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WHAT´S WRONG WITH EUROPE?

AND BY THE WAY: WHY DON´T YOU FIX IT?

A KEYNOTE-SPEECH

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In academic papers, the authors often single out key-words to have their readers concentrate their minds. Following their example, here are some key-words from my speech, to start you thinking:

Insolvent banks. Unsustainable debt. Toxic loans. Junk ratings. Bailouts. Defaults. Tax-havens. Markets vs the (welfare)state. The 1% vs. the 99%. Moral hazard. Social contract. Plutocracy vs. democracy. Crisis of democracy.

1. **How to save capitalism from the capitalists?**

The current twin crisis of insolvent banks and unsustainable debt has reminded us, that banks are inherently dangerous. More dangerous indeed than standing armies, according to **Thomas Jefferson**, the only US president, who is said to have raised the intelligence in the White House measurably, - when he dined alone.

Why are banks dangerous? Well, They are in essence a **Ponzi**-scheme. They attract our savings by the lure of interest rates, promising to make money work for us, without effort. But since banks only keep small fractional reserves, they can´t pay us back on demand (i.e. if we all turn up at once). It is just like a Ponzi-scheme. **Mr. Madoff**, the $100-billion swindler on Wall Street, who duped even the Federal Reserve, could tell us all about it.

This is a lesson we learnt the hard way during the *Great Depression of unregulated capitalism* – in the thirties of the last century – when six thousand banks went bankrupt in the US in the wake of a stock-exchange panic. That was when guests checking in at hotels on Manhattan were asked: For sleeping or for jumping? Since then we knew – or should have known – that banks are too dangerous to be left alone – unregulated and unsupervised. To maintain trust the state must guarantee the safety of at least a minimum of deposits, entrusted to a bank.

This, to my mind, explains the essence of the crisis that has engulfed America and Europe for the past five years. This is a crisis that threatens to paralyze the world economy – in a sort of repeat version of the Great Depression. But, not only have we forgotten lessons learnt long ago from our experience during the Great Depression. We have also let ourselves be duped by a simplistic ideology, a naïve belief in the infallibility of markets.

This has been the mantra of uncontested wisdom in the boardrooms of multinationals, in cabinet meetings as well as in academic circles, around the globe. The results are here for all to see, i.e. if your eyesight is not perturbed by ideological blinkers. *Too many banks lent too much money they didn´t own to people they knew (or should have known) that couldn´t pay back*. Or to put it differently: The capitalist machine is broke – out of steam – and the capitalists themselves – believe it or not – expect the state to come to their rescue.

Everything they wanted us to believe about the superiority of markets and the evil of state intervention, has been turned upside down. We are living through the *greatest rescue operation in history by the state,* in order to save capitalism from the capitalists.

2. **Plutocracy vs. democracy: Repudiating the social contract.**

Let us retrace a few of the major steps that have brought us towards the brink of the abyss:

- **The firewall:** First we tore down the *firewall* that had been raised, after the Great Depression,between retail-banks, that were supposed to keep our savings deposits safe, and the „shadow banking system“ (investment banks, wealth management funds, hedge funds, etc.) which, let loose from the restraining hands of the regulators, took every risk imaginable to maximize profits.
- **Ballooning of the financial sector:** In doing so we opened up a Pandora´s box of speculative frenzy which, in less than thirty years, has led to the ballooning of the financial sector. According to some estimates the financial sector has outgrown the real economies´ global GDP by a factor of seven to ten. This is footloose and fickle capital, whose owners and managers are searching the globe for short term profit, prone to panic at the slightest sign of trouble, descending on vulnerable nation states like predators encircling sickly prey. In terms of power relations, many under-developed nation states are no match for those financial predators, when put to the test.
- **Frequency of Financial crisis:** Financial crisis of this type are becoming more and more frequent: Mexico in 1994, South Korea, Thailand, Indonesia and Malaysia in 1997; Russia, Brazil, Equador, Pakistan and Ukraine in 1998 and 1999, Turkey and Argentina in 2001. **Nouriel Roubini,** one of the few outstanding economists of his generation, who famously foresaw the coming great recession already in 2005, describes the process like this: „After flooding these countries with capital, foreign investors got spooked and fled in droves, leaving behind currency crisis, waves of failures in the banking and corporate sectors, and defaults on government debt. Only the timely interventions of the IMF and World´s Central Banks prevented a worldwide economic disaster“. – Once again *financial markets being rescued by the State.*
- **Weapons of financial mass destruction:** Of all the glamorous high-tech financial products generated by the financial sector and peddled around the world during the bubble, an alarmingly high proportion turned out to be fake, based on fraud, and verging on the criminal. This is what **Warren Buffett**, the third richest individual in the world, had in mind when he described them as *„the weapons of financial mass-destruction“*. We live in an age of terrorism. If the aim of Islamist terrorists is to destroy Western Democracy, they could learn a thing or two from those financial terrorists.

