How Well Have Europe and the U.S. Handled the Global Crisis?

Nicholas Dungan

European Union Studies Center

City University of New York

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That was a very kind introduction. I am deeply grateful to Professor Hugo Kaufmann for his invitation, on behalf of the European Union Studies Center, to be with you this afternoon. Thank you, Hugo. I also wish to thank Aida Hansapapa who has done an absolutely superb job in organizing this conference, and Irene Savvas, for her assistance today. I was rather looking forward to doing this talk in the Skylight Room upstairs, with a breathtaking view through the glass roof up to the Empire State Building. When I learned that the venue had been switched to this Recital Hall, I wondered if it wasn't a sort of signal from Hugo, his way of saying: "Nicholas, if you want to get to the top, you have to start at the ground floor!" But in fact we were oversubscribed and couldn't fit into the space upstairs, so thank you all for being here.

"How Well Have Europe and the U.S. Handled the Global Crisis?" What crisis? Isn't it finished? Didn't Ben Bernanke say just yesterday that the recession in the U.S. "is very likely over"? The news is so good we can even pardon his grammar. Wasn't it just a bad dream? Can't we move on?

Where were you a year ago? Staring into the abyss like the rest of us, that's where you were. I was asked in a television interview on Monday whether I had been worried on September 15, 2008 and I said: "Very. And so was everybody else". Do you remember what the Queen of England said about this? Her question was: "If this was so big, why did nobody see it coming?" Well, I think I have an answer to that: "Nobody saw it coming, Ma'am, because it was so big." We've all read and watched the commentary over the past few days and, as I said, I've participated in some of that, and what strikes me is just how fragmented — and how fragmentary — the thinking about this crisis still is. So what I propose we do this afternoon is to try to look at the big picture, see the forest for the trees, take the long view.

In order to look at the big picture, let us start by examining the nature of this crisis — not just its technical beginnings, or the play-by-play unfolding of the crisis, but its nature: what was it, or is it, really? Then we can spend a few minutes thinking about what is likely to happen next. Based on that analysis and that forecast, we can come back and finish by trying to answer the original question: "How Well have Europe and the U.S. Handled the Global Crisis?"

As we look at the nature of the crisis, my premise is that the further you go, the more there is. Think of it as peeling the onion, or Russian dolls, or the tip of an iceberg, or geological strata.

The bubble that burst a year ago had been a long time in the inflating, and when the financial system finally began to collapse the problem wasn't just sub-prime mortgages, collateralized debt obligations or credit default swaps. The problem was a crisis of credit. *Credere* — to believe; *debere* — to doubt. People had stopped believing, they had lost faith not just in the system, but in the biggest players in the system. And the reason was that they didn't know what they could believe, what they could trust. They didn't know what was there — and they didn't think anybody else knew, either.

The problem with sub-prime mortgages wasn't only that they were dud loans to borrowers who couldn't repay, and structured in such a way that it was virtually guaranteed that a huge number of them would go into default; it was also that there wasn't financial information on the borrowers. Beyond that, the loans weren't anywhere on banks' books; in fact many of the loans had never even transited through banks' books; they had been instantly repackaged into collateralized debt obligations, but unlike the asset-backed securities of the past, where you knew that if Mr. Jones in Cleveland missed his April payment, the value of your bond would go down, here the collateral had been sliced and diced to such a point that it was like spraying confetti all over the room: only the rating agencies, and as it turns out probably not even the rating agencies, knew for sure. And the credit default swaps that were written as supposed insurance policies on those CDOs and other financial instruments weren't really insurance after all because they weren't attached to specific instruments as such; in fact, there was sixty trillion dollars in credit default swaps outstanding — five times the American annual gross national product — and nowhere near as much in the way of underlying securities, so all the superfluous credit default swaps were actually just bets on the price movements of securities and were bound to default themselves when the securities were found to have no value. It was a house of cards and when one card was removed, whichever one it was, the house of cards had to come tumbling down.

