existing debt. Above all the crisis has exposed the weakness of European cooperation and may have damaged the prospects for European integration for a considerable period of time.

When the crisis hit Europe with increased force in September/October 2008, the response continued to be limited to national economic policy. Whilst there has been a token European recovery program, in essence Europeans returned to the national level for rescue packages. Of course, this was particularly so for banks, who – as one observer quipped – grow abroad but die at home. Consequently, bailout packages were organized by national governments. ING turned to the Dutch authorities, Northern Rock and the Royal Bank of Scotland to Downing Street, and IKB to the German government. Cross-border banks turned out to pose a problem: Fortis, a Belgian-Dutch finance group, had to be dismantled into 'national' entities before governments came to the rescue.

For all the praise the European Union has received for overcoming conflict and tension, the group turned out to be unable to implement a joint response to the crisis. The lack of a common financial policy became an issue. Finance ministers from the 27 countries tended to

express as many opinions and the group was and continues to be unable to express a common position on financial reform at home and abroad.

Moreover, the old split between Britain and Continental Europe became more pronounced in the crisis. In the first part of the crisis, from the collapse of Northern Rock in September 2007 to the collapse of Lehman Brothers about one year later, many continental Europeans viewed the crisis as a phenomenon limited to the USA and the United Kingdom. The failure of the liberalized financial sectors in the USA and the United Kingdom was observed with a touch of *schadenfreude*, until policy makers and citizens in Germany, Holland and France realized that those that lent to the USA often came from continental Europe.

With hindsight, this phase of satisfaction and self-approval was wasted time. Instead of preparing Europe for what was to come, many policy makers in Germany, France and other countries were far too complacent and reacted belatedly. Moreover, when they realized that the crisis would not spare them, the reactions were frequently hastily implemented and lacked a coherent strategy. A particular nasty example is the German guarantee for deposits of October 2008, which I will discuss in greater detail below. But in general, all member countries of the European Union were reacting in panic, and this represents an astounding contrast to the Chinese crisis management, which appears to have been implemented in a much more strategic manner. Effectively, European integration may emerge from the American-made crisis as the biggest casualty.

Crisis Management at the National Level

The European Union is the most successful regional integration project in the world, or at least it has been in the past. The question is whether European governments have been reacting appropriately to the crisis. For Europe, the crisis could have represented a unique opportunity to promote a reform of international financial markets and institutions of global governance, given that the Anglo-American model of financial markets has been discredited. The crisis provided the EU with an unprecedented opportunity to demonstrate its collective ability to manage and master a crisis of enormous dimensions, but the EU has failed this

litmus test. Whilst there was a lot of rhetoric on the need to cooperate in the crisis, in reality the more powerful member countries have chosen to pursue their own national agendas and have continued to do so since.

The national responses have been implemented against a background of limited cooperation before the crisis. It should be noted that the regulation of the financial sector in the European Union continued to escape efforts to develop a uniform approach. One factor here is that the European Union has at least three distinct levels of cooperation in financial affairs. The core is the eurozone. Whilst monetary policy is run by the European Central Bank, the ECB's mandate is limited. It is responsible for price stability, not for the much broader concept of financial stability. Thus, even within the eurozone there has not been any significant supranational financial supervision. Denmark represents the second level of cooperation: it continues to have its own currency, the krone, which is tied to the euro at a fixed rate and is part of the old European Monetary System. The third group is neither having any cooperation on exchange rate stability nor any meaningful cooperation with regard to the regulation of financial markets. The United Kingdom is, of course, the most important country in this category. In contrast to many other policy areas, e.g. agriculture or foreign trade, the European Union continues to be characterised by an impoverished infrastructure in finance.

Against this background, it is not surprising that Europe has not presented itself as a model of good behaviour in a crisis. The problems started in early 2007 when European governments did not take sufficient note of the first hints of the crisis and failed to respond accordingly. As a result, one comparatively hastily designed programme followed the next, conveying the impression of hectic and uninformed politics and hence exacerbating the crisis. In Europe government policies have often not been contributing to restoring confidence, but have occasionally contributed to the already emerging fears in their population. In particular, the continuous repetition of the inevitability of doom and gloom, prominent especially after the collapse of Lehman Brothers in September 2008, dented the expectations of even the most ardent optimists.