- **Accelerating inequality:** We also live in an age of accelerating inequality. Before 1970 the ratio between the salaries of CEOs and average employées in the US was 130:1. In the first decade of the 21st century this ratio had reached the scale of 400:1. Those financial *Wunderkinds* reaped truly astronomical rewards. At the same time the average salaries of employées in the US were stagnant in real terms. The compulsive urge to maximize short-term profits of owners of capital has, contrary to the tenets of the *„tricle-down"* theory, led to decreasing investments, lower rate of growth and higher levels of unemployment and poverty, than in earlier periods.
- Out of the total increase in income generated in the US between 1989-2006, 91% of it accrued to 10% of the richest; 60% of the total increase of income went into the pockets of the 1%, at the very top of the pyramid. Of all income gains since the recession started, 90% has gone to the top 1%. Crisis-what crisis? For the 1%, there seems to be no crisis.This explains the increasing polarization of society between the so called 1% - metaphorically speaking – who own or control the accumulated wealth of nations, on the one hand, and the so called 99% who, at the same time, are experiencing stagnant or declining living standards, increasing insecurity, unemployment, etc.. In the light of those facts it is paradoxical, to say the least, when representatives of the people in Western democracies are demanding, that the 99% pay higher taxes and accept deprivation of social services, - in order to *bail out* the 1%. The justification is supposed to be that they are „**too big to fail**".
- **Weak nation-states – dictatorship of markets:** The greatest transfer of power – sovereignty if you like – from nation states, has not been to supranational institutions, such as those within the EU. The greatest transfer of sovereignty from nation states in our times is to the *„markets*". The markets dictate the yields of your bonds; They implode your borrowing costs; they insist that the state bail-out private banks; they drive up the sovereign debt. And then the rating agencies do the rest.
- **Rating agencies:** Who are they, by the way? The fact that they derive their revenue from the banks they rate, has created a massive conflict of interest. All the Icelandic banks had tripple A-ratings until the night before they fell. Also, the rating agencies sell „consulting" services on the side to issuers of debt. This creates another conflict of interests. Of course the investors themselves should be paying for ratings of debt, not the institutions that issue the debt. What we have here is massive conflict of interest and a systemic incentive for deception. The same applies for the big accounting internationals. They were more or less discredited during the bubble. But has the system changed? No – why not?
- **Moral hazard** is defined as somone´s willingness to take (excessive) risks (that he would normally avoid) simply because someone else (in this case the tax-payer) will shoulder the negative consequences of failure. This is what a *bail-out* is all about. The money moguls got huge compensation for peddling their fake financial products to their unwary customers all over the world. But they bore no responsibility. *The separation of freedom from responsibility was complete.* The fall-out of their irresponsible decisions became the tax-payers´problem, not theirs.
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Case studies: Ireland vs. Iceland – bail-outs vs. bankruptcy.

Those sister islands have both suffered heavily from the financial crisis. Pranksters in Dublin said that the difference between the two was one letter and one week. But in reality the difference is between a *bail-out and bankruptcy.* First, take the case of Ireland. The Irish government made the fateful mistake of guaranteeing the debt of private Irish banks, without even knowing about the toxic loans, hidden in their vaults. Subsequently, the Irish government was more or less forced to accept a bail-out by the ECB and the IMF to the amount of ca. 68 billion euros. According to the IMF, Ireland has now displaced Japan as the world´s most indebted economy. Government, household and non-financial company debt add up to 524% of GDP. Funding this gargantuan debt load at 4.5% rate of interest, will take a quarter of Ireland´s GDP – the entire industrial output of the nation – for years to come. This is both unjustifiable and unsustainable. And who is being bailed out, by the way? According to the Basel Bank of international settlements (BIS), German banks had more than 300 billions of euros of exposure to Spain and Ireland alone by the end of 2011. Who financed the real estate bubbles in those countries? Who is being saved from the consequences of their own disastrous decisions – *German bankers or Irish taxpayers?*