How did we get to that point? Here we come to the next layer: the crisis of governance. The crisis of governance had been longer in the making. In large part it has to do with a shift in thinking over the past fifteen or twenty years about what people in power are supposed to do. In the old command-and-control model, which began in the Renaissance (that's why Machiavelli wrote *The Prince* then), it was accepted that the people at the top had to make decisions that affected other peoples' behavior, that influenced other peoples' lives and fortunes and therefore that took into account a multitude of decision-making factors over a long-term period of time. This applied to heads of corporations and other institutions, and to government officials including regulators.

At the end of the Cold War, we were supposed to put behind us the conflict of ideologies. Remember Fukuyama's "The End of History and the Last Man"? The idea was that market economics had won, freedom had triumphed over tyranny, and that was that. In reality, because nature abhors a vacuum, new ideologies came to replace the old. In the realm of international relations, you had the neo-conservatives and the project for the new American century — and that got us into a lot of trouble. And in economics, you had Alan Greenspan and the objectivism he had espoused by virtue of his conversion to the ideas of Ayn Rand. She says: "Man — every man — is an end in himself, not the means to the ends of others. He must exist for his own sake, neither sacrificing himself to others nor sacrificing others to himself. The pursuit of his own rational self-interest and of his own happiness is the highest moral purpose of his life. The ideal political-economic system is laissez-faire capitalism. It is a system where men deal with one another, not as victims and executioners, nor as masters and slaves, but as traders, by free, voluntary exchange to mutual benefit." So Alan Greenspan had a genuine faith in markets and the conviction that individual decisions, in the aggregate, would always prove to be in the general interest. Alan Greenspan arrived as chairman of the board of Governors of the Federal Reserve System of the United States in 1987 and held that office until 2006. On October 23, 2008, a bit more than a month after the fall of Lehman Brothers and the nationalization of AIG, and in the midst of the continuing maelstrom (and the presidential election in the United States), he testified before Congress that "Those of us who have looked to the self-interest of lending institutions to protect shareholders' equity are in a state of shocked disbelief".

During this same period, it became the norm that CEOs ran their corporations for one purpose and one purpose only: to enhance shareholder value, in other words, to boost the stock price. Jack Welch may have said in March 2009 that to focus on shareholder value was "an obsession" and "a dumb idea" but that is what he did for twenty years as the head of General Electric. Enron, Tyco and the other scandals show the scope for abuse of this notion. Indeed, any concept that there is only one means to an end is fatally flawed. During this same period, there was no serious attempt to reform what one statesman has called the "alphabet soup" of U.S. securities regulators, which Hank Paulson, then Secretary of the Treasury, described in a speech at Chatham House in London in the summer of 2008, just before the crisis broke, as "Balkanized". During this same period, a president of the United States was elected thanks to hanging chads and public opinion of members of the United States Congress fell to historic lows. In response to Juvenal's question: "Sed quis custodiet ipsos custodes?" — "Who is watching the watchmen themselves?", the answer was "Nobody". The crisis of credit happened because there was a crisis of governance and the crisis of governance — in business and politics and regulation — was that no-one was looking. They didn't think they had to.

Let's go one more level into the crisis and ask where the crisis of governance came from. You are probably thinking right now: "crisis of leadership"! And you are right, but let's put that into an even larger context: a crisis of responsibility.

From the time of the arrival in power of Margaret Thatcher in Britain in 1979 and Ronald Reagan in America in 1981, the concept of the collective in public life has been diminishing. This is less true in continental Europe, perhaps, but it was certainly exacerbated in France, for example, at the same time, by the specious attempts at broad-based socialism instituted by François Mitterrand in 1981 and 1982. Margaret Thatcher broke the unions, instituted deregulation and privatization and pursued free-market economics. Reagan said "government is the problem" and around him came the advocates of smaller government, getting government out of peoples' lives, leaving people to themselves. These political tendencies, combined with the laissez-faire market economics and then, after the end of the Cold War, accentuated by globalization and technology, have led to an increase in individualism and, in the West and especially in America, but not only in America, have led to a sense of personal entitlement and therefore an unwillingness on the part of individuals to make sacrifices for society, even an unwillingness to recognize that one might actually have a duty to others or to society, and a concomitant sense of intense satisfaction with oneself as an individual. David Brooks described that in a column in the *New York Times* this week called "High-Five Nation". This tendency toward exaggerated freedom and individualism has been expressed at a macro level by the Washington Consensus and at micro level has practically been translated into a philosophy of life. That is the crisis of responsibility, which has been growing for the past thirty years, and it will take leadership over the next thirty years to turn it around. Unless we address the crisis of responsibility, there will be no lasting solution to the crisis of governance, because people won't feel accountable for their actions, and the next crisis of credit will come sooner rather than later and we will be staring into the abyss all over again.