Government officials in many European economies have fuelled the crisis with their negative comments. This requires an explanation. Why have they collectively done this? Either the situation was as bleak as they portrayed it, which is possible, or policy makers were trying to shore up public support for their bailout packages, which appears more likely. Without the negative sentiment that appeared to be the consensus amongst political parties in many European economies, and certainly in Germany, the large rescue operations of 2008 would have been discussed much more critically and the call for limits to the bailout operations would have been more widespread.

But why were policy makers so keen on spending billions of euros on private institutions that obviously did not fully understand their business? Why were politicians eager to dismantle one of the characteristics of the capitalist system, the principle that market participants that fail have to exit the markets and go into bankruptcy? Again, there are two potential answers to that question. The explanation given in public was that all banks that were at risk in 2008 were so important to the future functioning of the financial system that they had to be bailed out at almost any cost. Governments were, so they argued, not willing to risk the collapse of the financial system. However, in Europe all banks were considered systemically important, even small institutions that no one outside the trading floors had heard of prior to their calamities.

Representative of this extended coverage is the 'Deutsche Industriebank' (IKB) in Germany, a small bank specialised in providing finance to small- and medium-sized companies in Germany.¹ IKB had been founded in 1924 and had weathered the turbulent 20th century, but not the subprime crisis. IKB was small: total assets of euro 50 billion and 1.800 employees do not constitute a large bank and, given the business of IKB, it is impossible to consider it systemically relevant. Nevertheless, IKB was rescued with about euro 10 billion of public money (German Ministry of Finance 2009). Subsequently, IKB was quickly re-privatised to the American Investor 'Lone Star', a private equity institution. Whilst there has not been an official confirmation for the value of the

¹ Of course, the bank's core activity did not cause trouble, but rather its engagement in the US, for which IKB was ill equipped.

transaction, newspapers have estimated the price that Lone Star paid at euro 137 million (*Handelsblatt*, 19 June 2009, p. 1).

Of course, the question arises why IKB and, later on, other larger banks, such as Hypo Real Estate in Germany or Fortis in Belgium and the Netherlands, were rescued. Indeed, there appears to be a significant difference from the crisis management of the USA, which permitted the bankruptcy of at least one investment bank, Lehman Brothers. By contrast, virtually all banks were rescued in Europe.

In essence, there are four potential explanations. First, and least convincing, is the idea that all banks have indeed become too big to fail. Whilst this is certainly the case for large financial conglomerates such as Deutsche Bank or the Royal Bank of Scotland, not all banks, least of all IKB, were so large that they could disrupt the entire financial sector.

Second, policy makers may have thought that all banks had to be rescued and may have been afraid to be the first that did not rescue a bank. Historical evidence would have given them some support for their arguments. In previous financial crises, e.g. in the 1930s or 1970s, individual bank collapses were identified as at least the trigger, if not the cause of severe turbulence. In July 1931, the collapse of the 'Darmstädter und Nationalbank – Danat Bank' triggered a crisis that not only deepened the already two-year old depression, but also had international repercussions. The United Kingdom, which had lent to Germany and the 'Danat Bank', the second-largest German bank at the time, was facing severe liquidity shortages and the Bank of England had to take Britain off the gold standard in September 1931. The collapse of 'Herstatt Bank' in 1974, caused by a bunch of inexperienced young currency traders, sent shockwaves through the financial markets of Europe and the United States. Consequently, the assumption that policy makers were unable to differentiate between systemically relevant banks and those that may be sent into liquidation has a certain appeal.

Third, policy makers may have been concerned about the short- and long-term consequences of bank collapses. This idea is reflected on the website of the German Ministry of Finance, where the rescue operations are justified with an interesting explanation: any collapse of a bank would have destroyed confidence in the German banking system. Whilst

related to the second explanation, there is an additional dimension: the future competitiveness of the banking system may have been at risk, and therefore policy makers decided to risk taxpayers' money for bailout operations.