Then look at my country, Iceland. There, greedy, irresponsible and incompetent banksters had turned recently privatized banks into international hedge funds. Within five years they piled up foreign currency debt to the tune of Iceland´s *GDP ten times*, way beyond what our tiny central bank´s reserves could back up. When the British authorities were alarmed, after the fall of Lehmans, that the Icelandic banks, based in London, were not merely illiquid but insolvent, they put not only the banks, but the Icelandic government, along with the Central Bank, on a black list of *terrorist organizations* alongside with Al-Qaeda. That turned out to be our luck, courtesy of **Gordon Brown**.The banks were immediately declared bankrupt. The Central Bank was broke, the country was downgraded to junk and access to financial markets was immediately closed. Under those circumstances there was no way the Icelandic government had the means to bail out the banks. That´s why the foreign creditors – again mainly German banks – were forced to take heavy losses themselves (approximately to the tune of 5 times Iceland´s GDP). This debt was soon written off to clean up the banks´ balance sheets. The Icelandic government then bought Icelandic assets out of the bankruptcies at a discount. This reminds me of a famous saying, accredited to an American airline executive in the early eighties: *„Capitalism without bankruptcy is like Christianity without hell".*

This is why Iceland, which initially suffered both the collapse of its entire financial system and its currency, has now, unlike Ireland, managed a recovery of a sort. It is due to the bankruptcy of the banks, which excluded even the possibility of a bail-out; and to the collapse of the currency, which is a short-term fix to reduce the living standards of a nation, grown used to living beyond her means, at a stroke. The other side of that coin is that devaluation doubled the foreign currency denominated debt, which led to massive bankruptcies and, more or less, dispossessed the youngest generation.

- **The social contract:** In a capitalist market economy there is a sort of unwritten but underlying social contract that must be complied with, if we are to maintain a minimum of public trust and social cohesion. One of the basic rules is this: You are free to seek maximum profits and reap rich rewards, so long as you risk your own money. And as long as you accept, that, in the case of failure, you carry the loss yourself. *Profit and loss are after all two sides of the same coin.* And I might add: As long as you pay your taxes and other dues to the social infrastructure of the society, which, after all, made you rich. Listen again to **Warren Buffett**, who once said famously about his billionaire-status: *„What would have become of me, had I been born in Bagladesh?"*

- **The crisis of democracy:** This is why most people accept a certain degree of inequality, as a just reward for enterprise, effort and the willingness to take risks. But if those basic commandments are all turned upside down; if the huge *profits in boom times are privatized* (and even tax-evaded), *but the losses in hard times are nationalized* – then the underlying *raison-d´étre* of capitalist society is no longer valid. Then we are no longer merely dealing with the consequences of a financial crisis. *The financial crisis is then undermining the pillars of the capitalist market economy itself. We have a systemic crisis on our hands.*
  And when the super-rich – the so called 1% - add insult to injury by hiding their accumulated wealth, mainly for reasons of tax evasion, in so called *„tax-havens",* they have set themselves *above the law*. How much is it, which is stored away from the short arm of the law in those money havens? It is trillions and trillions of dollars. To be exact, it adds up to the GDPs of the US and Japan put together. Merely the taxable proportion of that amount would suffice to solve the current sovereign debt crisis of the world. A tiny proportion of this hidden treasure would suffice to save the people´s welfare state from being ruined. Instead, taxpayers of the afflicted countries are now being forced to pay higher taxes to *bail out the rich*.

  This, it seems to me, is the greatest challenge to democratic governance, since the communist take-over in Russia after the First World War and the fascist insurgency in Europe in the interwar years. It was the weakness of parliamentary democracy in dealing with the consequences of the Great Depression, that led directly to the horrors of the Second World War. Are we really doomed to repeat all those mistakes once again? When will we ever learn?

3. European integration: Success and failure.

I have been an observer of the European political scene for more than half a century. I am a fervent advocate of the European idea; that European integration is the right lesson to be drawn from the history of Europe´s war-like past for millennia. It is a unique experiment in international cooperation; solving conflicts between nation states on the basis of the rule of law and peaceful negotiations – instead of resorting to violence. That is why the recent award of the **Nobel Peace Prize** to the European Union was well deserved.

So far the European project has been a great success. It has benefitted both the advanced and the affluent, as well as the poor and the less developed. And it has helped many nations to escape from the shackles of dictatorship, into the family of democratic nations. The greatest beneficiaries have been the *small nations* of Europe, who in the past were the frequent victims of war. Now, through EU membership, they have a seat at the table, and a voice and a vote, when decisions that determine their fate are made.