Having looked at the crisis in terms of time — credit, governance, responsibility; short, medium, long — let's shift the method from time to place, and take a trip around the world. If you subscribe to the premise that leadership will be required to address this multi-layered crisis, where will that leadership come from?

It is good that South Africa and Brazil and Argentina are part of the G20, for the problems of the developing world are more and more important. But it's unlikely that solutions will come from there. In Asia, China is the big winner from this crisis. Annual economic growth is close to eight percent, bank credit growth is thirty percent, fixed-asset investment is thirty percent and China has over two trillion dollars of foreign currency reserves. But China doesn't have ideas that it is exporting. Global policy initiatives aren't emerging from the Middle Kingdom. Nor do Japan, Korea, South Asia or India look like moving to the forefront of policy proposers. Saudi Arabia is a member of the G20 but the Middle East isn't a model of global governance; and Russia is still trying to play the Great Game. So that leaves us with the United States and Europe.

What kind of leadership is the U.S. likely to show in tackling the multi-layered crisis? The United States in the coming years is probably going to be a pretty patchy partner — *un partenaire irrégulier*. First, the U.S. is going to be very preoccupied with problems of its own. One of the consequences of the crisis of responsibility is that the average American hasn't seen his income grow in over a generation. At the same time, Americans have not invested in the future but they have put future generations into debt. The American dream — the belief that one could make a better life for one's children by one's own efforts — has lost a lot of credibility. A lot of America's infrastructure — schools, roads, reservoirs — dates from the Great Depression or the 1950s and needs to be renewed. There are a hundred and four nuclear plants operating in this country, supplying twenty percent of America's electricity (that is all of America's air conditioning) and there has not been a new nuclear power plant built since 1977. The existing plants have been re-certified for another twenty years but all will have to be replaced or upgraded in the next two decades and thirty more need to be built in order to keep pace with growth in electricity demand. The last oil refinery in the United States was built in 1976. Water is going to be an increasingly scarce resource: there are ten thousand water companies in the U.S. and fewer than twenty have access to private capital; most are owned and operated by municipalities without recourse to global technology or know-how. We are having a health-care debate in this country: according to World Economic Forum figures, the U.S. ranks twenty-ninth in life expectancy (that's the ultimate "healthcare outcome") behind almost all of Europe, Japan, Hong Kong, Singapore and Israel. U.S. primary education is ranked twenty-fifth in the world behind all of western Europe except Britain, and forty-eighth for teaching of science and math. So America has a lot of investing to do, and with nearly ten trillion dollars in additional U.S. government debt forecast over the next decade, Americans will have plenty to worry about at home.

Less than a year into Barack Obama's term, after an initial bounce in optimism, a majority of Americans are once again convinced that the country is "headed in the wrong direction". Part of the problem is that it is not at all clear that some of the fundamentals of the American system are in fact well-adapted to the challenges of the twenty-first century. The difficulty of getting stimulus money to people through the fifty states tested the efficiency of the federal system and the chaos in California and New York is not reassuring. The tendency to solve problems through competition rather than consensus, to give priority to the individual over the group, to operate on the assumption of an abundance of resources, all these American traits are being called into question, but they are deep in the American character and likely to change only slowly over time. Barack Obama is taking on a lot of special interests, yet the Congress in the U.S. is vastly more powerful than the parliament in any European country and the Congress is supported by those special interests. There are mid-term Congressional elections next year and the campaign will begin in less than six months: how long will Barack Obama be supported by his own party? Outside the United States, American-style market capitalism has been given a very bloody nose and the U.S. hasn't recovered all its lost credibility after its geopolitical and military over-reaction to the events of September 11, 2001.

