

“Never waste a good crisis” –
Why Europe will prosper

Public lecture given by
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In just four days from today, another EU summit will take place in Brussels. I do not know about you, but I have lost track of the number of such meetings since the outbreak of the Eurozone crisis.

If I had to guess I would probably say that there have been more than a dozen. But I did not bother to check the exact number.

What is more interesting is that in this case, looking back is almost as easy as looking forward. According to Mark Twain, the guru of truisms, predictions are always difficult, especially those about the future.

I dare say that if he were alive, he would rephrase his remark something like this: Predictions are always difficult, except those about the Eurozone as it is a rather safe bet that there will be more ad-hoc summits in 2012.

Indeed: The crisis is far from over. People with much more authority than an ambassador have stated publicly that we are faced with the most severe crisis since the launch of the Euro, if not in the history of European unification.

So, we had better brace ourselves for more rather than less crisis management in 2012.

But eventually, this like any other crisis will come to an end. Crises cannot go on forever because neither individuals nor societies or nations can stand the physical and psychological stress indefinitely.

Which offers a first glimmer of hope. Surely, some might not see it as a glimmer of hope but as an ominous writing on the wall. For it all depends how this crisis will end: will Europe survive or will it disintegrate?

Except for those who would consider dissolution a desirable rather than a nightmarish option, this is a stark alternative. For a conviction European like me, it is deeply regrettable that it has come to this. But denial is no way out. Unless you bank on sheer luck, crisis management has to begin with a sober analysis of the present situation and a recognition that the situation is grave.

As I see it, the Eurozone crisis has three dimensions.

First, overindebtedness. There has been too much spending and too little saving. And too much spending has gone into consumption and too little into productive investment. By no means all Europeans, but too many have lived beyond their means. And this applies both to public and private sectors, with the latter not only including private households but banks as well.

Now, the day of reckoning or, to use the technical term, the day of deleveraging has arrived. Today, most people would concede that it was bound to come, and some can even claim a “told you so”. But the bonanza went on too well for too long so that the whistle-blowers were ignored or denounced as party-poopers. As Chuck Prince, the then head of Citigroup, told the Financial Times just weeks before the credit crunch in August 2007: “As long as the music is playing, you’ve got to get up and dance.”

Can you blame him? After all, the shareholders of Citigroup appointed him to maximise profits, and for years the quickest and easiest way to do so had been to take part in what the Economist called the “toxic two-step” of credit growth and asset price inflation, particularly in property.

A similar kind of “logic” was at work in politics. Politicians serve as easy scapegoats but in a democracy they need a popular mandate to govern and to deliver. Among the goods they are expected to deliver prosperity is usually at the very top. So when a society enjoys an economic boom and politicians are elected to prolong it, what is the chance that people will get elected by sounding the alarm and urging restraint?

Do not get me wrong. Democracy, as Churchill famously stated, is the worst form of government – except for all the others that have been tried from time to time. And political leaders have a responsibility to lead which can involve taking unpopular decisions. Ultimately, however, they need a popular mandate and if they do not get it they cannot lead.

A second source of instability are economic imbalances within the Eurozone, in particular between countries with large surpluses in trade and investment and those with persistent deficits. Diverging competitiveness between national economies is a major cause of these imbalances. When the external financing of deficits dried up

and investors started demanding substantially higher interest rates, this dormant source of instability became manifest.

A third and related cause of the Eurozone crisis is the instability of the financial system, known as the too-big-and-too-interconnected-to-fail syndrome. It is not confined to the Eurozone as became apparent in 2008 following the collapse of Lehman Brothers.

During the good times credit and property bubbles were fuelled and external deficits made affordable by cheap money funnelled through the global banking system. When the crunch came, taxpayers had to bail out so-called SIFIs or Systemically Important Financial Institutions because letting them fail was too risky for the economy as a whole.

The same is true for the Eurozone. Its instability is in part caused by the risk of contagion posed by financial institutions that are too big or too interconnected to let them fail. Moreover, the magnitude of the risk is unknown because nobody appears to know how many dominos would fall once the virus began to spread. This massively enhances uncertainty and has led banks to refuse to lend to each other, which in turn restricts access to credit by business and consumers.