The greatest achievements so far have been the *inner market* and the *euro*. Not only have they been good for both Germany and Greece; not only have they been good for both business and ordinary people, who have won the same freedom of movement across borders as capital. That´s unique. It sets an example for the rest of the world. But the European project has also been a powerful instrument to help the less advanced nations of Europe to *catch up with* the more advanced. Again this is setting an example for the rest of the world.

But all is not well with the European project. The ghosts of the past are still haunting us. The European Monetary Union (EMU) had from the beginning *fatal flaws* in design. Everyone who has taken a beginners´ course in monetary economics knows that, for a monetary union to succeed, it has, at the minimum, to fulfill three basic preconditions. The Central Bank must have full powers to act as a lender of last resort to member states. It must have full powers to control the money supply, including buying bonds from member states. And a central authority must have the power to enforce at least a minimum of fiscal co-ordination, to supplement and support moneteray policy in maintaining the stability of the economic system.

This is necessary for several reasons. On occasion the Central Bank must have the power to shield weaker member states from the volatility of the market. It must be able to prevent borrowing costs of those states from getting out of control. It must be able to stop market ambushes in their tracks. This is necessary for states in political trouble to gain time for implementing structural reforms, without paralyzing essential services, exactly when they are most needed, both as *built-in stabilizers* and *stimulants for growth*.

As we all know the European Central Bank has none of those powers. Why not? Didn´t **Delors** and his people know at the time, that those could become fatal flaws in the future? Yes, they did. But Germany simply would not budge from her historical inflationary hang-over. It was a classical case of the *irresistible force* (of European integration) meeting the *immovable object* (the ghosts of Europe´s past). Apart from this, the pioneers of the EMU-project simply hoped for the best; namely that with time the strong and the weak would *converge* so that those in-built discrepancies would gradually disappear.

This was a mistake, for which we are paying dearly. The EMU is therefore like a *half-way-house*, incomplete and on shaky foundations. It is highly vulnerable, when the disruptive powers of the elements are blowing at full force. For years now, we have had before our eyes the sorry sight of European leaders reacting to events with half-measures and short-term fixes; rather than following a plan with well designed long-term solutions. If they go on like this, they are doomed to fail.

The USA and the EMU: A comparison.

To bring home this truth, take a look at the USA as an example. By now the USA is a well established and reasonably functioning *monetary union,* with no less than 50, enormously different member states. Some people say, that you simply can´t maintain a monetary union

– a *unified exchange rate* – with countries as fundamentally different as Germany and Greece. Well, take a look at New York State and Alabama; at Alaska in the high North and Louisiana in the deep South. Or try to find a common denominator between the venture capitalists in Silicon Valley and the home-spun farmers of North Dakota. Admittedly, they have one thing in common. Its called the *English language*. But, are we not communicating in this contemporary *lingua franca,* here today?

Or make a comparative analysis between *California and Spain.* California accounts for 12% of the US economy, roughly the same as Spain´s contribution to the EU GDP. Californa is fiscally bankrupt and has been so for years (just like Greece). Constitutionally California no longer has the sovereign power of raising taxes, although state expenditures are proliferating. The result is a *fiscal black hole* amidst political gridlock. Why haven´t the markets besieged California? Why haven´t they exploded California´s borrowing costs and sunk it into unsustainable debt? Has anyone in Washington or Chicago or Seattle proposed to throw California out of the union? No. And why not? Because the US Federal Government and the the Federal Reserve (The US Central Bank*) stand by California and support it to the hilt.* Noone is complaining that they won´t pay the debts of proliferate Californians, basking in the sun. The mutualization of debt is a *sine qua non* of a successfull monetary union. Either we are in it *one for all and all for one*, or we should never have started this union in the first place.

If some US-member state is in trouble, it is not in danger of being ambushed by financial predators, because then they have to face the overwhelming power of the Federal Government and the Federal Reserve, who have enough resources to stop any ambush in its tracks. That´s what the European Union should have done right at the beginning in the case of Greece.*That´s what a federal government and a central bank are for*. Of course they can legitimately set conditions for support, e.g. that certain *structural reforms* should be implemented. But a sensible central authority does not insist on an *austerity program*, that kills off any hope of economic growth and thus deprives the recipient of aid of the means to pay back.

We can after all learn a lot from the Americans – both on how *not to do things* and also on *how to do things* successfully. We have been learning a lot of the former, but neglecting the latter.