Yet it would be a huge mistake to write off the U.S. or to assume it will be irrelevant. America continues to have a dynamism, resilience and world-class centers of excellence — for example in its academic, think-tank and entrepreneurial communities — unrivalled elsewhere. And the United States Navy guarantees, virtually single-handedly, the freedom of the seas for all the countries of the world. But reform will come hard to America. When Barack Obama spoke on Wall Street on Monday, the bankers were staring at their shoes. It will be tough to get measures through Congress, and to keep the attention of Congress. People don't want to change, and they want to go back to what they know, to business as usual. Americans don't like doubt, or questioning themselves. So all in all, the U.S. will be there, but not across-the-board, a patchy partner, *un partenaire irrégulier*.

Which brings us to Europe. Let's face one fact: the formation of the European Union is one of the biggest success stories in human history. You have to go back to 1291 and the founding of the Swiss Confederation to find a similar example of beating swords into ploughshares. Europe has a legitimacy and capacity for soft power unmatched in the world today. But if America can be accused of not always practicing what it preaches, Europe's problem is that it hasn't done enough to preach what it practices. Yet there are voices coming from Europe that are increasingly ahead of U.S. thinking, increasingly united as Europeans and are being increasingly heard around the world. European voices have been adamant in insisting on resolving issues raised by the crisis of credit with an attitude of increased governance and increased responsibility. Christine Lagarde initiated a letter to the *Financial Times* co-signed by seven of her fellow European finance ministers to say that the G20 must bring the banks' bonus culture to an end. Anders Borg, the Swedish finance minister, said, "The bankers are partying like it's 1999, and it's 2009". Adair Turner, the chairman of Britain's Financial Services Authority, has proposed a global transaction tax on financial services and questioned the social utility of some of the financial services industry, as well as insisting on living wills providing for the orderly liquidation of big banks that go bust, like Lehman. Nicolas Sarkozy, in an impressive speech to the annual Conference of French Ambassadors at the Elysée Palace at the end of August, made clear his determination that a crisis like the one last year must not be allowed to happen again. President Sarkozy also commissioned the Stiglitz report in advance of the recession, which enlarges the definition of economic well-being beyond what President Sarkozy called the cult of statistics. The Europeans are past masters at working within international organizations and just yesterday we learned that the Financial Stability Board, led by Mario Draghi, the governor of the Bank of Italy, will present to the G20 in Pittsburgh a proposal that blends American and European priorities in linking banks' capitalization to the banks' bonus pools. That continued European determination is important to maintain and enhance. In particular, it is vital that Europeans concert among themselves in advance on major policy issues, so as to be able to put forward joint positions, rather than one European leader announcing a policy position and asking the others to rally to it. A good example of this kind of joint action is the letter dated the third of September, on the stationery of the British Prime Minister, but co-signed by Nicolas Sarkozy and Angela Merkel together with Gordon Brown, addressed to the Swedish Prime Minister, as president of the European Council, laying out their priorities for strong joint European positions at the G20 in Pittsburgh next week.

Such, then, is the nature of the crisis — credit, governance, responsibility — and such are the places — America, but with a strong European partner — to which we can look for continuing leadership. One final thought about where leadership is going to come from, this one sectoral not geographical: there has been no business leadership in this crisis. Lloyd Blankfein, the CEO of Goldman Sachs, made a contrite speech to the *Handelsblatt* conference in Germany last week; but no ideas have come from the private sector on why this happened or what to do about it. The only leadership has come from civil servants, politicians and the commentariat: the media, think-tank and academic communities.