L&G,

Having listened to this analysis of the Eurozone crisis, you might wonder if there weren't people who saw it coming. The answer is: Yes, there were. True, hardly anybody could claim to have foreseen the exact nature, timing and scale of the crisis. But already when the Euro was launched, it was not just hard-core pessimists who argued that the Euro was bound to hit troubled waters.

We are now in just such waters. Primarily for the reasons just discussed: too much public and private debt; too much divergence in national competitiveness; and financial institutions that have become too big or too interconnected to fail.

Some of those who saw it coming would argue that these three causes have a common denominator. To them, the root cause of the current crisis is the common currency itself. Or rather how it was constructed.

According to this line of reasoning, the Euro edifice was prone to topple over because it rests on the single pillar of a common monetary policy.

In my view, proponents of this argument are half-right. They deserve credit for highlighting a potential faultline of the Eurozone, namely the absence of a common economic and fiscal policy to complement the common currency.

But this design flaw only partly explains the current crisis. Here it is useful to remember that the global financial crisis did not originate in the Eurozone. It erupted in the United States of America which epitomises what economists call an “optimum currency area”, that is an area or state whose currency is rendered stable by unfettered labor and capital mobility as well as some form of transfer mechanisms to prevent excessive regional discrepancies that could destabilise the currency area.

What led to the crisis in the US was not a less than optimum currency area but a series of policy failures inspired by a free-market ideology that allowed the financial services sector to decouple itself from the real economy. The Economist put it this way: “The cause of today’s crunch – the buying of property at inflated prices in the hope that some greater fool will take it off your hands.” That is a simplification but it contains more than a kernel of truth and it comes from a paper that has been flying the capitalist banner for more than 150 years.

So being an optimum currency area is not sufficient in itself. But that provides no comfort for the Eurozone. Because not being an optimum currency area carries grave risks. And this is what the current crisis has brought to the fore.

Nobody will ever be able to find out whether the crisis would have been prevented if the Eurozone were an optimum currency area. Certainly not completely, because in one way or another, the Eurozone would inevitably have been hit by a US-bred crisis.

In any case, the three causes of the Eurozone crisis that I identified had been at work long before the global financial crash. Would an optimum Euro currency area have been a preventive recipe?

Again, nobody will ever know. Just like in the US, the crucial variable would have been what type of budgetary, economic and regulatory policies Euro member states would have pursued.

But pursuing such policies would have been much easier if the Eurozone had been an optimum currency area. In that case, the institutions and procedures to support such policies would have been in place. Equally if not more importantly, the political awareness and willingness to carry them out would have been much greater.

Still, the crisis did lay bare structural weaknesses of the currency union. Member states were not ready to complement a common monetary policy with a corresponding economic and fiscal policy. They wanted the cake and they wanted to eat it: enjoy the benefits of a common currency such as absence of exchange rate fluctuations and low interest rates due to price stability ensured by the ECB. But they did not want to pay the price of earning these benefits the hard way, that is through fiscal discipline and competitive national economies.

So far, so bad. Or as Eurosceptics could say: So far, so predictable. Didn't we warn you of introducing a currency union without a political union? From this, they draw two conclusions: First, the Euro was a stillborn project that should not have been launched in the first place. Secondly, the Eurozone is doomed to break up because member states will continue to be unwilling to do what is necessary for the survival of a common currency.

While I partly agree with the diagnosis, I completely disagree with the conclusions for two reasons: First, the conclusions ignore that the Euro has been and continues to be not only an economic, but also a political project. And secondly, not least because of its political nature, member states will defend and stabilise the Euro.

These two points are related: If you see the Euro as not merely an economic end in itself but also as a means to a political end, you are more likely to contest the proposition that this crisis proves the Euro is doomed to fail.

What is the political nature of the Euro?