However, these explanations are not fully satisfying. An additional fourth factor is the close network of interests between policy makers and the financial sector that has been developed over the years. Whilst this development has long been criticised in the United States, for example in Jagdish Bhagwati's 1998 article on the 'Wall Street Treasury Complex', published in the respected journal *Foreign Affairs*, there has not been a debate on the close links between politics and finance in continental Europe (Bhagwati 1998). Yet there are very close links. In the case of IKB, Jörg Asmussen, who was promoted to the position of German Deputy Minister of Finance in July 2008, sat on the board in the years before the crisis. Thus, the government not only bailed out the bank, but also tried to safeguard its own reputation.² The issue of networks in German finance will be revisited later in this article.

The Unilateral German Guarantee and Uncoordinated Stimulus Packages

The most striking example of national crisis management is provided by Germany, the EU's largest economy. After the collapse of Lehman Brothers in mid-September 2008, a period of unprecedented turbulence in financial markets followed. Liquidity in interbank markets dried up completely, and panic crept into the thinking of managers and citizens alike. There was an obvious need for leadership and guidance, which private markets were unable to provide. In essence, the weeks after the crash of Lehman would have required the joint effort of political leaders and their finance ministers. They could and should have demonstrated that they will be able to handle the crisis collectively. Unfortunately, that

² In spring 2009, Asmussen received some public criticism about his role in the run-up to the crisis, but without consequences. See, for example, a report on him on German television at <http://www.br-online.de/das-erste/report-muenchen/report-krisenmanager-asmussen-ID1246612708714.xml>.

was not happening. Instead, policy makers in virtually all European countries acted individually. In Germany, the government announced on 5 October 2008 a guarantee for all deposits in banks operating in the country, regardless of the size of the deposit. This unilateral measure may represent one of the worst mistakes of German post-war foreign policy.

That claim requires substantiation. What is wrong with a government guaranteeing the savings of its citizens, in particular when the economic history of Germany is considered? In the 20th century, Germans had lost most of their savings twice: in the hyperinflation of 1923 and in the post-war currency reform of 1948. These two events have shaped the preference of German citizens for safe investments and have contributed to the monetary policy of the Bundesbank, which was always characterized by a preference for stability over economic growth or high employment.

Against this background, it is understandable that the German government was concerned about a potential panic amongst German citizens. However, until the government announced its unilateral guarantee, there had not been any obvious sign of nervousness amongst savers. Yes, people were discussing the stability of the financial system, but there were no widespread withdrawals. Bundesbank personnel are said to have admitted unofficially that they had difficulty in restocking cash dispensers in the week before the guarantee, but there is no more evidence than that.

However, Germany's unilateral guarantee created severe problems for other economies. More advanced ones, including Australia, were also having to guarantee deposits because capital was seeking safe havens and OECD-countries that had issued government guarantees were considered the safest of all. Unfortunately, economies whose governments were not able to issue credible guarantees were the main victims. Capital was withdrawn from economies in Eastern Europe and from developing economies. Effectively, the uncoordinated and probably unnecessary German guarantee deepened the global crisis rather than containing it. Nobel laureate Paul Krugman has also been criticizing the German crisis management in general and Finance Minister Peer Steinbrück in particular, emphasising the drawbacks of the national crisis management

in Europe's biggest economy. Krugman saw a negative multiplier effect arising from Germany's policies (Krugman 2008).

Thereafter, European economies continued to implement national, rather than European, crisis management. The stimulus packages were an important element in that process. Each member country of the EU implemented a tailor-made program. Of course, the individual measures were influenced by each country's specific preferences and in many countries a lot of money went to the building industry, which is a sector with limited competition from abroad. Effectively, national governments were trying to make sure that taxpayers' money would not stimulate the economies of other countries. Whilst this is not surprising, it nevertheless constitutes a partial departure from the European project, which was characterized by collective problem-solving. The country that should have withstood that trend was Germany, which is both Europe's largest and most competitive economy. More than any other single country, Germany benefits from both European integration and a liberal global trade regime, and the failure of German politicians to realize their specific responsibility in the European and global economy attracted harsh criticism (See, for example, Collignon 2009).³ A comment of Germany's then Minister of Economics in November 2008 didn't help: he indicated his hope that '... the measures taken by other countries ... will help our export economy' (quoted in Münchau 2008).