So now, back to the question: "How Well Have Europe and the U.S. Handled the Global Crisis?" As regards the crisis of credit in the short term, the crisis management of the most immediate dangers has been superb, even if severe mistakes were made, particularly allowing the circumstances to develop that led to the collapse of Lehman Brothers and the near-death experience it provoked. President Sarkozy's quick action within the Eurozone when France held the EU presidency, and his tight coordination with President Bush and the American administration, assured a pretty seamless immediate crisis response by the transatlantic partners, even if everyone was terrified. Since then, there has been policy cohesion and no free-for-all, no significant protectionism, and now there seems to be consensus on not rushing to unwind the crisis measures. Countries have worked well internally and together, central banks and governments have largely cooperated despite Angela Merkel's and Nicolas Sarkozy's critiques of the ECB.

The crisis of credit is far from over, but its parameters have been mapped. The toxic assets are still on the banks' balance sheets, there is some trading in them, but basically the banks — in the broadest sense now — are being recapitalized by you and me because the Fed has lent them trillions of dollars at zero percent interest and they are buying government bonds at three and four percent and pocketing the interest differential, courtesy of the American taxpayer. The ones with big tax-loss carry-forwards will be able to keep all the income tax-free. Greenspan already used this technique in the early 1990s and it worked a charm. Some markets are coming back. Half of the U.S. credit market is securitization outside the banking system. The Fed was basically buying all that paper, then it went down to eighty percent, now it is down to half, so investors are back. But the central bank is still directly financing one half of one half of the new credit in this country. There are a few IPOs on the horizon, but no vast queue; there's not much in the way of corporate bonds; commercial paper is being issued again to investors and not just the Fed; some

M&A activity is back, but nowhere near historical volumes, especially if you strip out restructuring M&A. Let's not forget, though, that for the better part of a year, the central bank was the only provider of new liquidity around. So the crisis of credit is abating but not gone.

As to the crisis of governance, that is the debate that is starting to happen now. The G20 in Pittsburgh next week will begin to put in place some structural and technical elements to ensure that not just this crisis, but this type of crisis, cannot happen with the same speed, severity and lack of visibility. Given America's somewhat beleaguered position as the designated epicenter of the crisis, Europe's role will be vital in sustaining governance reforms. America can hold its own on promoting increased bank capital; Europe will have to carry the burden on insisting on greater personal and professional accountability, removing incentives for abuse, and the like. It will be much easier for the U.S. to sign up to an international consensus that is to some extent imposed, rather than making up its own mind to do better, and passing that legislation in Congress. The U.S. will still need to address the domestic questions of further consumer protection, which has only been enacted with respect to credit cards, and the designation of a systemic regulator, which is clearly needed but the subject of an intense power-sharing debate. The UK, also, is questioning the wisdom of the separation of powers among the Treasury, the Bank of England and the FSA. Europe, when the crisis struck, found it had no policy implementation capability at the EU level, so everything had to be done by the member states, often not in much coordination with the others. Witness the difficulties of some of the eastern European Union countries, alongside a relatively prosperous Poland.

As to the crisis of responsibility, we've only just begun to assess its scope. I think Barack Obama genuinely understands how big it is and if you re-read his inaugural address against that background, you will find a lot between the lines. After all, he called for a "new era of responsibility". I think Nicolas Sarkozy has had a very clear idea since well before the financial crisis that we were in a historical moment when our character was likely to be tested: go back and read his major set-piece speeches in the presidential campaign of 2007, especially his summing-up speech at Bercy a week before the election, and read also his speech to the Conference of Ambassadors last month. Still, addressing, much less solving, the crisis of responsibility is the work of a generation or more, such have been the follies and foibles of this generation. But it has to happen.

Here at the European Union Studies Center at the City University of New York, let me say, in response to all these crises, that it is vital for Europe and America to stick together. The world has been lacking cohesive, forward-looking western leadership since the end of the Cold War and that is dangerous for everyone. We cannot lead by insisting on our exceptionalism, we can only lead by offering our inclusiveness, which is, after all, at the core of our western values — and worked so well on the morrow of the Second World War. From a practical standpoint, we need to exercise our joint leadership once again by making policy together on the biggest questions of our era: climate change, sustainable human and economic development, the reform of global institutions and, yes, the reform of international finance. Let me close by saluting the work of the European Union Studies Center in promoting that sense of joint destiny and joint responsibility between Europe and America.