The somewhat paradoxical answer is: The Euro is a political project precisely because the currency union was not underpinned by a political union. Just like Eurosceptics, the founders of the Euro were aware that this could pose a risk. But they were willing to incur the risk because they saw it as a price worth paying for a higher political end.

This end was and remains the reinforcement of the European space of peace, prosperity and democratic stability. The Euro was conceived as and is a means to this political end.

And what a political end it is! The EU is the most successful continent-wide project in European history. It is based on and it thrives on the recognition that peace, prosperity and democratic stability go hand in hand and that they are objectives which can only be pursued together: Either we enjoy them together or we lose them together. This is the prime lesson drawn from the tragic history of war-torn Europe.

We have learnt this lesson so successfully that today peace is taken for granted. Which is a great triumph as well as a potential tragedy.

The triumph is the extraordinary stability of the peace. Imagine for a second the whole world consisted only of the EU. We could then abolish our military altogether. Not because such a world would be without conflicts. But as in today's EU we would trust each other so much that we would need no military reassurance to resolve our differences.

There is no way of proving that our ultra-stable peace is the result of European integration. Indeed, I would readily concede that there were other factors involved as well: horrific memories of two world wars which discredited traditional balance-of-power politics among European nation-states; the Cold War and the bipolar confrontation that unified the democratic and capitalist West against the communist East; American power and protection which facilitated European reconciliation and integration.

But the Soviet Union is long gone and there is no unifying communist threat any more. For more and more post-war generations the First and Second World War are becoming historical events rather than historic watersheds. And the United States is neither eager nor able to continue as Europe's pacifier.

And yet Europe's peace is not in danger. Granted, this is no definitive proof that European integration and stable peace are two sides of the same coin. But it provides conclusive evidence that such a link does exist.

What it does not provide, however, is a 21st century leitmotif for European unity. It is necessary to recall the peace-preserving character of European integration lest it be taken for granted that we have been enjoying the longest period of stable peace in Europe.

It is necessary but it is far from sufficient. This is demonstrated by a simple question. If the European Union did not exist, would we create it today and if so, why would we create it?

People aware of European history would still argue that European integration is the best available protector against a recurrence of violent conflict resolution. And rightly so. But against the backdrop of more than half a century of peaceful conflict resolution, this argument would lack the mighty impetus of the immediate post-war period.

So why should we create the Union today? The short answer is: Big is Better. Big may not always be beautiful, but big is better in order to advance our national interests in a globalised world.

This is by no means a new rationale. It is the basic idea underlying the single-market project which is a primary source of our prosperity. A rule-based and properly supervised huge market offers more competition, more opportunities and more choice for producers, consumers, investors and workers alike. It thus enables a better allocation of scarce resources and raises productivity not only internally but also in relation to external competitors.

The latter point is particularly important in today's globalised economy. In many ways, China has become a benchmark of economic efficiency. Expect this to intensify because just like Japan some decades ago, China will increasingly add a high-end, R&D driven sector to its vast economy. Only several times bigger than in Japan.

And there will be other newcomers like the Indians and the Brazilians as well. In addition, there is the United States of America. While they are struggling at the moment, theirs is and will remain a highly innovative and formidable economy. A well-functioning and huge European market will enable us to keep up with these global competitors.

But big is better not only in terms of market size. There is no such thing as a truly free-market economy. Markets need rules to function properly, and competition can flourish only if these rules are fair and enforced.

But the rules of the game are not set and enforced by an “invisible hand” alone. They are set and enforced -- or not enforced, as the case may be – by states and international institutions such as the World Trade Organisation or regional regimes.

Again, big is better. For it is inevitable that big players with economic clout in terms of market size and competitiveness can exert a greater influence on the rules of the game than smaller players. And only big players can provide a counterweight to other big players so that there is productive competition and everyone plays by the rules.

Take the example of the civil aircraft industry. Had it not been for Airbus, Boeing might have become a monopoly producer. And as airlines would have passed on the cost of monopoly pricing from Boeing, we passengers would have got the sharp end of the stick.