No Difference to Wall Street – The Quiet Networks in European Finance

Networks between finance and politics help to explain some dimensions of the crisis management, both in the USA and in Europe. In the USA, the crisis has shed light on the significant linkages between Wall Street and Treasury. Three recent American Secretaries of the Treasury – Robert Rubin, John Snow and Hank Paulson – came from Wall Street or went there after their time in office. Alan Greenspan has become an advisor to PIMCO, an important player in international bond markets. The former chief economist of the International Monetary Fund, Simon

³ See also *The Economist*, Miss World goes missing, 22.11.2008, pp. 35-36.

Johnson, has argued that the financial industry has effectively captured the American government. Comparing the American financial sector to Russian Oligarchs, he has recommended a tough medicine:

The second problem the U.S. faces—the power of the oligarchy—is just as important as the immediate crisis of lending. And the advice from the IMF on this front would again be simple: break the oligarchy (Johnson 2009).

The linkages between the government and the financial sector are well known and well-documented in the USA, but Europe, and Germany in particular, is not structurally different. As mentioned above, a key figure in German has been the Deputy Finance Minister Jörg Asmussen, a Social Democrat. Asmussen joined the Ministry of Finance in 1996 at the age of 30. Quickly promoted, he became Head of Department VII – financial markets and their regulation – in 2003. Asmussen pushed innovation in German finance, securitization in particular, in subsequent years. In an article in a finance journal in 2006, Asmussen praised the benefits that asset backed securities would have. Besides, he explicitly indicated that the German Ministry of Finance will not insist on ‘unnecessary testing and documentation requirements’ (Asmussen 2006). As mentioned above, he sat on the board of the failed IKB and was thus partly responsible for this bank failure.

Some observers had expected that Asmussen, following the IKB debacle, would have been sent into early retirement. Instead, he was promoted in July 2008 to the position of Deputy Minister of Finance and became responsible for the bailout measures – a classic case of ‘poacher turned gamekeeper’. The very person that had been pushing deregulation and lax banking supervision in Germany became the most important person in the rescue operation. Ironically, or perhaps rather a confirmation of Asmussen’s good networks, he has been one of the very few senior officials from the Social Democrats that remained in office after the change of government in autumn 2009.⁴

⁴ The German newspaper *Frankfurter Allgemeine Zeitung* characterized Asmussen’s remaining in office as a big surprise. Gerhard Schick, Green Member of Parliament, expressed criticism and suggested that the policies of the previous coalition would probably be continued (29.10.2009, p. 17).

In addition, Asmussen has strong private links with German finance. His partner, Henriette Peuker, is the chief lobbyist of the German Stock Exchange in Berlin (Afhüppe 2009). Asmussen studied at Bonn University, and one of his fellow students was Jens Weidmann, who has been Angela Merkel's main economic advisor since 2005. These two were taught at Bonn by the economist Axel Weber, who was promoted to the presidency of the Bundesbank in 2004, following a proposal of Asmussen (Fietz 2009). The regulation and supervision of German financial markets, as well as the subsequent rescue operation, was in the hands of a social circle that shared not only their academic background but also their market-friendly economic orientation.

The existence of links between the government and the financial sector it is not astonishing, but their intensity is remarkable. As in the United States a regular exchange of personnel can be observed. One of Asmussen's predecessors, Caio Koch-Weser, left the Ministry of Finance for a lucrative position at Deutsche Bank in 2006. Another Deputy Minister of Finance, Axel Nawrath, left the government in 2009 to take up a position in the Government-owned KfW-Bank. The scale of the links between finance and the government may not be the same as in the USA, but the trend and effects appear similar.