4. How to fix it?

I hope I have by now said enough to indicate what sort of a *choice* we are facing: Either the owners of capital get away with murder – getting bailed out by taxpayers for being too big to fail; or you, the representatives of the people, reassert the will of the people, and apply the power of the state to stop them. *The democratic state does have the legitimacy and the power – legislative, executive and judiciary – to get blackmailing by the markets under control and to put plutocrats in their proper place.* If you fail to do so, the logic of events will fatally weaken and even ultimately break up the euro-zone. I leave it up to up you to contemplate the consequences. I am reminded of a saying by that great reformer, **Tage Erlander**, the long serving PM of Sweden**:** *„The market is a useful servant but an abominable* *master".* If you do your duty – and restore *government of the people, by the people and for the people,* you will give the euro-project a new lease on life.

Here are a few of the steps that have to be taken along the way:

- **A fully fletched central bank**: Empower the ECB to act as a lender of last resort to member governments, and as an issuer of euro-bonds and buyer of sovereign bonds – as an ally of hard-pressed national governments. Do so on condition, if you will, that those same governments implement structural reforms. But buy them time to implement those reforms. Do not force governments to dismember *the welfare state of the people*, when its services are most needed, during a recession, both as an economic stimulus to keep up demand and as an antidote to **growth killing-austerity.**
- **Rebuild the fire-wall** between retail banks, guardians of general savings, covered by a state guarantee for minimum deposits – and the shadow banking system (investment banks, money management funds, hedge funds, etc.) Those are in the business of *maximizing short-term profits* for their owners and should themselves *alone carry the loss in the case of failure*. Let us definitely *put an end to the moral hazard encouraged by privatizing profit but nationalizing the losses.*
- **Fiscal co-ordination:** It should be institutionalized, building on the existing stability pact. But ensure full compliance by member states. You should give serious thought to the proposals, put forward by the Economist Intelligence Unit, that a Central EU Authority overtake all sovereign debt beyond 60% of GDP (the maximum under the Stability Pact), and negotiate their maturities into the future at lower rates. This would force „the markets" to accept reasonable „haircuts" as their fair share of responsibility for building up an unsustainable bubble, during the pre-crisis boom . Listen to the cautionary words of the former Minister of Finance of Germany and recently adopted candidate for Chancellor, Hr. **Steinbrucker**: *„There must be an end to the state accepting the liability for bad decisions, ignorance of risk and speculative deals*. *Even banks must realize the danger of failure*".
- **An all EU-wide Banking Authority** should be set up for the purpose of regulating and supervising all banks and financial institutions operating across borders, making sure the deposit-guarantee funds can withstand even *systemic crisis.*
- **The Tobin Tax** on financial transactions should be adopted, both for generating revenue and as an instrument of control. It is a handy instrument for restraining many of the excessive practices, that led to the financial system spinning out of control, during the bubble.
- **Reform the rating agencies:** Apply the power of the *law and the regulator* in uprooting the massive conflict of interest that was an open invitation for corruption and deception, in the operations of the rating agencies.
- **Shut down the tax-havens:** Democratic governments are obliged to uphold the rule of law. They should faithfully uphold the basic principle of equality before the law. International institutions such as the G-20, The World Bank, The International Monetary Fund and indeed The European Union, like to present themselves as guardians of a level playing field in the conduct of international business. Why then, in God´s name, should democratic governments, representing the will of the people, impotently accept that the owners of capital, the super-rich, the so-called 1%, if you like, take the law in their own hands and

exempt their wealth and income from taxation for the common good? Why on earth should democratic governments hand out such privileges to the plutocratic elite? How can we expect law-abiding companies and citizens to compete in the market place with competitors beyond the law, that have been given *a priori* such advantages before the race begins?
Stop it – and stop it now.

More than a century ago a US president, faced with the overwhelming and unaccountable power of the so called „*robber barons*“ of America – the predecessors of today´s plutocratic elite – said in a major policy speech, that it was time to demand a fairer division of the toils of labor „*between the men that possess more than they have earned and the men who have earned more than they possess*“. In this case, **Theodore Roosevelt** stood by his words. He applied the power of the state to put the oligarchs in their proper place. He liked to be called a tough guy. And it was he who said, that *when the going gets tough, the tough get going.* There are indeed tough times ahead. But what is holding you back? Get going.

About the author: J. B. Hannibalsson was leader of the Icelandic Social-Democratic Party 1984-96. He was Minister of Finance, Minister for Foreign Affairs and External Trade of Iceland 1987 – 95. In 1998 – 2006 he was Ambassador of Iceland to the USA and to Finland and the Baltic countries. He is a frequent writer on economic policy and international affairs and a media commentator.