The Airbus case is illustrative of what we Europeans can achieve when we pool our resources and act as one. The European Commission has successfully taken on giants such as Microsoft to provide better conditions for smaller competitors. Internally, the Commission has forced telecom companies to offer us a much better deal on roaming fees. No national anti-trust agency would have been powerful enough to do this.

Big is better also when it comes to financial markets. As noted earlier, one of the problems bedeviling the Eurozone is that financial institutions have become too big or interconnected to fail. Heaping blame on sinister bankers misses a crucial point. Banks were allowed to become too big because deregulation went too far. Now that they have become too big it takes actors powerful and independent enough to re-regulate the sector and to re-connect it

with the real economy. On its own, perhaps even Europe is not big enough. But without Europe it is unlikely to happen.

Or take climate change. Europe alone cannot prevent a catastrophic climate change. But it can do and has done two things. First, of all major political actors, Europe has been the most active in raising international awareness and in pushing for a global accord. Secondly, Europe has been able to do this by the sheer size of its economy and through leading by example, that is by setting itself ambitious targets and making its economies more energy-efficient.

Then there are even more political examples of “big is better”. Europe may not always be a shining example of altruism but it is the largest donor of official development assistance and it is a vitally important trading partner for many developing countries. Promoting human rights is an area where Europe has been found wanting. But the fact is that without a united Europe the human rights situation in the world would be even more deplorable.

Finally and importantly, there is the “Yes, you can”-Europe. Yes, it is possible to bury age-old rivalries and create a “win-win situation” of mutual trust and common prosperity. True, what we have achieved in Europe cannot be simply copied in other parts of the world, but the very existence of a peaceful, prosperous and democratic Europe serves as a source of inspiration for others.

So here then is the 21st century rationale for a strong and united Europe. In a world of global opportunities and global risks, the EU is our way of ensuring that the risks and benefits of globalisation are shared and that its rules are shaped in a way that takes into account our values and our interests.

For in a such world, not a single European country qualifies for the global Premier League. As individual countries, we are middleweight at best. Only by pooling our resources are we powerful enough to compel others to cooperate with us on an equal footing. And by acting together we can be a much more effective force for good in the world.

L&G,

You may now think: so far, so convincing. But would the speaker please come back to the burning issue of the Eurozone and what to do about it?

Well, to me the link is obvious. The Euro is not just an economic end in itself; it is also an essential means to a dual political end. Internally, to strengthen the European space of peace, prosperity and democracy, and externally, to help turn Europe into a global force for good that promotes the values and interests of its member states.

At the end of the day, this perspective on the Euro largely determines where you stand in the current debate. If you share my view that the Euro also is an economic means to political ends, you are more likely to support it and stress its positive potential. If you do not, you are more likely to be less supportive and less concerned about its possible demise.

So much for the poetry. Now comes the prose. And the prose is this.

A means unsuited to furthering an end can destroy that end. This is especially true of the Euro. For agreeing on a common currency is very different from agreeing on an EU regulation on, say, roaming fees.

In the case of a currency union, the economic and political stakes are infinitely higher. Therefore, when it comes to the Euro, great care must be taken to neutralize Murphy's law that what can go wrong will go wrong.

So what is to be done to ensure that the Euro furthers rather than undermines European integration? And what is Germany's role in all of this?

I will start with the German question.

In one way or another, you often hear that "The Euro goes where Germany goes". Indeed, Germany is pivotal to the stability of the Eurozone. If Germany were to renege on its commitment to the Euro, it would be doomed.

As regards the German commitment, the Chancellor has said repeatedly: "Europe fails if the Euro fails". So the government is acutely aware of what is at stake. And not just the German government. All major legislation on measures to stabilise the Eurozone has been passed with opposition support in the

Bundestag. And recent opinion polls have shown that two out of three Germans believe in the future of the Euro.

This reflects that all major political forces and the German people continue to see the Euro as essential to the well-being of my country. Consequently, Germany has supported and will continue to support the Eurozone even if this means incurring substantial risks and costs.

But the good news comes with a note of caution. Germany alone cannot do it. Even our resources are limited. It takes two to tango. I do not know if there is a dance that takes exactly 17 to perform, but for the Eurozone the message is simple: we are all in this together and we must all act for it together.