The drift towards less regulation for the financial sector in Germany has been implemented under the auspices of Social Democratic Ministers of Finance, who held this office since the change of government in 1998. Whilst the previous conservative coalition, led by Helmut Kohl, was not hostile to the interests of the financial sector, it was their Social Democratic successors that deregulated financial markets. The parallels to other countries are quite striking: In Australia, financial markets were deregulated by the Hawke/Keating government following its election in 1983. In the USA, important regulatory restrictions, for instance the separation of investment and commercial banking required by the Glass-Steagall Act of 1933, were scrapped by the Clinton administration in 1999. And in the United Kingdom, Tony Blair's Labour government championed 'light-touch regulation', the term being coined by Gordon Brown. In all those cases, including Germany, the interests of finance industry were accommodated by ostensibly left-leaning governments.

Of course, the importance of the small group of economists at the German Ministry of Finance and the Bundesbank rose dramatically during the financial crisis. Effectively, the crisis was managed by half a dozen men in Germany – Finance Minister Peer Steinbrück, Axel Weber from the Bundesbank, Josef Ackermann from Deutsche Bank and Jochen Sanio from BAFIN, the agency supervising financial markets, Jörg Asmussen and Jens Weidmann coordinating the rescue operations in the background.⁵ Given the great importance of Asmussen in particular, there has been a substantial amount of criticism, both in the political sphere and in the media (See, for example, Ramthun 2009, Stern 2009, Zeit 2009). As mentioned above, this criticism has not destabilized his position.

As in other countries, the preferences of the private sector have changed over the last two decades, and at the centre of this change is Deutsche Bank, Germany's only global player in finance. Josef Ackermann, the chief executive of Deutsche Bank, is the by far most important representative of the banking industry in Germany. He has continued and eventually championed the transformation of Deutsche Bank from a national player into a globally operating investment bank. Since 2005, Ackermann has been frequently consulted by Chancellor Angela Merkel and has been a prominent figure in German crisis management.

The contrast to previous decades is striking. In the first four decades after World War II, Deutsche Bank was very closely intertwined with German industry. Since the early 1950s, for example, Deutsche Bank owned 25 percent of the shares of Daimler-Benz, one of the largest and probably most prestigious industrial producers in Germany. The close relationship between German Banks and the manufacturing sector – labeled 'Deutschland AG' or Germany Inc. – came under intense pressure in the 1990s. Again, it was the Social Democrats who facilitated change. Deutsche Bank, to take the example from above, had acquired Daimler-Benz shares at a share price that was of course a fraction of their valuation decades later. Had they sold the shares under the old tax regime, Deutsche Bank would have been forced to pay billions in taxes on their capital gains. However, a change of the tax regime introduced by

⁵ 'Die sechs Nothelfer', *Süddeutsche Zeitung*, 13.10.2008, at <http://www.sueddeutsche.de/finanzen/952/313855/text/>.

the Social Democratic Finance Minister Hans Eichel in the late 1990s enabled German Banks to sever their ties with German industry and realize enormous tax-free gains (Maisch 2005). Since then, the interests of German banks have of course changed fundamentally. Whilst prior to the late 1990s, German banks regularly were advocates of German industry, since then industry and finance often have diverging positions.

Silence on Imbalances

At the macroeconomic level, the crisis has exposed the vulnerability of capital exporters. In recent years China, Japan, Russia, Saudi Arabia, and Germany have exported huge amounts of capital and contributed to speculative excesses in other countries. But the role of the capital exporters plays a minor role both in the analysis of the crisis and in the debate on crisis prevention. This is surprising.

There are good reasons to give more thought to these imbalances. The whole business was a rotten deal. Germany sold machines and high-quality cars and received Lehman derivatives in return. Germany's enormous surpluses landed back in the United States where they helped fuel the dubious dealings of the US financial sector. This is not a model to emulate. However, at the international level there is still no earnest discussion about getting rid of the imbalances. There are reasons for the silence.

For the economies involved, the existing model has offered advantages and satisfied particular preferences. That claim applies especially to the United States and China. The former is the economy with the biggest appetite for capital, whereas the latter is already the world's most important manufacturer of consumer goods of all kinds. A specific division of labour has emerged over the past decade: China manufactures goods and supplies the credit for their purchase; while the United States buys Chinese goods and accumulates debt. Back in 2003, the Basle Bank for International Settlements was already describing this arrangement as 'vendor finance'.

China is not the only surplus country, however. In Europe, Germany's enormous surpluses have led to tensions within the EU. Without the

common European currency, the large German current account surplus (more than 260 billion US dollars in 2007) would have driven up the exchange rate of the deutschmark. In the absence of an external stability pact, this drives a dangerous wedge into the European Union (Dullien & Schwarzer 2009). Ultimately, German capital exports helped to finance the bubbles in Spain, Ireland and a number of Eastern European countries. German capital exports were a poor deal for Germans anyway. Despite their preference for safe investments, risk-shy German savers have been left carrying the can all the same – through the state budget – for the risks taken by financial intermediaries.

Of course, given the risk-averse preferences of German savers, there had to be a transformation of savings into high-risk investment. This transformation was often facilitated by state-owned 'Landesbanken'. Typically, these government-owned and government-guaranteed banks were engaged in financing investment in Germany. Their particular legal construction, especially their explicit government guarantees, came under pressure from the European Commission, which considered the government-guarantees to be an illegal subsidy and a competitive disadvantage for other European banks. Since the government guarantees had to be scrapped, the Landesbanken perceived a need to expand their activities and engage in new, potentially more risky activities. Many of them, for example Sachsen LB, Westdeutsche LB and Bayerische Landesbank, were aggressively expanding their activities in the current decade. Unfortunately, they did not know their new trade well, and most of them needed big bailout packages from the German taxpayer. German policy makers, some of whom oversaw these ventures, have been criticising the greed of investment banks, but were at the same time much more reluctant to disapprove of those banks which have been under their direct influence.

Surprisingly, both the contribution of German savers to the fuelling of bubbles elsewhere and the involvement of German federal and state governments in financial adventures abroad are hardly discussed in Germany. With regard to the production of surpluses, most Germans appear eager to return to successful exporting and appear not concerned that this eventuality could lead to yet another financial calamity.

Model Endorsed – Gains Wasted

The global financial crisis represented an opportunity for Europe, but that opportunity has been wasted. Continental Europe, without the United Kingdom and Ireland, has not had financial sectors that had grown out of proportion and had continued to place emphasis on a more sustainable economic development. In the crisis, continental European economies – in particular Germany, France, Italy and Spain – could have both led the group out of crisis and re-emphasized their political preference for a sound and more comprehensively regulated financial sector. Neither happened. Crisis management was primarily organised at the national, not the regional level; and a member country of the EU, Hungary, had to call the International Monetary Fund to the rescue.

In the subsequent reform debate, continental Europe is as silent as ever, whilst the discussion is led by British politicians, who have lately suggested rather dramatic measures. Adair Turner, head of the Financial Services Authority FSA, categorized the City of London as having grown ‘beyond a socially reasonable size’ and has been advocating a transaction or Tobin tax, hitherto anathema for the British establishment.⁶ Mervyn King, Governor of the Bank of England, has even called for the break up of banks into government-protected commercial banks and investment banks, with the latter free to gamble but not to be rescued if they fail.⁷

Whilst China appears to benefit from the crisis in OECD countries, the countries of the European Union have failed to utilize the historic opportunity that the crisis provided. Contributing to the failure have been mediocre crisis management driven by national rather than European priorities, structural weaknesses in regional economic governance and the inability of European governments to develop joint positions on financial governance.

⁶ *Financial Times*, 27.8.2009, at <http://www.ft.com/cms/s/0/08943b5a-926a-11de-b63b-00144feabdc0.html>.

⁷ *Financial Times*, 21.10.2009, at <http://www.ft.com/cms/s/0/7056b56a-bda8-11de-9f6a-00144feab49a.html>.

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