Euro member states have made great strides to stabilise their common currency. Above all, there is general recognition of three things. First, crunch time has arrived; secondly, there are no quick fixes, and thirdly, radical and sustained efforts are required to overcome the crisis.

I will not go into the details of current negotiations. Moreover, if I knew of a German masterplan, the government would not allow me to disclose it.

On a more general – if you like: ambassadorial – level, however, I would like to make four points:

1. Germany does not think that all it takes is for others to become like us. Europe thrives on diversity and our Union is based on mutual respect for different traditions and mentalities. And would you really want to be utterly bored by dealing with the likes of yourselves all the time?

2. What you do want, however, is that all play by agreed rules and that everyone contribute their fair share. In other words, that all members assume their individual responsibility for the common good and that none is allowed to be a free rider.

3. The treaty on fiscal discipline is vital. It is needed to address the problem of overindebtedness in a way that convinces both our publics and taxpayers on the one hand as well as investors on the other that this time we are serious about debt reduction.

4. Fiscal discipline is vital, but not sufficient. At the outset, I identified three causes of the crisis. They carry a clear message: alchemy does not work.

As regards public and private debts, no magic wand will make them disappear; instead, in one way or another, living beyond your means will come to haunt you.

Similarly, a high standard of living has to be secured through high productivity and competitiveness. Unless nature's generosity has endowed you with oil or gas, there is no magic formula to get around this. And in most cases there is no magic formula at hand to restore economic competitiveness in the short run. Usually, it takes efforts sustained over several years.

Finally, financial alchemy does not work either. It may appear to work for a while, and last time the music – to return to Chuck Prince's metaphor – the music played several years. But when it stopped, we were left with a most severe hangover. The task now is to re-instate market rules in the financial sector and to make it fail-safe for the real economy. This, too, cannot be achieved overnight.

Clearly then, the crisis is not an ordinary one. It is worth remembering that it did not originate in Europe. It is also worth keeping in mind that the crisis is taking place amidst a fundamental reshaping of the global political and economic landscape. We are no longer living in a world defined by the "West and the Rest". The so-called "emerging countries" are no more because they have already emerged as new centers of economic and political gravity.

This development should not scare us. In any case it is happening and we had better brace ourselves for it. More importantly, though, why should China and India or others not be responsible stakeholders of the one planet we all share? There is nothing in our or their DNA that says that we can whereas they can not.

At the same time, there is no guarantee whatsoever that others will shape globalisation in line with our preferences. On the contrary, just like us they will tend to look after their interests first. Which is why "Big is Better": Together we Europeans are a global heavyweight, together we can stand up for our values and have others respect our preferences. And together we can act as a formidable force for good in the world.

L&G,

This is what is at stake in the current crisis. At stake not in the sense of averting a colossal disaster. Truly, if we fail to do what is necessary to safeguard our common currency, we will all suffer tremendously. But rather than emphasising what we stand to lose, I would like to end on a positive note and stress what we stand to gain by sticking together and bringing our house in order.

This is why I chose the title “Never waste a good crisis”. It is in quotation marks because they are the words of Rahm Emanuel, President Obama’s former chief of staff. It remains to be seen whether it will help President Obama to get re-elected.

But it should help us here in Europe. This crisis is not a good crisis, but it can be put to good use if we heed it as a wake-up call. The crisis has laid bare structural deficiencies of the Eurozone construction, and it has revealed the ruinous effects of too much debt, too little competitiveness and too much financial alchemy.

When, if not now, is the time to address these deficiencies and weaknesses? And when, if not now, is it time to stand up and make a case for Europe? A case for collective European sovereignty to safeguard our national interests and to promote our common values, and a case for collective European sovereignty to bring about a just and sustainable world order.

The Euro is essential for the exercise of this collective sovereignty. It is an economic and political project that must not be allowed to fail. Indeed, if there is an institution that is too big to fail, it is the Euro. Count on Germany that it will not happen.